

OPINION: MULTISTATE FORMULA APPORTIONMENT: CLOSE ENOUGH FOR GOVERNMENT WORK?

By David R. Doerr



An obscure and arcane formula used to determine how much business income of a multistate or multinational corporation is subject to tax in California has become a hot political issue. Calls to change the formula are being heard from the governor, from legislators, and from initiative proponents. It has been constant fodder for lawsuits. The Franchise Tax Board continues to try to fine-tune the formula through the regulatory process.

In short, unlike the United States and most other countries, California does not try to determine the actual income of a corporation that is earned within its boundaries. Instead, the state taxes a percentage of a corporation's income earned in the United States or earned all over the world. Because of the meat-axe effects of this formula, the Legislature and the tax agency have provided variations of the formula for certain types of taxpayers.

Even with the variations, the percentage of business income California will tax is computed using surrogate factors that are some combination of property, payroll and sales, or sales only, in California as a percentage of total property, payroll and sales or total sales.

The formula affects business climate decisions, determines state revenue and creates major disputes and ill will between taxpayers and the Franchise Tax Board. But does it correctly determine the amount of income a corporation earned in California? Only a fool would answer "yes" to that question. Another question: Does the formula produce a result that is even "close enough for government work"?

There are only two problems with the formula: it is wrong in theory and it does not work well in practice.

First, the defective theory: It is absurd to assume that the same percentage of property, payroll and sales in one state will produce the same income as in another. There may be different product lines, different investment strategies, different profit margins, different economic environments, etc. If an investment in one state will produce the same return as in another, why are some states attracting more investments than others?

The property factor is bogus because the formula does not use accurate values of property. The payroll factor is based on the curious notion that if a company raised wages by 100 percent for California employees only, with no employee raises in other states, it would make more profit in this state. A 200 percent raise here would apportion even more profit to California, etc. As for the sales factor, it is a model of ambiguity. Also, it is impossible to know where every item or service is sold or where it is

purchased. In fact, in a death-defying leap of logic, for California-domiciled corporations only, California law requires sales in some other states (under certain conditions) and sales to the federal government to be counted as California sales.

The courts have recognized that formula apportionment does not result in the correct determination of business income to a state for tax purposes. The U.S. Supreme Court has said it is OK to use a single sales factor formula to apportion income. It also has said that it is OK to use a three-factor formula. A taxpayer can have a very different percentage using one method over another. Both numbers cannot be right, even if the courts say the use of either is OK.

As bad as the formula is in theory, it also is unfair in practice. The various definitions and non-definitions underpinning the formula are so vague that taxpayers have an impossible job in reporting. The vagueness and lack of transparency leads to disputes with the FTB, and draconian penalties can be imposed when there are no standards and no right answers.

For example, a recent California Supreme Court decision held that treasury receipts are included in the sales factor, but also ruled that the taxpayer (Microsoft) could not include all of its treasury receipts in the sales factor, because that caused "distortion." However, there is no bright-line test for distortion, and the FTB has not seen fit to establish one. How does a taxpayer know how to report its treasury function receipts? Even more troubling, how is there a higher standard that can impeach the formula? Who determines "distortion"? If this standard is so superior to the current apportionment formula that it can impeach the formula, why is it not being used as the method of apportionment?

The above problems are not all-inclusive, as they are meant to illustrate the inaccuracy of the formula. There are scores of other examples stemming from formula apportionment and its companion, unitary combination. One more: The recent court decision in *Apple v. FTB* on the treatment of foreign dividends from income that already have been included in the formula, and will not be subject to additional taxes, does not appear to be good public policy. The practical effect will be to trap these dividends overseas, as they cannot be repatriated until all taxable dividends are repatriated. This means money that could create jobs and improve the business climate in California will be stuck overseas.

These observations should not be interpreted as criticisms of the FTB, as the agency is stuck with administering the law as it is written.

This brings us back to the question: Does the formula produce a number that is "close enough for government work"? One could, and probably should, answer "no." However, any change will be difficult, if not impossible. Even the smallest of changes in the formula usually produces "winners" and "losers," with some taxpayers paying more and others paying less (although there have been some changes with all "winners" and other proposals with all "losers").

Further, a change may have a revenue impact on the state's coffers, and changes that reduce revenue will be fought by the "spending lobby" in Sacramento. On this point, the method of estimating revenue effects of changes has not been helpful, as changes are scored using a static model that does not factor in economic and behavioral changes that will occur as a result of such changes. California should switch to the use of a dynamic revenue estimate.

What are some of the alternatives to formula apportionment? Eliminating the corporate income tax, as suggested by the recent Parsky Commission report, could solve the problem, but is unlikely, due to the revenue loss. And other alternatives might also come with a new set of formula apportionment problems.

Another alternative would be separate accounting. A long time ago, before computers, the "experts" said separate accounting should not be used to determine the portion of a corporation's income that is taxable in California. Is this still the case? Concerns about revenue loss and the creation of winners and losers might be problems, even if this approach is feasible.

If California is stuck with the current formula approach or some variation thereof, some additional reforms in the apportionment scheme should be considered:

- The formula should be scrubbed clean to remove any ambiguities and to reduce the time and effort imposed on taxpayers to comply and determine an apportionment percentage.
- The throwback sales rule, which counts certain sales of California-domiciled corporations in other states as California sales, should be repealed.
- A business climate factor should be considered, to reduce the final computed percentage to compensate for the fact that California has a bad business climate and investments in this state may not have the same percentage return as in other states.
- The draconian penalties should be repealed if a taxpayer reports an apportionment percentage that is anywhere between the percentages that would be derived by using any of the apportionment formulas that the courts have allowed to be used to fairly show income earned in a state.

One final thought: California cannot legally tax corporate income that is not earned in California, and should not try to do so.

(The views and opinions in this article are solely those of the author, David R. Doerr, who was chief consultant to the Assembly Revenue and Taxation Committee from 1963 to 1987, and has worked on formula apportionment proposals for almost 50 years.)