State Corporate Taxation of Sales to the Federal Government

Introduction

This report has been prepared in response to Resolution Chapter 157, Statutes of 1998 (SCR 44, Calderon). That measure directs the Legislative Analyst's Office to study and report on California's treatment of sales of tangible personal property to the U.S. government within its formula for apportioning corporate income to California.

The purpose of California's apportionment formula is to designate what portion of the income of multistate and multinational corporations shall be subject to taxation under the state's bank and corporation tax (BCT). Such a formula has been developed because the business-related activities of these multigeographic corporations cross state boundaries, making it difficult to determine exactly what part of their income California should appropriately tax. As discussed in detail below, California's apportionment formula takes into account the locations of a company's sales, property, and employee payroll.

Under current California law, the location of most sales to private parties is generally based on the *destination point*—that is, the location where the customer takes "meaningful possession" of the product. However, in the case of sales to the U.S. government, the transaction is attributed to the *point of origin*. Some companies in the aerospace industry have asserted that California's treatment places defense contracting firms in this state at a competitive disadvantage with others in the defense industry who have the majority of their operations located in other states. The focus of this report relates to this concern.

Requirements of the Report

Resolution Chapter 157 directs our office to study and address the following four questions regarding California's BCT apportionment formula:

- What are the historical *reasons* for the current formulation of the franchise tax apportionment formula?
- Are there any existing factors that strongly indicate that sales to the U.S. government *should* be treated differently from sales to all other parties for purposes of the franchise tax apportionment formula?
- What is the current *level of sales* to the U.S. government that are exported from, and imported to, California?
- What are the *broad implications* of treating corporate sales to the U.S. government differently from all other sales in the state's apportionment formula?

Before addressing these specific issues, we first provide (in the following section) background information on (1) California's apportionment of income for multistate and multinational corporations, (2) how California's apportionment-related treatment of sales to the U.S. government compares to other states, and (3) the characteristics of those companies subject to California taxation that have major amounts of sales to the U.S. government.

Background

California's Apportionment of Income for Multistate Corporations

California is one of 48 states that levies a tax on the taxable income of corporations. A key issue relating to the corporation franchise tax involves the determination of income for corporations doing business both inside and outside of California. In theory, this allocation should take into account the amount of a company's consolidated income that is attributable to its business activities in each state. One logical approach would be to explicitly identify, through separate accounting methods, the receipts and expenses of each operating division within each state.

However, an important drawback of separate accounting methodologies is that it is often difficult in practice to accurately measure the contribution of various operating divisions to a company's overall profits. For example, many questions arise regarding such factors as how to value intermediate goods that are transferred between divisions, and how to allocate among different operating divisions the costs of centrally performed functions such as management and advertising.

As a result of these difficulties and limitations, most states rely on an alternative methodology which apportions the consolidated earnings of multistate companies (or groups of closely affiliated companies) based on the share of a company's total property, payroll, and sales which are located in the particular state. While the specific apportionment factors vary from state to state, the standard apportionment formula generally used is shown in Figure 1 (see page 4).

What Do the Three Apportionment Factors Represent? The property and payroll factors in the apportionment formula are intended to approximate each state's contribution of capital and labor, respectively, toward a company's overall earnings. By comparison, the sales factor is intended to take into account the contribution of the company's consumer markets toward its overall profitability.

Figure 1

The Standard Corporate Apportionment Formula

$$\text{Share of Total Corporate Income Apportioned} = \left[\frac{\frac{\text{Statewide Property}}{\text{Total Property}} + \frac{\text{Statewide Payroll}}{\text{Total Payroll}} + \frac{\text{Statewide Sales}}{\text{Total Sales}}}{3}\right] \times \text{Total Income}$$

An Example Involving the Standard Formula. As an example of how the apportionment formula in Figure 1 is applied, consider a domestic company which has $100 million in total U.S. profits. Also, assume that 50 percent of the company's nationwide property, 40 percent of its nationwide payroll, and 10 percent of its nationwide sales are attributable to a particular state. (The fact that the sales factor is so much lower than the other two factors could occur, for example, if the company were a manufacturer with substantial operations in California, but which sold its products to a nationwide market.) Based on the standard apportionment formula shown in Figure 1, the income attributable to that state would be (.5 + .4 + .1)/3 times $100 million, or $33.3 million.

California "Double Weights" the Sales Factor. Many states have adopted variations of the basic formula shown in Figure 1, primarily to provide businesses with incentives to locate and expand employment and investment within their boundaries. In 1992, California modified its apportionment formula, by "double weighting" the sales factor. The modified apportionment formula used in California is shown in Figure 2.

Figure 2

California's Modified Version of the Corporate Apportionment Formula

$$\text{Share of Total Corporate Income Apportioned} = \left[\frac{\frac{\text{Statewide Property}}{\text{Total Property}} + \frac{\text{Statewide Payroll}}{\text{Total Payroll}} + 2 \times \left(\frac{\text{Statewide Sales}}{\text{Total Sales}}\right)}{4}\right] \times \text{Total Income}$$

An Example Involving California's Formula. For the hypothetical corporation discussed previously, the double weighting of the sales factor would lower the overall amount of income that is apportioned to California from $33.3 million to $27.5 million (that is, [.5 + .4 + 2 * .1]/4 times $100 million).

Issues Related to Apportionment Can Affect Corporate Tax Liabilities. Many issues arise in measuring the numerator and denominator (that is, the state versus nationwide amounts, respectively) for each of the apportionment factors. How these issues are resolved can have a substantial impact on the amount of taxable income attributed to a particular state, and hence, the amount of corporate tax liabilities paid by multistate businesses. In California, issues relating to the sales factor—including those raised by Resolution Chapter 157—can have particularly significant implications, since this factor is double weighted in California's apportionment formula.

How Does California's Treatment of Sales To the U.S. Government Compare to Other States?

As shown in Figure 3, California is one of 28 states that use *origin* as the basis for determining how much of a company's sales to the U.S. government should be allocated to it for apportionment purposes. The remaining 19 states apportioning corporate income use *destination* as the basis for determining the location of the sale. However, among the ten leading states in terms of federal government procurement expenditures, three states (including California) use origin, while seven states use destination, as the basis for determining the location of sales to the U.S. government. Thus, origin is less used by the major procurement states than for states generally.

States' Treatment Hasn't Changed Much in Recent Years. Based on our discussion with representatives of the Multistate Tax Commission (MTC), contacts at the Federation of Tax Administrators, and tax officials in other states, it appears that the issue of origin versus destination for sales to the U.S. government has not been the focus of significant legislative debate in recent years. The only state we found which has recently made changes is Arizona. That state eliminated all of its "throwback" provisions last year—including those relating to U.S. government sales.

Figure 3

Treatment of Sales to U.S. Government In Apportionment Formulas

States Attributing Sales to Origin	States Attributing Sales To Destination/Other
Alabama	Arizona
Alaska	Colorado
Arkansas	Connecticut
California	Delaware
District of Columbia	Florida
Hawaii	Georgia
Idaho	Iowa
Illinois	Louisiana
Indiana	Maryland
Kansas	Massachusetts
Kentucky	Minnesota
Maine	New Jersey
Michigan	New York
Mississippi	North Carolina
Missouri	Ohio
Montana	Pennsylvania
Nebraska	Rhode Island
New Hampshire	South Carolina
New Mexico	Virginia
North Dakota	
Oklahoma	
Oregon	
Tennessee	
Texas	
Utah	
Vermont	
West Virginia	
Wisconsin	

Sources: Research Institute of America, Commerce Clearing House, and various state tax returns.

Industries Involved in U.S. Government Sales

Although many companies from a variety of industries are involved in contracting to provide goods and products to the federal government, the majority of such sales are attributable to manufacturers engaged in the production of aircraft and parts, missiles and space equipment, and aerospace instruments. Together, these categories comprise what is generally referred to as the aerospace industry.

Aerospace Industry Is Characterized by Large Integrated Firms. The aerospace industry has undergone successive rounds of mergers and acquisitions in recent years in an effort to adjust to the downsizing of the U.S. defense budget. As a result of these consolidations, the "prime contractors" in the industry (that is, those with the majority of sales to the U.S. government) are becoming more and more concentrated among relatively few large integrated firms which have their operations spread throughout the nation. Examples of recent consolidations in California include the mergers of Raytheon and Hughes Electronics, Northrop and Grumman Corporations, Lockheed and Martin Murietta, and Boeing's acquisition of McDonnell Douglas. Industry analysts expect that the trend toward consolidations will continue into the future.

These consolidations are significant because many of the prime defense contractors in California are divisions of consolidated corporations with operations located throughout the U.S. In many instances, these companies have both products which are made *inside* California but shipped *outside* of the state, as well as products made in *other* states but which are shipped to the federal government at sites within *California.*

California's Largest Defense-Related Contractors. Figure 4 identifies the companies that are California's five largest defense-related contractors.

Figure 4

Five Largest Defense Contractors In California

Lockheed Martin Corporation
The Boeing Company
Northrop/Grumman Corporation
Raytheon Company Inc.
TRW Corporation

Analysis

In this section, we address the specific questions and issues to which Resolution Chapter 157 requires our office to respond.

ISSUE #1—THE HISTORICAL BASIS FOR THE CURRENT FORMULATION

California's origin-based treatment of sales of tangible property to the U.S. government has been in effect for more than three decades. The state's treatment can be traced back to the Uniform Division of Income for Tax Purposes Act (UDIPTA), which was originally drafted in 1957 by the National Conference of Commissioners on Uniform State Laws.

Purpose of UDIPTA. The objective of UDIPTA was to provide for a uniform method for allocating income between states. A goal of the proposed legislation was to devise a model which would, if followed by all states levying corporate income taxes, assure that 100 percent of a company's U.S. earnings would be subject to state income taxes. The act also was aimed at both (1) simplifying the tax-related reporting requirements of multistate businesses and (2) facilitating efficiency in tax collection and auditing activities, since states using the same general approach could share information and procedures with one another. A central element of UDIPTA was the adoption of the three-factor income apportionment formula discussed earlier for allocating multistate business income.

The UDIPTA's Treatment of Sales in the Apportionment Formula. The UDIPTA specifies that sales of tangible personal property are generally attributed to the *destination* state to which the goods are shipped (as opposed to the state of *origin* from which the shipments occur). While the destination rule applies to the majority of sales, the drafters of UDITPA included the following two exceptions to the general destination rule:

- The first exception is where the destination state does not have jurisdiction to tax the corporation involved. (Under federal law, a company must have "nexus"—that is, a meaningful presence—in order for a state to levy income taxes on it.) In this case, the sales are "thrown back" to the geographic point of their shipment.
- The second exception is that sales to the U.S. government are based on the point of shipment (that is, their *origin*), instead of where the U.S. government takes possession of the product.

California adopted UDIPTA in 1966, and is one of 23 states that conform to most or all of the act's provisions. In this regard, the state attributes most sales to their destination point, but also includes UDIPTA's exceptions relating to the throwback of certain sales and the attribution of sales to the U.S. government back to their point of origin.

It also is important to note that in 1974, California became a member of the MTC. The MTC is an organization which promotes uniformity among the various states with regard to their taxation of interstate businesses. Among other things, the MTC assists its members in multistate audit activities, and also has developed an arbitration process for settling disputes between states regarding the apportionment of income. The apportionment rules set forth in UDITPA—including the treatment of sales to the U.S. government—have been adopted by the MTC.

Issue #2—Reasons for Current Formulation

The arguments for California treating sales to the U.S. government differently from other sales in its apportionment formula fall into three general categories.

Tax Policy Reasons. The reason that the drafters of UDIPTA chose to base the location of most sales on destination (versus origin) was the belief that the contribution of "consumers" toward the production of income for multistate companies should somehow be recognized in the apportionment formula. This rationale does not, however, necessarily apply to sales to the U.S. government. In many instances, the location where the federal government takes possession of a product may bear no relationship to the location of the "market" for that product. This is particularly true of purchases of tangible products used for common purposes, such as national defense, space exploration, or satellite systems. A related consideration raised by the drafters of UDITPA was that the use of destination in the case of sales to the U.S. government would result in a disproportionate share of products being attributed to Washington D.C. and other major federal government centers where title transfers for products occur.

The drafters of UDIPTA recognized that attributing sales to the U.S. government back to their origin would itself result in some distortions. For instance, the use of origin would raise the apportionment factors of states that receive a disproportionately large share of federal defense contracts and other defense-related federal government contracts. Despite these concerns, however, it was believed that the benefits of using origin would outweigh the possible distortions.

Tax Administration Reasons. Representatives of the Franchise Tax Board (FTB), which administers the BCT, indicated that using origin as a basis for determining the location of government contracts enables the state to avoid potentially difficult issues relating to the BCT's administration. For example, they indicated that tracking the destination of government contracts—especially with regard to classified programs—would be difficult and that disputes could arise in relation to sales where the U.S. government takes possession in California, but the product is ultimately used overseas.

It is true that tax administration issues and problems also apply to private sales where destination is used as the sales location determinant. Indeed, establishing the "destination" for sales has been a contentious issue for many years—one involving many court challenges. However, in the view of the tax officials we spoke to, these problems would likely be even more complex and formidable if destination were used instead of origin with regard to sales to the U.S. government.

Conformity With Other States. As indicated above, California's approach is consistent with the majority of other states which levy taxes on corporate income, and is in conformance with both UDIPTA and the MTC. Uniformity in these areas increases the chances that companies will pay taxes on 100 percent of their combined earnings. It also tends to reduce tax-related disputes that may arise between states regarding the apportionment of income.

Issue #3—Sales to the U.S. Government That Are Exported From and Imported to California

Due to the lack of comprehensive data on the geographic distribution of federal government-related sales, it is not possible for us to provide a precise estimate of the flow of federal government contract expenditures between states. While Department of Defense (DoD) data provides fairly good information on where prime defense contracts are negotiated and awarded, it does not provide information on where the U.S. government takes possession of the tangible products involved. To overcome this limitation, we attempted to supplement the DoD data with information from large defense contracting firms. However, in many instances, these firms were not able to provide us with the detailed contract information that would be necessary to provide an accurate estimate of the associated contract-related expenditure flows. The companies indicated that the recent mergers and acquisitions discussed earlier have made it difficult to provide a comprehensive expenditure-flow picture at this time.

Given these limitations, it is not possible to provide an accurate estimate of sales to the U.S. government that are exported from and imported to California. However, based on the limited information available to us and discussed below, we are able to at least provide a *rough magnitude* of these measures.

Federal Contracts Awarded to California Firms

In 1997, unclassified federal contract awards to public and private entities in California totaled $26.2 billion. About $18.5 billion, or over two-thirds of this amount, was for defense procurement. The other one-third represents spending by National Aeronautics and Space Administration ($2.7 billion), the Department of Energy ($1.9 billion), and other agencies ($3.1 billion). Much of the contracts awarded by the Department of Energy are related to nuclear weapons systems. Thus, the great majority of sales to the U.S. government are related to defense- and space-related activities.

Figure 5 provides additional information on the characteristics of spending by DoD. It shows that, of the $18.5 billion in defense contracts awarded in 1997 to firms located in California, slightly less than one-half—or about $9 billion—represents sales of tangible personal property. The remainder involves research, development, testing and evaluation (RDT&E), and services contracts, which under current law, are attributed to point of performance.

Figure 5

Classification of Defense Contracts Awarded to Entities in California

(In Billions)

Category of Expenditure	1997 Amount
Supplies and equipment	$7.6
Construction related	1.3
Subtotal, total tangible property	($8.9)
Services	$5.3
Research, development, testing and evaluation (RDT&E)	4.2
Subtotal, services and RDT&E	($9.5)
Total	**$18.5**

Source: Department of Defense Directorate for Information Operations and Reports.

Assuming that the same proportion of sales to other agencies are for tangible personal property, the total amount of contracts awarded to California entities for tangible property would be *roughly $13 billion* in 1997.

Imports and Exports of Contracts

With regard to the exports, products associated with these contracts from California to other states, as well as the imports of U.S. government sales from other states into California, our review suggests the following:

- ***Exports.*** The majority of the $13 billion in prime contracts awarded to California firms for the delivery of tangible personal property—perhaps two-thirds to three-fourths of the total—are delivered to the U.S. government at sites *outside* of California. This relatively high proportion partly reflects the fact that many of the products resulting from the state's largest contracts—including those for the B-2 bomber, the C-17 transport aircraft, space shuttle components, and large missile systems—are shipped from California to other states.

- ***Imports.*** The amount of sales which are shipped from outside California to the U.S. government at sites within California, while substantial, would appear to be *less* than the amount of products produced in-state and shipped to the U.S. government at locations outside the state. This partly reflects the fact that, as the result of successive rounds of military base closures, the proportion of military bases and other related operations located in California has declined substantially in recent years.

Given the above, we estimate that California is a "net exporter" of defense-related goods—that is, more tangible products are produced in California and shipped to the U.S. government at locations elsewhere, than are shipped to the U.S. government inside of California from other places. The exact magnitude of this differential is unknown and could vary significantly from year to year, but a rough estimate would be *several billions of dollars annually*.

ISSUE # 4—BROAD IMPLICATIONS OF CALIFORNIA'S TREATMENT OF SALES TO THE U.S. GOVERNMENT

In this section, we discuss the broad fiscal and economic effects of California's current treatment of sales to the U.S. government in the BCT apportionment formula.

At the outset, it is important to stress that these effects depend primarily on the characteristics of the individual corporations that have contracts with and sales to the U.S. government, along with the particulars associated with these sales such as geographic production and delivery locations. Unfortunately, the companies we contacted generally chose, or were only able, to provide us with very limited information in these areas. In fact, as noted below, certain major companies went so far as to tell us that they *themselves* did not know how they would fare if the apportionment formula were revised to use destination as opposed to origin regarding federal sales. Given this, reliable quantitative estimates of the fiscal and economic effects requested under Resolution Chapter 157 were not possible to develop.

Fiscal Effects

The fact that California is a "net exporter" to other states of sales to the U.S. government implies that BCT payments to California are higher under current law than they would be if California were to use destination as the basis for determining the location of government sales in applying the apportionment formula.

Based on aggregate apportionment factors provided for the aerospace industry by FTB for the 1996 income year, our rough estimate is that shifting from origin to destination as a basis for determining the location of sales to the U.S. government could result in an annual revenue loss in the general range of $10 million per year. The actual revenue effect, however, could be higher or lower than this estimate, depending on such factors as future sales patterns and industry profitability.

If the Legislature were to pursue legislation involving modification of the apportionment formula, it would be important for the aerospace industry to provide more detailed information on the magnitude and characteristics of its sales to the U.S. government so that a more reliable fiscal estimate could be developed.

Economic Effects

If all states levying a corporation profits tax used identical or largely similar methods for determining the location of sales to the U.S. government, and if all states had the same corporate tax rates and apportionment technique, companies would be indifferent as to where the sales were apportioned. Any increases in the sales factor (and hence tax liabilities) in one state would be offset by identical decreases in other states.

However, given the significant differences in state tax systems that exist across the country, an individual state's choice of methods for allocating sales to the U.S. government can have a considerable financial impact on companies located within its boundaries. In the case of California, which has a somewhat higher-than-average corporate tax rate:

- Companies that produce goods in California and ship them to the U.S. government at locations elsewhere are *worse off* under California's current system than they would be if the sales were attributed to a lower-tax destination state.
- At the same time, companies with most of their operations in lower-tax states outside of California which ship products to the U.S. government within Califor-

nia would be *better off* if both states used California's current system. This is because the sales would be attributed to the other state.

- Between these two extremes are multistate companies which have sales to the U.S. government flowing in both directions—both from California to other states, and from other states into California. The effect of California's current tax treatment (and thus the effect of using destination as opposed to origin for allocating government sales) on these companies would be mixed.

As indicated above, we believe that the California aerospace industry *as a whole* pays more California taxes under the current system than it would if California used destination as a basis for determining the location of sales. Consequently, a shift from origin to destination would reduce the total amount of state BCT taxes paid by the industry. This could provide an incentive for some firms to maintain a larger share of their operations in California than is the case under current law. However, we are not able to determine the *size* of any such impact in view of the above-noted data deficiencies and the multitude of other factors affecting business location decisions.

Considerable Variation Exists Between Firms Within the Industry. Despite the difficulty of providing reliable aggregate quantitative estimates relating to the treatment of federal sales, one thing is clear—namely, within the aerospace industry, there is considerable variation among businesses regarding the effects of California's current taxation methodology. For example, of the five largest defense contract firms in California (shown in Figure 4), only one indicated that the California's current tax treatment results in substantially higher apportionment factors than would be the case if the state were to use destination as the basis for the sales factor. A second company indicated that a shift from origin to destination would result in a slight decline in its California taxes. The remaining three of these large companies were in the third category described above, and thus were unable to determine whether a shift would result in a significant increase or decrease in their apportionment factors. In these latter cases, the companies indicated that they had shipments being delivered to U.S. government sites both inside and outside of California. Because of recent acquisitions and uncertainty about future contracts, the companies were not able to determine what the net impact would be of changing the sales apportionment approach.

Illustrative Simulation of Potential Fiscal and Economic Effects

In order to explore the potential fiscal and economic effects of treating government sales using either an origin or destination approach, we developed a simulation model capable of measuring the effects of these different approaches on corporate earnings and investment rates of return. This simulation model was constructed with the flexibility to look at a variety of alternative assumptions involving such factors as corporate pretax earnings, assets, federal income tax rates, state income tax rates for both California and other states, and the proportion of total sales that are to the U.S. government. For illustrative purposes, our analysis focused on a hypothetical aerospace company with operations in both California and other states, having characteristics generally consistent with many of the larger companies in California's aerospace industry.

Baseline Scenario. In this scenario, we first calculated the company's financial situation under current tax laws, assuming pretax earnings of $100 million, assets of about $700 million, and California property and payroll apportionment factors of roughly 50 percent apiece. We also assumed that about three-fourths of its sales are to the U.S. government, all of which are attributable to California. In addition, under this simulation we assumed that all of the firm's sales to the federal government are delivered outside of the state, that all such sales are subject to state taxation somewhere, that all states use origin (versus destination), and that the average of the other states' income tax rates is 6 percent (or somewhat below California's 8.83 percent rate). Under these assumptions, we found that the company's pretax annual rate of return on equity was 15 percent, its after-tax annual rate of return would be a bit under 9.3 percent, and its total federal and state income taxes would be roughly $38 million.

Alternative Scenarios. We then modified our baseline scenario to show the effects of a variety of changes involving apportionment-related assumptions. In particular, we considered the case where "destination" is used instead of "origin" by both California and other states. This results in U.S. government sales being apportioned to other states instead of to California. In this case, the company was better off, but not by a substantial amount. Specifically, its total income taxes fell by about $700,000, raising its annual after-tax rate of return from 9.3 percent to 9.4 percent.

Next, we assumed that California uses "destination" while other states where the company ships government products continue to use origin. As a result, U.S. government sales no longer show up in the sales totals for California or other states. In this case, the company's taxes fall by a more significant amount—about $2.2 million (or roughly 6 percent)—while its annual after-tax rate of return increases to 9.6 percent.

Conclusion. These scenarios suggest that a shift by California from origin to destination would have a modest impact on a "typical" company's combined federal-state tax payments and its after tax rate-of-return. The most significant impact would be in the case where such a company was able to have income that is not taxed in any state. (An equivalent effect could occur if companies currently being taxed in more than one state on the same income could avoid such "double taxation" through a California shift to destination.) However, to the extent that income would merely be shifted from California to other states that would tax it, albeit at somewhat lower rates, the effect would be fairly modest.

Summary

In summary, our review of California's treatment of sales to the U.S. government in its apportionment formula suggests the following:

1. ***California's treatment of sales to the U.S. government is consistent with the majority of other states.***

   California is one of 28 states that base the location of sales to the U.S. government for apportionment purposes on the point of shipment (that is, on origin), instead of on destination. The state has used this treatment for more than three decades, since it adopted the UDIPTA in 1966.

2. ***Neither "destination" nor "origin" are perfect measures.***

   In the case of defense and related aerospace contracts, the place where the U.S. government takes possession of the product does not necessarily bear any relationship to the "market" for the defense product. In a sense, the market for goods that are used for common purposes, such as national defense or space exploration, cannot be attributed to *any* specific geographic location or area, including a certain state. This is the key reason stated by the drafters of UDIPTA for treating sales to the U.S. government differently from other types of sales. At the same time, however, attributing such sales back to their point of shipment also provides an inaccurate measure of the contribution of "consumer states" to the profitability of a company. This is because it falsely implies that the market for the product is in the same place as its production location. Given this, the primary benefits of using the shipment point of origin for determining the location of a government sale is ease of administration and conformity to a long-established set of apportionment rules that have been adopted by the majority of states.

3. ***Shifting from origin to destination would reduce overall taxes paid by California's aerospace industry.***

   We estimate that shifting from origin to destination would result in lower state-level income taxes for the aerospace industry overall. This reduction would occur because many of the larger defense contracts awarded to California firms result in products which are shipped to the U.S. government at sites outside of this state. The lower taxes could provide some firms with incentives to expand or maintain operations, relative to their situation under current law. However, the extent to which such changes would translate into additional investments in California is unclear, given all of the other factors affecting the location decisions of businesses.

4. ***However, not all companies would benefit equally.***

   California's current apportionment methodology has widely varying impacts on different companies within the aerospace industry. Some would benefit tax wise from a shift from origin to destination regarding the treatment of government sales, while others could end up paying more in state income taxes. However, of the five large companies we surveyed, only one indicated that it would experience major tax reductions if California were to change from origin to destination. Judging from the responses and feedback we received from other companies, the effect on the remaining companies would be more mixed.

Changing California Law Would Involve Trade-Offs

Given the above findings, it appears that changing California's apportionment treatment by shifting from origin to destination for U.S. government sales would involve some significant trade-offs.

Such a change would lower taxes paid by certain companies, and in such cases may provide at least some incentives for companies to maintain or expand operations in the state. However, such a change also would likely result in revenue losses to the state, potentially in the range of $10 million annually.

In addition, it would cause California to fall out of conformity with a major provision of UDIPTA, and would make California's treatment of such sales inconsistent with the majority of other states. This, in turn, could impose additional tax compliance burdens on certain taxpayers.

Finally, according to the FTB, using destination for U.S. government sales would make it harder to measure and substantiate the location of sales to the U.S. government, thereby complicating administration of the BCT, especially with regard to its various compliance and enforcement activities.

The Legislature would need to carefully evaluate and weigh these trade-offs in considering any change to its existing policy relating to U.S. government sales in its formula for apportioning corporate income.

Legislature May Wish to Consider Other Alternatives

If the Legislature does decide to pursue tax relief for U.S. government contractors (and, in particular, for defense-related contractors), there are other alternative options which it may wish to consider. For example:

- ***Single Weighting of Government Sales.*** One alternative that would provide partial tax relief would be to allow companies the option of "single weighting" U.S. government sales in California's apportionment formula. By doing so, any distortions caused by attributing sales back to their point of origin would be lessened. While providing less total dollar tax relief to the industry as a whole than a shift to destination, this option would enable California to maintain conformity with the majority of other states and would raise fewer concerns relating to the administration and multistate auditing activities associated with California's BCT.

- ***Zero Weighting of Government Sales.*** A second option would be to "throw out" U.S. government sales altogether (that is, give it a "zero weight") from both the numerator and denominator of the sales factor. This would enable companies to eliminate the effects of distortions resulting from the attribution of sales to the U.S. government to California. Such a throw out rule would provide tax relief to companies (and result in associated revenue reductions) equal to about one-half the magnitude of that which would occur if California were to shift from origin to destination.

Regardless of what alternative(s) the Legislature might consider to current law—a switch to destination, changing the weighting of the U.S. government sales factor, or some other alternative—it will be important that it obtain sufficient information from the aerospace industry to provide a detailed picture of the characteristics of sales to the federal government. It is only with this information that the likely fiscal effects of proposed change, if desired, can be reliably estimated.

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