STAFF SUMMARY AND RECOMMENDATION
SECTION 25137 PETITION
Ceradyne, Inc.

Background

Ceradyne is headquartered in Costa Mesa, California and does business both inside and outside California. Ceradyne is the key corporation in original and amended combined reports filed for taxable years 2003 through 2007. Ceradyne manufactures ceramic materials that are used in various industries, including automotive, electronic, semiconductor, and aerospace. Ceradyne also manufactures proprietary ceramic tiles that are assembled with other material and sold to the U.S. military as body armor inserts. The company's advanced ceramic armor system is also used on military helicopters and military vehicles.

Ceradyne manufactures, from raw materials, ceramic tiles for military use, and ceramic blanks for commercial use. The manufacturing process for tiles and blanks begins when powders are mixed with binding agents. The mixed powder is pressed and furnaced at extreme pressure and temperatures. The material is cooled and separated into individual tiles and blanks. Furnace cycle time ranges from 24 hours to nine days, depending on the product. Ceradyne's manufacturing process includes proprietary equipment and machinery, and is energy and labor intensive.

In 2003 and 2004, Ceradyne manufactured nearly all of the body armor ceramics at its Costa Mesa, California, and Irvine, California, facilities. The company, in response to a surge in equipment demand, expanded a pre-existing Lexington, Kentucky facility in 2003. Ceradyne expanded the Kentucky plant rather than the California plant because Kentucky energy costs were lower than California energy costs. By 2005, about half of all body armor ceramics were manufactured in Kentucky. After the ceramics are manufactured in Kentucky, they are shipped to California for finishing into completed body armor inserts.

Finishing is the assembly of the ceramic tiles with adhesives, ballistic backings and nonballistic backings to create the armor insert product sold to the U.S. government. Ceradyne manufactures the ceramic tiles, but purchases adhesives and backings from third parties. Ceradyne uses machine and hand labor to finish the ceramic plates into the armor inserts at its California facilities. Final inspection by the government occurs in California and the body armor inserts and armor systems are then shipped from this state to the U.S. government. After delivery, the U.S. military places the body armor inserts into pockets of special vests and jackets. Ceradyne does not provide the special vests or jackets to the military or attach armor to military helicopters and vehicles.

Ceradyne's sales of body armor inserts to the U.S. government increased during the years in issue. Overall sales to the U.S. government were 34 percent of Ceradyne's sales in 2002. But from 2003 through 2007, sales to the U.S. government accounted for between 52 percent and 76 percent of the company's sales. Ceradyne stated in its Section 25137 Petition that the company focused on the sale of ceramic products to the defense market in response to U.S. government demand, and revenue gains were largely from the significant increase in U.S. government sales. Ceradyne's revenues grew from roughly $61 million in 2002 to about $662 million in 2006. The taxpayer's 2007 10-K states: "We currently receive more than 74.0% of our revenues and more than 90.0% of our profits from sales of defense-related products."

The Petition

Ceradyne filed a section 25137 petition, attached as Exhibit A, on September 11, 2008 for taxable years 2003 through 2007. The petition argues that the inclusion of the U.S. government sales in the California numerator is distortive and seeks to remedy that distortion by removing the sales from the California sales factor numerator. In addition, the taxpayer seeks a closing agreement that would allow for similar treatment for the next five years (2008 -2012) to allow them to continue to use a 25137 variant so long as at least 40% of the company's sales are to the U.S. government.

Apportionment Factor Effect of Petition

As set forth in the petition, the sale factor effect of removing the receipts from the California sales factor numerator is as follows:

Year in issue	Ca Sales Factor as originally filed	Ca. Sales Factor with Govt. Sales removed from the Ca. numerator
2003	75.18%	28.59%
2004	68.58%	12.78%
2005	61.41%	5.42%
2006	70.41%	5.71%

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The taxpayer expanded upon its position in a letter to staff dated February 23, 2010, attached as Exhibit C, in response to staff's determination to recommend denial of the petition. In this letter they provide schedules that appear to address the alternative of throw-out of the receipts from both the numerator and the denominator of the sales factor. These schedules set forth that if the U.S. government sales are removed entirely, the sales factor for the years in issue would be as follows:

Year in issue	Ca Sales Factor as originally filed	Ca. Sales Factor with Govt. Sales removed entirely
2003	75.18%	52.62%
2004	68.58%	39.98%
2005	61.41%	19.39%
2006	70.41%	23.83%

Tax Effects of Petition

In its petition, the taxpayer sets forth the tax effect (claims for refund) of the petition as follows:

Year in issue	Tax effect
2003	(0)
2004	($937,849)
2005	($2,167,088)
2006	(5,619,681)

This appears to be based on the numerator removal remedy rather than the throw-out remedy. For 2007 the claim was a letter claim listing only $1 or more. Staff believes the refund amount will be approximately $6,600,000 if the numerator removal remedy were granted for 2007. The taxpayer also provided, in its letter to staff dated February 23, 2010, a schedule that sets forth that for the years 2003 – 2008, if the throw-out method were to be used the total tax refund would be $14,859,317.

The taxpayer also provided additional argument in a letter dated August 18, 2010, which is attached as Exhibit F. Staffs final response to the taxpayer is also attached as Exhibit G.

Standard UDITPA Rules

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state, and the denominator is the total sales everywhere. (Rev. & Tax. Code, § 25134.) Sales of tangible personal property are in California if the property is delivered or shipped to a purchaser within this state. (Rev. & Tax. Code, § 25135, subd. (a); Cal. Code Regs., tit. 18, § 25135, subd. (a).) An exception to this rule is made for sales to the U.S. government, which are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. (Rev. & Tax. Code, § 25135, subd. (a)(2); Cal. Code Regs., tit. 18, § 25135, subd. (b).)

For most sales of tangible personal property, the sales factor is intended to attribute sales to the consumer state. Attributing sales to the consumer state recognizes the contribution of the consumer state in the production of the taxpayer's income. (Pierce, *The Uniform Division of Income Tax for State Tax Purposes,* 35 Tax 747 (October 1957.) However, U.S. government consumption of tangible personal property cannot be said to occur in a specific state. (Pierce, supra.) The place where the U.S. government takes possession of purchased tangible personal property may bear no relationship to the location of the market for that product. This is particularly true for products used for common purposes, such as national defense. Therefore, rather than attempting to find the "market," the sales factor rule for sales to the U.S. government was specifically carved out and treated differently. Sales to the U.S. government utilize a "shipped to" rule instead of a market rule.

Staff Recommendation

As set forth more fully in Exhibit B, staff's recommendation to deny the petition, dated December 15, 2009, and in Exhibit D, staff's determination upon reconsideration of the taxpayer's petition, dated April 1, 2010, staff recommends denial of the petition. Staff believes that the standard formula is functioning as intended. The U.S. government sales rule is not a market rule. It is unreasonable to believe that at the time UDITPA was drafted the drafters would have included in the standard formula a rule that, when functioning as intended, operates to unfairly represent the activities of the taxpayer in this state such that relief may be granted under section 25137.

It appears to staff that the taxpayer's real complaint is that the sales factor *should* represent the market and that the government sales rule is not a market rule. While it is true that the rule is based on shipping location and not the destination of the goods, this does not mean that the rule is incorrect or that the standard formula results in distortion. If all that was required for relief were a showing that the standard rule is not "market," all taxpayers with sales to the government would be entitled to relief. This would effectively write section 25135(a)(2) out of the Code, a position the taxpayer is not advocating for in this matter.

Staff also believes there are tax policy reasons that support the use of shipping location for the assignment of U.S. government sales. Perhaps the most obvious of these is that there really is no easily definable "market" for sales to the U.S. government. The U.S. government is located in all 50 states and may choose to take delivery in any place it feels is appropriate. The final destination of the goods it purchases may be in other states or other countries, as needed. The Legislative Analyst's Office (LAO) discussed these issues in a January 1999 report on the taxation of corporate sales to the federal government (copy attached as Exhibit E):

> 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 LAO report also points to the ease of administering the current rule and the uniformity of the rule, as additional reasons justifying the use of a “shipped from” rule instead of a “destination” rule for U.S. government sales.

Even if the Board were to find that an unfair representation of the taxpayer's activities has occurred, staff also has concerns about the remedy that the taxpayer has suggested. The taxpayer seeks to remove the sales from the California numerator while maintaining the sales in the denominator. This is meant to reflect “the market” but it leads to all of the government sales escaping assignment entirely and a large amount of the taxpayer’s income escaping tax entirely. This is unreasonable.

During the petition process the taxpayer also raised the possibility of “throw out” which would remove the government sales from both the numerator and denominator of the sales factor. While this could potentially avoid the “nowhere income” issue raised by the numerator exclusion (assuming the taxpayer were to file amended returns in all of the states where it does business to reflect the new denominator), it results in assigning income from the taxpayer's largest revenue generating activity to various locations that had nothing whatsoever to do with the manufacturing and sale of the body armor. This is also unreasonable.

Finally, the taxpayer offered to work with the FTB to develop a system to assign the sales between California and Kentucky, which, if it were found that the inclusion of the sales in the California numerator were in fact causing an unfair representation of the taxpayer's activities, seems a more reasonable alternative. However, when questioned further about this, the taxpayer, in its February 23rd letter, opined that "whether or not Kentucky taxes the sales in question is irrelevant."

Staff must disagree. Kentucky utilizes the same "shipped from" rule as California.[1] If staff accepted the taxpayer's argument that distortion is caused by manufacturing in both states but shipping from only California, then the most logical remedy for that distortion would be to assign the receipts from Kentucky manufactured products to Kentucky. Kentucky law would then operate to ensure that these sales are in the Kentucky sales factor numerator. This results in all of the sales being assigned to the two states where the manufacturing occurred.

The unwillingness of the taxpayer to discuss its filing position in Kentucky goes to the reasonableness of the alternative it offers. By refusing to take its Kentucky filing position into consideration, the taxpayer undermines its efforts and leads to the conclusion that it is not interested in discussing this alternative.

[1] Ky. Rev. Stat. Ann. § 141.120(8)(c)(2)(b)

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September 11, 2008

W C SEP 23 2008 REC'D

Franchise Tax Board Legal Division
ATTN: Geoff Way, Chief Counsel
P.O. Box 1720
Rancho Cordova CA 95741-1720
FAX (916) 845-3648

Re: Petition for Special Apportionment/Claim for Refund
Ceradyne, Inc. and Subsidiaries
California Corporate Number: 1588785
Taxable Years Ended December 31, 2003 to December 31, 2007

Dear Mr. Way:

Ceradyne, Inc. and Subsidiaries (hereinafter referred to as "Taxpayers") hereby file this claim for refunds for taxable years ended December 31, 2003 to December 2007 in the following amounts:

	Balance Due (Overpayment)
2003 California 100X	($0)
2004 California 100X	($937,849)
2005 California 100X	($2,167,088)
2006 California 100X	($5,619,681)
2007 California Refund Letter	($ 1 or more)

In short, the taxpayer apportioned their income according to California Revenue and Tax Code Regulations 25128 to 25136. Recent changes in the Taxpayer's market has created a situation where the aforementioned regulations which guide the public on how to apportion business income results in an unfair representation of the taxpayers business (Please refer to enclosed Petition). In accordance with California Revenue and Tax Code § 25137, Taxpayer respectfully requests relief from the apportionment results outlined in the petition which burdens the Taxpayer.

Very truly yours,

Lance Wood
Partner, Tax Services

LW:pjm, Enclosures

Ceradyne, Inc. ("Ceradyne")
Petition for Alternative Apportionment
Tax Years Ended December 31, 2003 through December 31, 2006, and Thereafter
(California Revenue and Taxation Code Section 25137)

Ceradyne petitions the Franchise Tax Board ("FTB") for relief pursuant to California Revenue and Taxation Code Section ("R&TC") 25137.[1] Ceradyne seeks relief for its taxable years ended December 31, 2003 through December 31, 2006, and for each of its years thereafter so long as Ceradyne's business activities remain substantially similar to the four years expressly stated in this Petition.

I. INTRODUCTION

Ceradyne is a worldwide developer and producer of advanced technical ceramics. Ceradyne manufactures military protective gear or "bullet proof vests" used in combat by the United States military. In recent years, contracts with the U.S. government constituted a significant portion of Ceradyne's total sales due to the increased demand for defense products.

The objective of the sales factor is to reflect the contribution of the market state in the production of Ceradyne's income. However, the formula does a gross injustice because a special rule forces all U.S. government sales to be arbitrarily attributed to California, the shipping point. The special rule artificially inflates the relative degree of activity in California since California does not provide a market for Ceradyne's products. To prevent these incongruous results under Section 25135(b)(1), Ceradyne should be allowed to remove the U.S. government receipts from numerator of the sales factor or at a minimum, "throw out" the receipts from both the numerator and the denominator, to fairly reflect the contribution of California to Ceradyne's business activities.

II. FACTS

A. CERADYNE'S BUSINESS

Founded in 1967, Ceradyne has diversified its product lines to capture opportunities created by the growing need for better performance and cost-effectiveness in

[1] Unless otherwise indicated, all section references are to the indicated section of the California Revenue and Taxation Code in effect for the years at issue.

components made of traditional materials. The unique characteristics of advanced technical ceramics—hardness, light weight, ability to withstand extremely high temperatures, resistance to wear and corrosion, low friction, and special electrical properties—offer significant advantages over traditional materials such as metals and plastics. As a result, Ceradyne used these advantages to help protect the U.S. military by using the versatility of advanced technical ceramics in a broad range of applications.

B. CERADYNE ARMOR SALES OPERATIONS

As a result of the market demand, Ceradyne focused on the manufacture and sale of ceramic products in the defense market. Ceradyne's patented body armor ceramic technology is both lightweight and durable to protect against bullets at point blank range. Their advanced ceramic armor system provides protection for soldiers, military helicopters and vehicles. The success of Ceradyne's military armor led to a dramatic increase in government sales. In fact, in 2002, government sales only represented 34 percent of Ceradyne's sales. However, from tax years 2003 to 2006 government sales ranged from a low of 58 percent to a high of 85 percent of the company's total sales.

1. Solicitation Occurs Outside of California

To increase its marketability and success in obtaining government contracts, Ceradyne strategically placed an active and concentrated presence near the Pentagon. Marc King ("Mr. King"), the vice president of armor operations, was located in Virginia. His experience with the military and various government sales companies were one of the keys to Ceradyne's success in body armor sales to the government. Since Mr. King's start with Ceradyne in 2004, his responsibilities included the solicitation of customers, contract negotiations, research and development, and quality control. Mr. King traveled all over the country including Wisconsin, California, Michigan, Florida and Maryland to market Ceradyne. His connections were an invaluable asset to Ceradyne, becoming the essential component to the expansion of Ceradyne's government sales.
Mr. King plays a significant role in Ceradyne's day to day activities. He maintains established domestic and international clients, travels to client locations to hold meetings, present products, negotiate contracts, and assists clients with the installation of Ceradyne products or works with the client to resolve engineering problems.

Tradeshows are an important step in the process of securing government contracts. Since orders are not usually taken at tradeshows, Mr. King has to promote and market Ceradyne, using the forum to demonstrate to the customer the new technologies, advanced systems, and research and development efforts being developed for future applications. These key activities, which are critical for the successful procurement of government contracts occurred wholly outside of California. The body armor tradeshows are in Washington, DC, North Carolina, Florida, Georgia, Kentucky, Virginia and international locations such as France. As a result of Ceradyne's focus on obtaining government contracts, Ceradyne concentrated its resources, such as Mr. King in strategic locations. As a result, Ceradyne's California payroll factor accurately reflected that the efforts and contributions of the individuals responsible for Ceradyne's sales were executed wholly outside the state.

2. Overview of Armor Sales and Manufacturing Cycle

Approximately 95% of the body armor testing is done at an independent testing facility selected by the government to meet the government's requirements to bid on a project. Larry Puckett, an independent contractor, monitors the testing at the Maryland facility on behalf of Ceradyne. His role is to witness the testing, ensure everything is properly set up in the testing lab, answer questions and provide input. Once a government contract is awarded to Ceradyne, manufacturing begins. In general, manufacturing is done either in Lexington, Kentucky or in the Cost Mesa, California facility. Additional quality control tests occur during the manufacturing processes at the manufacturing plant and is usually a small sample of larger lots, e.g. for every 3,000 products, 3 dozen are tested. The contract with the U.S. government requires all goods to be shipped to California for inspection, regardless of where it was manufactured, before the goods are shipped to the intended point of consumption outside California.

In 2003, Ceradyne expanded its facilities in Kentucky because of lower energy costs and to ease the burden of the California facility, as a result of the significant increase in demand for body armor. This dramatic shift to the Kentucky facilities substantially decreased Ceradyne's California property and payroll. Between 2003 and 2006 there was a dramatic shift from manufacturing body armor in California to manufacturing body armor in Kentucky as follows:

	2003	2004	2005	2006
CA	99.9%	100.0%	53.4%	56.3%
KY	0.1%	0.0%	46.6%	43.7%

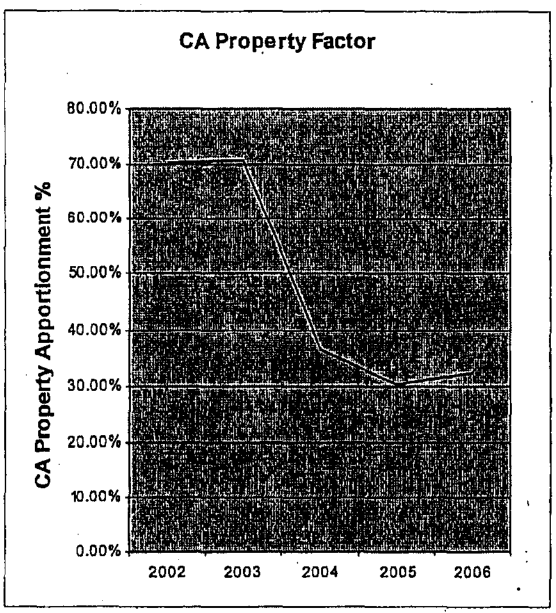
Since Ceradyne's contract with the U.S. government requires that all final products must be shipped back to the Costa Mesa facility in California for final assembly, inspection and approval by a U.S. government representative that is stationed in Ceradyne's Costa Mesa facility. Each lot of armor has a sample that is tested for ballistic properties in Maryland and once it passes this test, the remaining products from the lot is packaged and shipped to the government, usually in Virginia. As a result, all the product ends up being shipped from California regardless of where it was manufactured, thereby unfairly including and representing the receipt in Ceradyne's California sales factor.

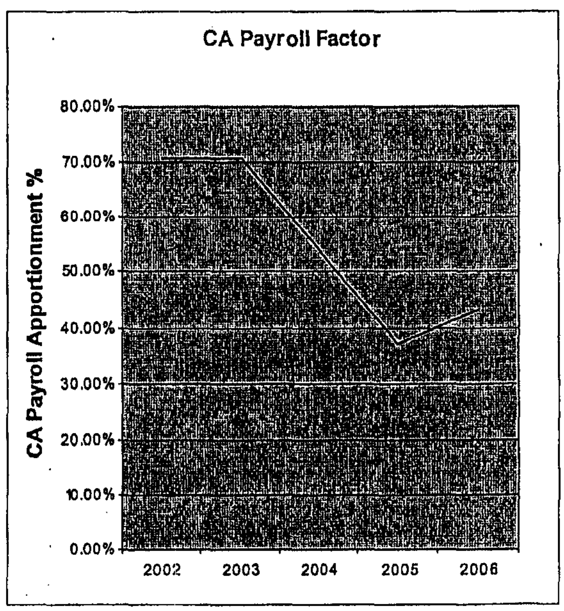
C. APPORTIONMENT OVERVIEW

In 2006, Ceradyne employed approximately 2,205 employees, 43 percent of which were located outside of California. During 2002 to 2006, Ceradyne's revenues grew from roughly $61 million to $662 million with its core revenues resulting from the significant increase in government sales. However, as highlighted in the chart below, as Ceradyne's out of state manufacturing activities and out of state sales activities increased, its California sales factor held relatively firm despite the significant shift out of California. The percentage decrease in California's property and payroll factors between 2003 and 2006 were 54% and 39% respectively, whereas the sales factor only dropped 5%. The sales factor's arbitrary allocation to California causes the overall apportionment percentage to unfairly reflect the activities in the state. This result is further exacerbated by the double weighting of the sales factor.

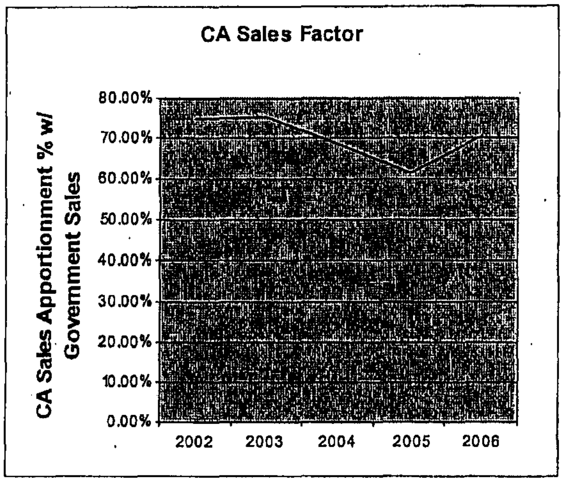
	CA Property Factor	CA Payroll Factor	CA Sales Factor under Section 25135(b)(1)	CA Apportionment Factor
12/31/2002	70.24%	70.88%	74.89%	72.72%
12/31/2003	70.78%	70.68%	75.18%	72.96%
12/31/2004	36.43%	54.03%	68.58%	56.90%
12/31/2005	30.32%	36.91%	61.41%	47.52%
12/31/2006	32.23%	43.39%	70.41%	54.11%

The following charts illustrate Ceradyne's property, payroll and sales factors as filed under Section 25135(b)(1). Both the property and payroll factors reflect Ceradyne's dramatic shift from California facilities to Kentucky facilities and Mr. King's contribution to Ceradyne's sales.





However, the sales factor continued to falsely portray a consistent concentration of sales activities in California.



Contrary to the purpose of UDITPA, the sales factor exaggerates Ceradyne's income producing activities in California and does not fairly reflect how Ceradyne generates income from its resources. Therefore, Ceradyne should be permitted to use an alternative apportionment method under Section 25137 and remove the receipts from the numerator of the sales factor or "throw-out" government receipts to relieve the distortive effect.

The result eliminates the unreasonable concentration and overstatement of Ceradyne's business activities in California and fairly reflects the actual contribution of California's contribution to Ceradyne's production of income as shown in the property and payroll factor charts above.

III. LAW and DISCUSSION

California enacted the standard apportionment formula attributing income to states based on property, payroll and sales factors when California adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") in 1966 to provide for a uniform method for allocating income between states. To conform with UDITPA, California's apportionment formula for income from sales to the U.S. government is based on Section 25135(b)(1), which provides that sales of tangible personal property are in this state if the property is shipped from an office, store, warehouse, factory or other place of storage in California and the purchaser is the United States government.

A. THE PURPOSE OF THE SALES FACTOR

A fair apportionment formula should strive to "give appropriate weight to the various factors which are responsible for earning the income." (Altman and Keesling, *Allocation of Income in State Taxation*, p. 107 (Chicago, Commerce Clearing House, Inc., 2d Ed., 1950).) To state the Supreme Court's precept, a fair formula "must actually reflect a reasonable sense of how income is generated." (*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983).)

As part of the apportionment formula, the sales factor was designed solely to give weight to the marketplace. The UDITPA drafters debated the various approaches to the sales factor before adopting the destination rule. The debate centered on the argument "that manufacturing states probably would prefer a system attributing sales to the place from which goods are shipped. However, ... such a system would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing state, so that there would tend to be a duplication by such a sales factor. Moreover, it is believed that the contribution of the consumer states toward the production of income should be recognized by attributing the sales to those states." (William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes No. 10, 780, Oct. 1957; see also Jerome Hellerstein and Walter Hellerstein, State and Local Taxation, 2d Ed. 1993, p. 8-41.) The sales factor "is necessary to provide the market state with an appropriate share of the income base and to prevent the manufacturing state from claiming an excessive share of such base." (McLure, *The State Corporation Income Tax* (1984) pages 134-135, article by Benjamin F. Miller, *Worldwide Unitary Combination: The California Practice*, at pp. 132-166.)

Recognizing the manufacturing bias inherent in the standard formula, the formula seeks to balance the payroll and property factors through the sales factor as determined by location of the market state. Sales of tangible personal property sourced to the state in which the property is delivered or shipped. Absent such a balancing factor, all revenues would have been attributed to the location of a company's offices and manufacturing facilities. (Altman and Keesling, *Allocation of Income in State Taxation* (Chicago, Commerce Clearing House, Inc., 2d Ed., 1950).) However, for California income and franchise tax purposes, sales to the U.S. government are assigned to the state from which the goods are shipped.

California Code of Regulations, title 18,[2] section 25137(a) states that section 25137 applies "where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results." In *Appeal of Crisa Corporation*, the California State Board of Equalization ("BOE") identified the test for distortion under Section 25137:

[2] Unless otherwise specified, all further references to Regulation sections are to title 18 of the California Code.

> The central question under Section 25137 is not whether some quantitative comparison has produced a large enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula... The answer to this question lies in the analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then Section 25137 may apply.

(*Appeal of Crisa Corporation* 2002-SBE-004.)

The FTB acknowledges that the sales factor may not fairly represent market activities and provides regulatory solutions when the sale factor does not serve its intended purpose or otherwise may give rise to distortive results and have used Section 25137 to develop an alternate apportionment formula. For example, regulation 25137(c) provides for the exclusion of substantial and occasional receipts which might unfairly apportion too much income to one jurisdiction. (See also FTB Legal Ruling 97-1.) Or, more recently, the FTB has proposed regulation 25137-14 to address the market for mutual fund service providers to recognize that the "customers of these companies are the fund shareholders, who receive the benefit of the services in locations scattered amongst all fifty states." (FTB Initial Statement of Reasons for the Adoption of California Code of Regulations, Title 18, Section 25137-14.)[3]

Each of the authorities addressing the sales factor reflects a consistent theme. If application of the standard sales factor does not reflect the market for the income subject to apportionment, then the sales factor should be adjusted to give appropriate weight to those markets or the receipts should be excluded.

Section 25135(b)(1) fails here because it does not fairly reflect Ceradyne's business activities that occur wholly outside the state. The shipment of the products back to California for final assembly and inspection by a government representative forces Ceradyne to source its U.S government sales, a majority of its total sales, to California. The assignment of such receipts to California results in an overstatement of Ceradyne's activities in the state by ignoring the contribution of the activities in Kentucky. In

[3] The sales factor prescribed for contractors reflects the market for construction services, the state of the location of the project. (Cal. Code Regs., tit. 18, § 25137-2(d)(6)(A).) For franchisers, California generally attributes franchise fees to the market state, the franchisee's place of business. (Cal. Code Regs., tit. 18, § 25137-3(b)(2)(A). Cal. Reg. § 25137-4.1(2)(B)(i).) A market state approach now applies to a large part of revenue generated by banks. (Cal. Code Regs., tit. 18, § 25137-4.2(c)(3)(C) and (D).) The regulation for motion picture and television film producers and television networks attributes film and broadcast revenues to the state of the ultimate customer, the viewer. (Cal. Code Regs., tit. 18, § 25137-8(c)(3).) Finally, the regulation for publishers and licensors of printed materials attributes revenues to the state of the ultimate customer, the reader, based on circulation statistics. (Cal. Code Regs., tit. 18, § 25137-12(c)(2) and (3).)

addition, double weighting of the sales factor further exasperates the exaggeration of Ceradyne's California market activities due to the shipping point rule under Section 25135(b)(1). Ceradyne's income producing activities that contribute significantly to the sale of the body armor are outside of California, as is reflected in the property and payroll factors. Furthermore, although product is shipped to California for final assembly and to prepare it for a mandatory inspection and testing, the U.S. government never intended to use the product in California, and California does not provide a market for Ceradyne's products. As a result, this mere formality inflates Ceradyne's California sales factor and overall apportionment, and thus does not fairly reflect income apportionable to California sources.

B. DISCUSSION

Application of the statutory formula fails to accurately represent Ceradyne's market activities relating to body armor sales to the U.S. government. Ceradyne shifted more than half its resources to Kentucky, while shipment of the products to California for a mandatory final inspection was a mere formality, before shipping the products to its final destination in Virginia.

A. Section 25137 Provides Appropriate Relief by Means of Removing the U.S. Government Receipts from the Numerator of the Sales Factor.

The U.S. government never intended to use the product in California and California does not represent a market for Ceradyne's goods as was intended by the sales factor. Once the mandatory inspection by the government representative in California was complete, the product was shipped to its final destination. This mere formality inflates Ceradyne's California sales factor and overall apportionment percentage, and thus does not fairly reflect income apportionable to California sources. Therefore, Ceradyne should be allowed to remove the U.S. government receipts from the numerator of the sales factor to fairly reflect the fact that California does not provide a market for Ceradyne's products.

1. Application of Section 25135(b)(1) will distort the extent of Ceradyne's business activities and fail to fairly reflect Ceradyne's contribution of its markets in its sales factor.

California provides an alternate methodology to taxpayers when the standard apportionment provisions "do not fairly represent the extent of the taxpayer's business activity in this state." (Cal. Rev. & Tax. Code, § 25137.) The party invoking section 25137 has "the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable." (*Microsoft Corp. v. Franchise Tax Bd.* (Aug. 17, 2006) 39 Cal.4th 750, at 770.) The California Supreme Court also stated that distortion included not only unique and nonrecurring circumstances, but also "systematic oversights and undersights." (Id. at 770.)

To meet the increased demand for body armor, Ceradyne shifted its investments outside the state, as is reflected in their payroll and property factors. The majority of the payroll activity related to the armor sales, which includes the key solicitation activities by Mr. King, occurs outside of California and its manufacturing activities shifted to the Kentucky facility. As indicated by the chart provided in the Apportionment Overview section (supra.), although the Ceradyne's California payroll and property factors decreased to reflect this change in business, the sales factor held firm. This inelasticity of the sales factor, however, did not result because of any corresponding increase in Ceradyne's California activities, but a mere formality requiring Ceradyne to ship the product to California for inspection.

The U.S. government required that all product be inspected in California, whether or not it was manufactured in California, however, the U.S. government never intended use the product in California, and shipped the product to its final destination once the inspection was complete. No substantial additions are made to the product when shipped to California. Ceradyne will add minor details such as labels, but the majority of the product was completed in the Kentucky facility. Therefore, sourcing the U.S. government receipts to California does not reflect the proper change attributable to the California marketplace and thus, does not serve the intended purpose of the sales factor.

The three factor apportionment formula is intended to reflect the relative level of corporate activities in a particular market state. As indicated in the chart below, as the California property and payroll factors decreased due to Ceradyne's shift of its activities to out of state facilities, the sales factor as determined pursuant to section 25135(b)(1) exaggerated California's overall apportionment percentage. Because of the government sales rule, the mere act of a California-based inspection results in an inaccurate and inflated sales factor. The overall apportionment percentage due to Section 25135(b)(1), is more than double the percentage than if the sales were removed from the numerator of the sales factor. The resulting distortive effect is that Ceradyne's California apportionment percentage as filed was 109% in 2006.

	CA Property Factor as Filed	CA Payroll Factor as Filed	CA Sales Factor w/ Gov't Sales Removed from Numerator	CA Apportionment w/ Gov't Sales Removed from Numerator of CA Sales Factor	CA Apportionment as Filed	Relative Distortive Effect
12/31/2003	70.78%	70.68%	28.59%	49.66%	72.96%	17.26%
12/31/2004	36.43%	54.03%	12.78%	29.00%	56.90%	53.00%
12/31/2005	30.32%	36.91%	5.42%	19.52%	47.52%	107.00%
12/31/2006	32.23%	43.39%	5.71%	21.76%	54.11%	109.00%

By excluding the U.S. government receipts from the apportionment formula, Ceradyne's property, payroll and sales factor is a fair representation of the corresponding decrease with Ceradyne's shift to out of state production facilities to serve the U.S. government market. Therefore, removing the receipts from the numerator produces a consistent and reasonable outcome, eliminating the incongruous result of Section 25135(b)(1).

B. Section 25137 Provides Appropriate Relief by Means of "Throwing-Out" Government Receipts.

Fair apportionment of Ceradyne's income may also be accomplished under 25137 by throwing out government receipts altogether from either just the numerator or at a minimum from both the numerator and the denominator of the sales factor. "A "throwout" rule results in "full accountability" for all the taxpayers income to the states in which the corporation is taxable." (Jerome Hellerstein and Walter Hellerstein, State and Local Taxation, 8th Ed. 2005, p. 667.) Since Ceradyne shifted its business activities out of state, the inclusion of the receipts distorts the extent of Ceradyne's business activities in California and does not accurately reflect Ceradyne's income producing activities. Therefore, the 'throw-out" method would eliminate the effects of distortion on Ceradyne's California sales factor, matching the capital investment and labor activities to show the contribution of the market state towards the production of income.

The inflated numerator unfairly overstates California's involvement to Ceradyne's production of income. Therefore, sourcing the U.S. government sales based on origin does not clearly reflect California's contribution to the market and overstates Ceradyne's activities in the state. As a result, "throwing-out" the government receipts will lower the distortive impact of Section 25135(b)(1).

IV. <u>CONCLUSION</u>

Receipts from Ceradyne's sales to the U.S. government should be excluded from the numerator of the sales factor or at the very least, both the numerator and denominator of the sales factor. The objective of the apportionment formula is to apportion income based on the market activities giving rise to that income. In this case, the income from the body armor sales cannot be fairly attributed to Ceradyne's California's market. Since application of the standard formula produces incongruous results, the FTB should exclude the receipts from these activities from the numerator of the sales factor so that the apportionment formula will fairly reflect Ceradyne's market activities in California or at a minimum, "throw out" the receipts from both the numerator and the denominator to lower the distortive effect of Section 25135(b)(1).

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FILE COPY

Date: 12.15.09

Case: 6920373994215256
Case Unit: 6920373994215416
In reply refer to: 410:BCM

Jon Sperring
PricewaterhouseCoopers
400 Capitol Mall, Suite 600
Sacramento CA 95814

Regarding: Ceradyne, Inc. Section 25137 Petition
Taxable Years: 2003, 2004, 2005 and 2006

Dear Mr. Sperring:

This letter is to inform you that staff is recommending denial of Ceradyne, Inc.'s Section 25137 Petition to apply an alternative method of allocation and apportionment. California Revenue and Taxation Code section 25135, subdivision (b)(1), assigns gross receipts to California when tangible personal property is shipped from this state and the purchaser is the U.S. government. Ceradyne shipped tangible personal property from California and the purchaser was the U.S. government. These sales to the U.S. government were properly assigned to the California sales factor numerator.

Ceradyne's Section 25137 Petition requested that gross receipts from sales to the U.S. government be removed from the sales factor numerator or removed from both the sales factor numerator and denominator (throw out). The petition characterized Revenue and Taxation Code section 25135, subdivision (b)(1), itself as distortive because all of Ceradyne's sales to the U.S. government, which were shipped from California, were assigned to California.

Ceradyne's petition also states that California is not the consumer market for the products sold to the U.S. government, that the taxpayer knows that the tangible personal property sold to the U.S. government would be consumed in Iraq and Afghanistan, and asserts that assigning these gross receipts to California does not further the sales factor's purpose of reflecting consumer markets. Ceradyne's Section 25137 Petition also asserts that gross receipts from tangible personal property primarily manufactured in Kentucky, but finished, inspected and shipped from California, should not be assigned to California because the California activity was a "mere formality."

Ceradyne's Section 25137 Petition fails to show that the standard allocation and apportionment provisions fail to represent the extent of its California business activity. The U.S. government sales rule is a standard allocation and apportionment provision.

Ceradyne did not proffer legal authority for its position that the U.S. government sales rule causes distortion to the allocation and apportionment of a taxpayer's income. Ceradyne also did not show that it had circumstances that caused the standard allocation and apportionment provisions to unfairly represent the extent of its California business activity.

Ceradyne's Section 25137 Petition asserts that the standard U.S. government sales rule itself is distortive, and that this should give rise to an alternative method to apportion and allocate Ceradyne's income. Ceradyne submitted as evidence a 1999 report by the Legislative Analyst's Office (LAO Report). The LAO Report was in response to Resolution Chapter 157, Statutes of 1998 (SCR 44, Calderon). The LAO Report explored the origins of the U.S. government sales rule, and recommended potential statutory changes that could be enacted by the California Legislature. Among those suggestions was a throw out rule like the rule requested in this petition. The Legislature, however, chose not to enact changes to the U.S. government sales rule. Ceradyne's Section 25137 Petition essentially asks the staff of the Franchise Tax Board to alter the U.S. government sales rule after the Legislature chose not to enact changes to the rule.

Ceradyne's Section 25137 Petition also asserts that the U.S. government sales rule causes distortion because all Ceradyne's U.S. government sales are shipped from California although manufacturing is done in Kentucky. Ceradyne manufactured nearly all of its body armor in California during taxable years 2003 and 2004, but nearly half of its body armor in Kentucky during taxable years 2005 and 2006. This body armor was sent to California for final assembly, inspection and approval by a U.S. government inspector. The finished and inspected body armor was then shipped from California to the U.S. government.

Ceradyne characterizes sending Kentucky manufactured material to California for finishing and inspection as a "mere formality." The finishing activity in California, which included installing adhesives and backings on ceramic product with both hand and machine labor were much more than mere formalities conducted in California.

Ceradyne asserts that assigning all U.S. government sales to California results in an overstatement of Ceradyne's California business activity "by ignoring the contribution of the activities in Kentucky." This is not necessarily accurate because Ceradyne's property and payroll factors represent Kentucky business activity. Furthermore, there is no indication that the taxpayer has approached Kentucky, a state with the same government assignment rule as California, to request similar relief to reflect the activities in Kentucky in its Kentucky sales factor numerator, therefore, were the Franchise Tax Board to allow the assignment of the sales to Kentucky, the result would be nowhere income, this is an unreasonable result.

In conclusion, Ceradyne's Section 25137 Petition does not establish that the standard allocation and apportionment provisions unfairly represent the extent of its California business activity. Ceradyne's Section 25137 Petition also did not establish that its proffered alternatives to the standard apportionment provisions are reasonable.

The taxpayer may request a hearing before the three-member Franchise Tax Board to review this determination.

Please let me know within the next 30 days how the taxpayer wishes to proceed with the petition.

Very truly yours,

Brian C Miller

Brian C. Miller
Tax Counsel III

PRICEWATERHOUSECOOPERS

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February 23, 2010

Mr. Carl Joseph
Assistant Chief Counsel - Multistate Tax Bureau
Franchise Tax Board - Legal Division
P.O. Box 1720
Sacramento, CA 95812-1720

Dear Mr. Joseph:

This letter is intended to respond to the Franchise Tax Board's ("FTB") determination letter dated December 15, 2009 and restate Ceradyne, Inc.'s case for distortion relief under California Revenue and Taxation Code ("CRTC") Section 25137. We would appreciate your consideration of this information, in addition to our prior submissions, in connection with our formal meeting on February 25, 2010.

A. FTB Determination Letter Response

In order to have a full and constructive conversation about the merits of Ceradyne's distortion petition, we wanted to address the main points in the FTB's determination letter that we disagree with.

> **FTB STATEMENT #1 – "Ceradyne did not proffer legal authority for its position that the U.S. government sales rule causes distortion to the allocation and apportionment of a taxpayer's income."**

CRTC Section 25137 requires a taxpayer to show distortion based upon specific facts. In addition, the relevant regulations and legal precedent make it clear that distortion may only be proven as a matter of fact, not law. California Code of Regulations, Tit. 18, Section 25137 states that "[s]ection 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocations provisions contained in these regulations." Similarly, the California State Board of Equalization stated in the *Appeal of Crisa Corporation*, that:

> The central question under Section 25137 is ... whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula ... The answer to this question lies in an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then Section 25137 may apply.

(*Appeal of Crisa Corporation 2002-SBE-004*)

Given this legal framework, Ceradyne's prior submissions set out to factually prove that the application of the government sales rule to Ceradyne's unique factual situation resulted in distortion. Furthermore, following our initial submission, the FTB's inquiries pursued information related to a remedy to this distortion. As no inquiries were made with respect to distortion, we believed the FTB agreed that distortion occurred with respect to the facts of this taxpayer and that we were resolving the issue of how to remedy the distortion.

> **FTB STATEMENT #2 – "Ceradyne also did not show that it had circumstances that cause the standard allocation and apportionment provisions to unfairly represent the extent of its California business activity."**

The factual representations made in our distortion petition and IDR responses clearly indicate the unique situation resulting from the introduction of significant war-time government contracts to an established commercial ceramics manufacturing business. We have shown graphically and numerically the effect the U.S. Government sales had on Ceradyne's otherwise representative California apportionment formula, and have illustrated the artificial inflation of the California activities that results from the application of the government sales rule to ceramic products produced in Kentucky but sent to California for finishing, inspection and final shipment. Nevertheless, we have prepared additional schedules, graphs and computations that we believe indicate the presence of distortion under the established quantitative tests. (Exhibit 1)

> **FTB STATEMENT #3 – "Ceradyne's Section 25137 Petition asserts that the standard U.S. government sales rule itself is distortive, and that this should give rise to an alternative method to apportion and allocate Ceradyne's income."**

It is very important that we properly distinguish the distortion caused by applying the government sales rule to Ceradyne's unique factual situation from a full fledged frontal assault on the government sales rule itself. We are not claiming, or even implying, that the government sales rule, when applied to all taxpayers, results in distortion requiring remedy under CRTC Section 25137. Instead, we are claiming that the government sales rule, when applied to a commercial ceramics manufacturer producing government grade ceramic tiles in California and Kentucky, creates considerable distortion where Kentucky produced goods are sent to California for finishing, final inspection and shipment. Furthermore, it is the extent to which the U.S. Government sales flooded Ceradyne's otherwise modest receipts factor that creates the improper assignment of receipts to California. Simply put, the California sales factor that results from the application of the government sales rule to Ceradyne's unique factual situation creates an overall California apportionment percentage that does not fairly represent Ceradyne's business activity taking place in California.

Our most recent submission cited a Legislative Analysts Office report stating that the U.S. Government Sales rule is inherently distortive.[1] However, it was not our intention to make that point our primary complaint. Instead, we wanted the FTB to recognize that where a rule has previously been considered by some to be inherently distortive, its application to Ceradyne's extreme set of facts (in which plates are produced in one state and then sent to another for final assembly) does result in distortion requiring a remedy under CRTC Section 25137.

---

[1] *State Corporate Taxation of Sales to the Federal Government,* LEGISLATIVE ANALYST'S OFFICE, January 1999.

FTB STATEMENT #4 – "Ceradyne's 25137 Petition essentially asks the staff of the Franchise Tax Board to alter the U.S. government sales rule after the Legislature chose not to enact changes to the rule."

Once again, Ceradyne's petition for relief under CRTC Section 25137 is not asking the FTB to alter the government sales rule. In fact, Ceradyne's petition recognizes that the government sales rule is in fact a standard component of the California apportionment factor by showing that the standard factor (including the U.S. government sales rule) results in distortion in this unique factual circumstance.

Furthermore, it is a well-established principle that failed legislation is of little value in determining the Legislature's original intent. (*Frazier Nuts, Inc. v. American AG Credit* (2006) 141 Cal.App.4th 1263, 1272.) The California Supreme Court has repeatedly observed that the Legislature's failure to enact a proposed amendment to an existing statutory scheme offers only limited guidance, if any, concerning the Legislature's original intent. (*Martin v. Szeto* (2004) 32 Cal.4th 445, 451.) Strictly stated, it is irrelevant.

FTB STATEMENT #5 – "The finishing activity in California, which included installing adhesives and backings on ceramic product with both hand and machine labor were much more than mere formalities conducted in California."

We agree that the finishing activities conducted in California amount to more than a mere formality when considered on their own. However, we feel it is appropriate to label them as such when compared to the complicated, proprietary ceramic foundry activities taking place outside of California.

More importantly, whether or not the finishing activities are substantial should play no part in determining whether or not a rule assigning sales of products produced in Kentucky to California results in distortion. During the years at issue, Ceradyne's property and payroll percentages reflected the move to out of state (Kentucky) production in order to meet the high demands of the new government contracts. Nevertheless, Ceradyne's California sales factor remained relatively flat during this period due the presence of these finishing activities in California and a mechanical application of the government sales rule. For this reason, Ceradyne's finishing and shipping activities in California are grossly overrepresented in Ceradyne's California apportionment factor and distortion results.

FTB STATEMENT #6 – "[T]here is no indication that the taxpayer has approached Kentucky, a state with the same government assignment rule as California, to request similar relief to reflect the activities in Kentucky in its Kentucky sales factor numerator, therefore, were the Franchise Tax Board to allow the assignment of the sales to Kentucky, the result would be nowhere income, this is an unreasonable result."

While we appreciate the FTB's attempt to avoid nowhere income by applying an internal consistency test to our request for distortion relief, whether or not Kentucky taxes the sales in question is irrelevant to the required inquiry under CRTC Section 25137. Ceradyne's distortion petition is seeking relief from the gross distortion caused by the application of the government sales rule to Ceradyne's unique factual situation in California. As such, nothing in CRTC Section 25137 requires the agreed upon relief methodology to become a general rule that could be applied to all taxpayers across multiple states.

Furthermore, asking for sales of tangible personal property produced in Kentucky to be assigned to Kentucky does not in itself result in nowhere income. Instead, it reduces Ceradyne's California sales factor to a level that bears some relationship to the activities taking place in California and the market for Ceradyne's products. Absent relief, California is proposing to tax **more than its fair share** of Ceradyne's income based on a sales factor rule that assigns sales destined for the east coast and foreign countries to California. Ceradyne's request for relief merely asks that this unfair result be cured by removing receipts from tangible personal property that is neither sold into nor produced in California from the California sales factor numerator.

B. Gross Distortion

As stated in our prior submissions, the extent and nature of Ceradyne's U.S. Government contracts, combined with California's application of the government sales rule, results in gross distortion that must be cured under CRTC Section 25137.

Following the California Supreme Court's ruling in *Microsoft Corp v. Franchise Tax Board*, it is now clear that distortion must be proven by quantitative and qualitative means. (*Microsoft Corp v. Franchise Tax Board* (2006) 39 Cal. 4th 750, 766; *Appeal of Crisa Corporation* 2002-SBE-004.) For a complete quantitative analysis of the resulting distortion, please refer to the charts, graphs and tables enclosed as Exhibit 1.

From a qualitative standpoint, the first contributing factor to the distortion evident in the present case is that all of Ceradyne's armour manufacturing occurs in two states but final shipment occurs in one state. When the drafters of the Uniform Division of Income for Tax Purposes Act ("UDITPA") conceived of the origin based government sales rule, they intended for taxpayers to be able to assign sales to the U.S. government, where the ultimate destination was often unknown or classified, to the location of the property and payroll responsible for producing the items sold. There is no debating that this rule fails to represent the actual market for the goods, but at least it reinforces the contribution the property and payroll made in producing the revenues. What makes Ceradyne's distortion so evident is the fact that roughly 50% of the ceramic plates sold to the U.S. Government were made outside of California and only passed through this state to be finished and inspected by the U.S. Government. As a result, application of the government sales rule to roughly 50% of Ceradyne's U.S. government sales fails to capture the intention of the rule itself that the sales be assigned to the location of the property and payroll responsible for producing the sales. While the government sales rule may operate fairly in many cases, its application here serves to reach profits which are in no just sense attributable to transactions within California's jurisdiction.

The second contributing factor to the distortion evident in the present case is the pure volume of government sales recorded by Ceradyne during the years at issue. During the years under petition, government sales make up as much as 72% of Ceradyne's total revenues. Therefore, it is clear that the contribution of the property and payroll responsible for producing those assets will be overrepresented in the factor under the government sales rule. In other words, the apportionment formula itself fails to be reflective of the nature of Ceradyne's multistate business when government sales are so large as to diminish any contribution of the market states and merely reflect the property and payroll responsible for producing the sales to the government. During the years under petition, the percentage of the company's California property, payroll and commercial sales decreased dramatically while the overall California apportionment percentage trended down less than half as much and, in fact, actually increased between 2005 and 2006!

What you are left with is an arbitrary assignment of receipts to California from goods that were neither produced in California nor intended to be used in California. In *Container Corp. v. Franchise Tax Board*, the California Supreme Court held,

> ... [w]e will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted... in that State,'... or has 'led to a grossly distorted result."
>
> (*Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159, 169.)

Clearly the assignment of U.S. Government sales to California in the present case results in an apportionment formula that fails to represent the extent of the activities conducted in California and attributes income to this state that is out of all appropriate proportions to the business transacted in California. As such, we pray for relief under the provisions of CRTC Section 25137.

C. Relief

Ceradyne has proposed two alternative relief methodologies in its petition:

1. Destination Sourcing - Remove Government Sales from the California Numerator;

2. Throw out Government Sales from the California Numerator and Denominator;

In prior conversations and written correspondence, Ceradyne, in response to FTB requests, has indicated a willingness to work with the department to develop a modified sales factor based on the assignment of government sales revenues to Kentucky for the actual plates that were produced in Kentucky or through the assignment of a portion of all revenues from government sales to Kentucky based on a production cost ratio of California versus Kentucky. Ceradyne remains willing to continue this dialogue on developing an appropriate remedy should the FTB agree that the government sales rule as applied to Ceradyne unique factual situation during the petition years results in distortion under CRTC Section 25137.

Very truly yours,

Jon A. Sperring
Partner, State and Local Tax

cc: Mr. Brian C. Miller, Tax Counsel III, Franchise Tax Board
Mr. Joel P. Moskowitz, CEO, Ceradyne Inc.
Mr. Jerrold J. Pellizon, CFO, Ceradyne Inc.
Mr. Lance Wood, Partner, PricewaterhouseCoopers LLP
Mr. Chris Whitney, Partner, PricewaterhouseCoopers LLP

Exhibit 1

Ceradyne
Distortive Impact of Government Sales to the Apportionment Formula ~ Summary
2003 ~ 2008

2008 As Filed		2008 Without Government Sales		2008 Impact		
Property	22.1590%	Property	22.1590%	----	ABSOLUTE	RELATIVE
Payroll	32.3375%	Payroll	32.3375%	----		
Sales	66.3550%	Sales	18.5833%	47.7717%	IMPACT	IMPACT
Sales	66.3550%	Sales	18.5833%	47.7717%		
TOTAL	**46.8016%**	TOTAL	**22.9158%**	**23.8858%**	**24%**	**104%**
			RELATIVE	**104.2330%**	**(*Merrill, Lynch)**	**(*Hans Rees')**

2007 As Filed		2007 Without Government Sales		2007 Impact		
Property	27.5241%	Property	27.5241%	----	ABSOLUTE	RELATIVE
Payroll	40.5653%	Payroll	40.5653%	----		
Sales	76.3970%	Sales	21.3957%	**55.0013%**	IMPACT	IMPACT
Sales	76.3970%	Sales	21.3957%	**55.0013%**		
TOTAL	**55.2209%**	TOTAL	**27.7202%**	**27.5007%**	**28%**	**99%**
			RELATIVE	**99.2080%**		

2006 As Filed		2006 Without Government Sales		2006 Impact		
Property	32.2251%	Property	32.2251%	----	ABSOLUTE	RELATIVE
Payroll	43.3906%	Payroll	43.3906%	----		
Sales	70.4116%	Sales	23.8305%	**46.5811%**	IMPACT	IMPACT
Sales	70.4116%	Sales	23.8305%	**46.5811%**		
TOTAL	**54.1097%**	TOTAL	**30.8192%**	**23.2906%**	**23%**	**76%**
			RELATIVE	**75.5717%**		

2005 As Filed		2005 Without Government Sales		2005 Impact		
Property	30.3222%	Property	30.3222%	----	ABSOLUTE	RELATIVE
Payroll	36.9108%	Payroll	36.9108%	----		
Sales	61.4134%	Sales	19.3943%	**42.0191%**	IMPACT	IMPACT
Sales	61.4134%	Sales	19.3943%	**42.0191%**		
TOTAL	**47.5150%**	TOTAL	**26.5054%**	**21.0096%**	**21%**	**79%**
			RELATIVE	**79.2653%**		

2004 As Filed		2004 Without Government Sales		2004 Impact		
Property	36.4270%	Property	36.4270%	----	ABSOLUTE	RELATIVE
Payroll	54.0344%	Payroll	54.0344%	----		
Sales	68.5787%	Sales	39.9833%	**28.5953%**	IMPACT	IMPACT
Sales	68.5787%	Sales	39.9833%	**28.5953%**		
TOTAL	**56.9047%**	TOTAL	**42.6070%**	**14.2977%**	**14%**	**34%**
			RELATIVE	**33.5571%**		

2003 As Filed		2003 Without Government Sales		2003 Impact		
Property	70.7799%	Property	70.7799%	----	ABSOLUTE	RELATIVE
Payroll	70.6837%	Payroll	70.6837%	----		
Sales	75.1849%	Sales	52.6203%	**22.5646%**	IMPACT	IMPACT
Sales	75.1849%	Sales	52.6203%	**22.5646%**		
TOTAL	**72.9583%**	TOTAL	**61.6760%**	**11.2823%**	**11%**	**18%**
			RELATIVE	**18.2928%**		

* *Absolute Impact, 22.9158%-46.8016%=24%; Computation is consistent with Merrill, Lynch, Pierce, Fenner & Smith, Inc., 89-SBE-017, June 2, 1989.*
* *Relative Impact, 23.8858/22.9158%=104%; Computation consistent with Hans Rees' Sons, Inc., v. North Carolina, 283 U.S. 123,135 (75 L.Ed. 879)(1931).*

Ceradyne
Distortive Impact of Government Sales to the Apportionment Formula & Tax
2003 ~ 2008

TOTAL IMPACT	RANGE	TAX
Absolute Impact to Apportionment Formula	**11 ~ 28%**	
Relative Impact to Apportionment Formula	**18 ~ 104%**	
Total Tax Impact		**$14,859,317**

2008

As Filed				Without Government Sales				Impact		
Property		22.1590%		Property		22.1590%		----		
Payroll		32.3375%		Payroll		32.3375%		----	**ABSOLUTE**	**RELATIVE**
Sales		66.3550%		Sales		18.5833%		47.7717%		
Sales		66.3550%		Sales		18.5833%		47.7717%	**IMPACT**	**IMPACT**
TOTAL		**46.8016%**		**TOTAL**		**22.9158%**		**23.8858%**		
Apportionable Income	$	163,579,384		Apportionable Income	$	163,579,384		----	**24%**	**104%**
Taxable Income	$	76,557,810		Taxable Income	$	37,485,484	$	39,072,326		
Tax rate		8.84%		Tax rate		8.84%		----		
Tax	**$**	**6,767,710**		**Tax**	**$**	**3,313,717**	**$**	**3,453,994**		
				Net Tax Change	$	(3,453,994)				
Government Sales	$	363,272,286	54%						***Merrill, Lynch**	***Hans Rees'**
Other Sales	$	305,819,673	46%			**Absolute Impact**		**23.8858%**		
Total Sales	$	669,091,959	100%			**Relative Impact**		**104.2330%**		

2007

As Filed				Without Government Sales				Impact		
Property		27.5241%		Property		27.5241%		----		
Payroll		40.5653%		Payroll		40.5653%		----	**ABSOLUTE**	**RELATIVE**
Sales		76.3970%		Sales		21.3957%		**55.0013%**		
Sales		76.3970%		Sales		21.3957%		**55.0013%**	**IMPACT**	**IMPACT**
TOTAL		**55.2209%**		**TOTAL**		**27.7202%**		**27.5007%**		
Apportionable Income	$	218,751,333		Apportionable Income	$	218,751,333		----	**28%**	**99%**
Taxable Income	$	120,796,345		Taxable Income	$	60,638,307	$	60,158,038		
Tax rate		8.84%		Tax rate		8.84%		----		
Tax	**$**	**10,679,207**		**Tax**	**$**	**5,360,426**	**$**	**5,318,781**		
				Net Tax Change	$	(5,318,781)				
Government Sales	$	512,002,341	66%							
Other Sales	$	258,258,605	34%			**Absolute Impact**		**27.5007%**		
Total Sales	$	770,260,946	100%			**Relative Impact**		**99.2080%**		

- *Absolute Impact, 22.9158%-46.8016%=24%; Computation is consistent with Merrill, Lynch, Pierce, Fenner & Smith, Inc., 89-SBE-017, June 2, 1989.*
- *Relative Impact, 23.8858/22.9158%=104%; Computation consistent with Hans Rees' Sons, Inc., v. North Carolina, 283 U.S. 123,135 (75 L.Ed. 879)(1931).*

Ceradyne
Distortive Impact of Government Sales to the Apportionment Formula & Tax
2003 ~ 2008

2006

As Filed				Without Government Sales				Impact	ABSOLUTE IMPACT	RELATIVE IMPACT
Property		32.2251%		Property		32.2251%		----	23%	76%
Payroll		43.3906%		Payroll		43.3906%		----		
Sales		70.4116%		Sales		23.8305%		**46.5811%**		
Sales		70.4116%		Sales		23.8305%		**46.5811%**		
TOTAL		**54.1097%**		**TOTAL**		**30.8192%**		**23.2906%**		
Apportionable Income	$	196,517,488		Apportionable Income	$	196,517,488		----		
Taxable Income	$	106,335,029		Taxable Income	$	60,565,022	**$**	**45,770,007**		
Tax rate		8.84%		Tax rate		8.84%		----		
Tax	**$**	**9,400,016**		**Tax**	**$**	**5,353,948**	**$**	**4,046,068**		
				Net Tax Change	$	(4,046,068)				
Government Sales	$	483,180,686	72%							
Other Sales	$	191,489,204	28%			**Absolute Impact**		**23.2906%**		
Total Sales	$	674,669,890	100%			**Relative Impact**		**75.5717%**		

2005

As Filed				Without Government Sales				Impact	ABSOLUTE IMPACT	RELATIVE IMPACT
Property		30.3222%		Property		30.3222%		----	21%	79%
Payroll		36.9108%		Payroll		36.9108%		----		
Sales		61.4134%		Sales		19.3943%		**42.0191%**		
Sales		61.4134%		Sales		19.3943%		**42.0191%**		
TOTAL		**47.5150%**		**TOTAL**		**26.5054%**		**21.0096%**		
Apportionable Income	$	73,931,784		Apportionable Income	$	73,931,784		----		
Taxable Income	$	35,128,652		Taxable Income	$	19,595,905	**$**	**15,532,747**		
Tax rate		8.84%		Tax rate		8.84%		----		
Tax	**$**	**3,107,776**		**Tax**	**$**	**1,732,278**	**$**	**1,375,498**		
				Net Tax Change	$	(1,375,498)				
Government Sales	$	192,895,483	52%							
Other Sales	$	177,695,345	48%			**Absolute Impact**		**21.0096%**		
Total Sales	$	370,590,828	100%			**Relative Impact**		**79.2653%**		

2004

As Filed				Without Government Sales				Impact	ABSOLUTE IMPACT	RELATIVE IMPACT
Property		36.4270%		Property		36.4270%		----	14%	34%
Payroll		54.0344%		Payroll		54.0344%		----		
Sales		68.5787%		Sales		39.9833%		**28.5953%**		
Sales		68.5787%		Sales		39.9833%		**28.5953%**		
TOTAL		**56.9047%**		**TOTAL**		**42.6070%**		**14.2977%**		
Apportionable Income	$	43,265,611		Apportionable Income	$	43,265,611		----		
Taxable Income	$	24,620,157		Taxable Income	$	18,434,187	$	6,185,970		
Tax rate		8.84%		Tax rate		8.84%		----		
Tax	**$**	**2,178,823**		**Tax**	**$**	**1,629,582**	**$**	**549,241**		
				Net Tax Change	$	(549,241)				
Government Sales	$	118,993,256	54%							
Other Sales	$	100,042,376	46%			**Absolute Impact**		**14.2977%**		
Total Sales	$	219,035,632	100%			**Relative Impact**		**33.5571%**		

Ceradyne
Distortive Impact of Government Sales to the Apportionment Formula & Tax
2003 ~ 2008

2003									
As Filed				**Without Government Sales**				**Impact**	
Property		70.7799%		Property		70.7799%		----	
Payroll		70.6837%		Payroll		70.6837%		----	
Sales		75.1849%		Sales		52.6203%		**22.5646%**	
Sales		75.1849%		Sales		52.6203%		**22.5646%**	
TOTAL		**72.9583%**		**TOTAL**		**61.6760%**		**11.2823%**	
Apportionable Income	$	11,363,442		Apportionable Income	$	11,363,442		----	
Taxable Income	$	8,290,579		Taxable Income	$	7,008,522	$	1,282,057	
Tax rate		8.84%		Tax rate		8.84%		----	
Tax	**$**	**735,288**		**Tax**	**$**	**619,553**	**$**	**115,735**	
				Net Tax Change	$	(115,735)			
Government Sales	$	54,996,733	54%						
Other Sales	$	46,784,133	46%			**Absolute Impact**		**11.2823%**	
Total Sales	$	101,780,866	100%			**Relative Impact**		**18.2928%**	

ABSOLUTE IMPACT	RELATIVE IMPACT
11%	**18%**

State of California
Franchise Tax Board
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FILE COPY

Date: 04.01.10

Case: 6920373994215256
Case Unit: 6920373994215416
In reply refer to: 410:BCM

Jon Sperring
PricewaterhouseCoopers
400 Capitol Mall, Suite 600
Sacramento CA 95814

Regarding: Ceradyne, Inc. Section 25137 Petition Reconsideration
Taxable Years: 2003, 2004, 2005, 2006 and 2007

Dear Mr. Sperring:

This letter is to inform you that after reconsideration of your client Ceradyne's Section 25137 Petition, including information and arguments provided by you for our February 25, 2010 meeting, and other material you submitted in support of the petition, the Franchise Tax Board (Department) staff regrets to inform you that the denial your client's Section 25137 Petition is reaffirmed.

The facts of the petition are not in dispute. Ceradyne manufactures ceramic materials that are used in various industries, including automotive, electronic, semiconductor, and aerospace. Ceradyne also manufactures proprietary ceramic tiles that are assembled with other material and sold to the U.S. military as body armor inserts. Ceradyne's sales of body armor inserts to the U.S. government increased during the years in issue. Overall sales to the U.S. government were 34 percent of Ceradyne's sales in 2002. But from 2003 through 2007, sales to the U.S. government accounted for between 52 percent and 76 percent of the company's sales. Ceradyne stated in its Section 25137 Petition that the company focused on the sale of ceramic products to the defense market in response to U.S. government demand, and revenue gains were largely from the significant increase in U.S. government sales. Ceradyne's revenues grew from roughly $61 million in 2002 to about $662 million in 2006.

In 2003 and 2004, Ceradyne manufactured nearly all of the body armor ceramics at its Costa Mesa, California, and Irvine, California, facilities. The company, in response to the surge in demand, expanded a pre-existing Lexington, Kentucky facility in 2003. Ceradyne expanded the Kentucky plant rather than the California plant in part because Kentucky energy costs were lower than California energy costs. By 2005, about half of all body armor ceramics were manufactured in Kentucky. Despite their manufacture in Kentucky, the body armor ceramics returned to California for final assembly and inspection. Ceradyne's assembly equipment, warehouse facilities and other infrastructure were in place in California before the company expanded its ceramic tile manufacturing activity in Kentucky. Ceradyne made a business decision to ship the ceramic tiles from Kentucky to California for finishing rather than build a redundant finishing infrastructure in Kentucky. Finished body armor inserts were inspected by a U.S. government representative stationed at Ceradyne's Costa Mesa facility[1]. The body armor inserts that passed inspection were packaged, labeled and shipped from Costa Mesa for delivery to the U.S. government. Ceradyne does not dispute that under the standard sales factor rule, contained in Revenue and Taxation Code section 25135 (b)(1), the sales are properly assigned to the California sales factor numerator.[2]

Ceradyne's Section 25137 Petition, accompanied by amended tax returns for taxable years 2003 through 2007, asks the Department to eliminate representation of sales to the U.S. government from the California sales factor numerator. Ceradyne's claims for taxable years 2003 through 2007 are estimated to total at least $8.7 million in tax refunds.

As Department staff previously informed you by letter dated December 15, 2009, staff was recommending denial of the petition because the taxpayer did not establish that the standard allocation and apportionment provisions unfairly represent the extent of Ceradyne's California business activity. The taxpayer then furnished additional argument and exhibits, dated February 23, 2010 and a meeting was held with the taxpayer's representatives on February 25, 2010.

In our meeting we discussed staff's concerns that the petition, if granted, would effectively lead to an override of the government sales rule contained in section 25135 for all defense contractors, because the taxpayer has not shown any unique or unusual circumstance that would merit relief based on its facts.[3] The taxpayer countered, in its February 23rd letter, that the unusual circumstance present in this matter is that "Kentucky based goods are sent to California for finishing, final inspection, and shipment," and that the large amount of sales to the U.S. government "flooded Ceradyne's otherwise modest receipts factor," causing "an overall California apportionment percentage that does not fairly represent Ceradyne's business activity taking place in California".

Unfortunately, staff is unable to agree that manufacturing in two states, with final assembly, inspection and shipping from one, but not the other, is an unusual fact situation distinguishing this taxpayer enough to warrant granting relief on that basis. It is not unusual for companies to

---

[1] The taxpayer's contract with the U.S. government required all goods, regardless of where they were manufactured, to be shipped to California for inspection.

[2] Revenue and Taxation Code section 25135 provides:

> Sales of tangible personal property are in this state if:
>
> (a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale.
> (b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

[3] The Board of Equalization stated, in *Appeal of Crisa Corp.* 2002-SBE-004 (June 20, 2002), that "the central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula."

take advantage of differences in labor and other costs in differing jurisdictions in order to manufacture products at the lowest possible expense.

The taxpayer's argument that the receipts from sales to the U.S. government "flooded" the sales factor" is also unpersuasive, because the argument fails to acknowledge that the sales at issue resulted in the lion's share of the taxpayer's income subject to apportionment. The taxpayer's 2007 10-K states: "We currently receive more than 74.0% of our revenues and more than 90.0% of our profits from sales of defense-related products." Given this strong relationship between the receipts at issue and the income being apportioned, staff is unable to conclude that the amount of receipts included in the sales factor numerator is inappropriate.

We also discussed the taxpayer's view of the case law regarding distortion. The taxpayer argued that it has shown distortion under the California Supreme Court case *Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4th 750. However, as we explained at the meeting, *Microsoft* is factually distinguishable from this petition. In *Microsoft*, the activity in issue was ancillary to the main line of business and produced an inconsequential amount of income, yet represented a large amount of the receipts that were included in the sales factor. This combination of an ancillary activity and a large effect on the assignment of income through the sales factor is simply not present in this matter. In this case, the activity in question *is* the taxpayer's main income generator, and representing this activity in the sales factor assigns income appropriately.

Upon further reflection, it appears that the taxpayer's real complaint is that the sales factor should represent the market and that the government sales rule is not a market rule. While it is true that the rule is based on shipping location and not the destination of the goods, this does not mean that the rule is incorrect or that the standard formula results in distortion. If all that was required for relief were a showing that the standard rule is not "market," all taxpayers with sales to the government would be entitled to relief. This would effectively write section 25135(b)(1) out of the Code, a position the taxpayer is not advocating for in this matter.

It is clear that the taxpayer believes that a market approach would be better for California based government contractors. However, it is not enough that the taxpayer comes up with a formula that it believes is "better" than the standard formula. A similar argument was made by the FTB, and rejected by the Board of Equalization, in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017 (June 2, 1989), where the Board stated:

> The FTB has also attempted to justify application of section 25137 by contending that its method is "better" than the standard formula. We have consistently rejected this type of argument as unavailing; what must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected.

There may be good policy reasons why a switch to a destination rule would be "better" for California based government contractors, and the taxpayer is certainly free to argue for such a change. However, the staff of the FTB is not the proper forum to make such arguments. The Legislature has the power to change the law; the staff of the Franchise Tax Board does not.

Staff also believes there are tax policy reasons that support the use of shipping location for the assignment of U.S. government sales. Perhaps the most obvious of these is that there really is no easily definable "market" for sales to the U.S. government. The U.S. government is located in all 50 states and may choose to take delivery in any place it feels is appropriate. The final destination of the goods it purchases may be in other states or other countries, as needed. The Legislative Analyst's Office (LAO) discussed these issues in a January 1999 report on the taxation of corporate sales to the federal government (copy attached):

> 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 LAO report also points to the ease of administering the current rule and the uniformity of the rule, as additional reasons justifying the use of a "shipped to" rule instead of a "destination" rule for U.S. government sales.

FTB staff also has concerns about the remedy that the taxpayer has suggested. The taxpayer seeks to remove the sales from the California numerator while maintaining the sales in the denominator. This is meant to reflect "the market" but it leads to all of the government sales escaping assignment entirely and a large amount of the taxpayer's income escaping tax. This is unacceptable.

During the petition process the taxpayer also raised the possibility of "throw out" which would remove the government sales from both the numerator and denominator of the sales factor. While this could potentially avoid the "nowhere income" issue raised by the numerator exclusion (assuming the taxpayer were to file amended returns in all of the states where it does business to reflect the new denominator), it results in assigning income from the taxpayer's largest revenue generating activity to various locations that had nothing whatsoever to do with the manufacturing and sale of the body armor.

Finally, the taxpayer offers to work with the FTB to develop a system to assign the sales between California and Kentucky, which, if it were found that the inclusion of the sales in the California numerator were in fact causing an unfair representation of the taxpayer's activities, seems a more reasonable alternative. However, when questioned further about this, the taxpayer, in its

February 23rd letter, opined that "whether or not Kentucky taxes the sales in question is irrelevant".

Staff must disagree. Kentucky utilizes the same "shipped to" rule as California.[4] If staff accepted the taxpayer's argument that distortion is caused by manufacturing in both states but shipping from only California, then the most logical remedy for that distortion would be to assign the receipts from Kentucky manufactured products to Kentucky. Kentucky law would then operate to ensure that these sales are in the Kentucky sales factor numerator. This results in all of the sales being assigned to the two states where the manufacturing occurred.

The unwillingness of the taxpayer to discuss its filing position in Kentucky goes to the reasonableness of the alternative it offers. By refusing to take its Kentucky filing position into consideration, the taxpayer undermines its efforts and leads to the conclusion that it is not interested in discussing this option further.

In summary, application of the U.S. government sales rule to Ceradyne, whose business predominately sold products to the U.S. government, does not result in an unfair representation of the extent of Ceradyne's California business activity. While I appreciated the opportunity to reexamine Ceradyne's Section 25137 Petition, Department staff regretfully recommends that the petition be denied.

Very truly yours,

Carl Joseph
Assistant Chief Counsel,
Chief, Multistate Tax Bureau

cc: Brian Miller
Yvette Stowers, State Board of Equalization

Enclosure:
LAO Report on State Corporate Taxation of Sales to the Federal Government

[4] Ky. Rev. Stat. Ann. § 141.120(8)(c)(2)(b)

LAO
55 Years of Service

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.

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.

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.

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.

Acknowledgments

This report was prepared primarily by Brad Williams, with contributions by David Vasché. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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LEGISLATIVE ANALYST'S OFFICE, JANUARY 1999

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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).

Figure 1

The Standard Corporate Apportionment Formula

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

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.

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.

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.

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.

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 yearsone 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 California 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 directionsboth 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 clearnamely, 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 lawa switch to destination, changing the weighting of the U.S. government sales factor, or some other alternativeit 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.

Acknowledgments	LAO Publications
This report was prepared primarily by Brad Williams, with contributions by David Vasché. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.	To request publications call (916) 445-2375. This report and others, as well as an E-mail subscription service, are available on the LAO's Internet site at www.lao.ca.gov. The LAO is located at 925 L Street, Suite 1000, Sacramento, CA 95814.

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SENT VIA FACSIMILIE

August 18, 2010

Mr. Carl Joseph
Assistant Chief Counsel - Multistate Tax Bureau
Franchise Tax Board - Legal Division
PO Box 1720
Sacramento, CA 95812-1720

Dear Mr. Joseph:

We are submitting this letter in response to your reconsideration letter dated April 1, 2010. We ask that you consider the following arguments in support of Ceradyne, Inc.'s ("Ceradyne's") California Revenue and Taxation Code Section ("CRTC") Section 25137 Petition.

Distortion

Ceradyne is seeking relief under CRTC Section 25137 because the government sales rule contained in CRTC Section 25135(b)(1), when applied to Ceradyne's unique facts, leads to a systematic undercounting of Ceradyne's out of state activities. Simply put, the government sales rule creates a situation in which Ceradyne's California property and payroll is hyper weighted to the detriment of Ceradyne's out of state property and payroll because final assembly of Ceradyne's government products takes place entirely in California[1]. This results in an unfair amount of income being apportioned to California by overstated activities that bear little to no relationship to the manner in which the income was actually generated.

During most of the years at issue, Ceradyne produced more than half of the ceramic plates sold to the U.S. Government in its state of the art facility in Lexington, Kentucky. This production facility was built at the request of the U.S. Government to meet the increased armor needs of our troops in Afghanistan and Iraq. With an additional production line and larger and more efficient furnaces, Ceradyne's Kentucky facility was able to produce the larger front and back plates needed for a bulletproof vest, while Ceradyne's existing facility in California focused on the smaller side plates. Despite these substantial out of state production activities, all of Ceradyne's receipts from the sale of ceramic body armor to the U.S. Government were sourced to California due to the fact that final assembly occurred at Ceradyne's original facility in Orange County.

While many large scale defence contractors manufacture multiple government products in multiple facilities, Ceradyne only manufactures one government product in two facilities and that single product represents between 52% and 76% of Ceradyne's overall receipts during the years at issue. Therefore, while the government sales rule may be an appropriate means of sourcing U.S. government sales in other contexts, it results in gross distortion when applied to Ceradyne's

[1] This "hyper weighting" of Ceradyne's California property and payroll results from Ceradyne's government sales being entirely attributable to California pursuant to the "shipped from" rule under CRTC 2513(b)(1).

limited government sales business. For this reason, Ceradyne is not asking the FTB to strike down the government sales rule in general, but rather to grant relief in an isolated instance in which a fair reflection of Cerayne's California activities is not achieved under the standard formula.

Furthermore, while we agree with your contention that "[t]here may be good policy reasons why a switch to a destination rule would be 'better' for California based government contractors" (FTB Response Letter, dated April 1, 2010, p. 3), we are not asking the FTB to find distortion merely because market based sourcing is not achieved in this instance. Instead, we are asking for distortion relief where Ceradyne's California sales factor fails to reflect either the market for the government sales or the location of the activities responsible for generating the government sales, and instead arbitrarily assigns receipts to California. This failure of the sales factor to reflect any activities taking place outside of California results in the overrepresentation of Ceradyne's California activities in the overall apportionment formula. In your letter of April 1, 2010, you state that there are also "tax policy reasons that support the use of shipping location for the assignment of U.S. government sales." Ceradyne is aware of arguments proffered for choosing "shipped from" over "destination" for sales to the U.S. government. However, the FTB is failing to recognize that the drafters of UDITPA never anticipated a single product being produced in two states but shipped entirely from one state when they settled on the "shipped from" compromise. Instead, the government sales rule was adopted in an era when products were mostly manufactured within one state, and most states apportioned income without reference to a sales factor. In this era, a shipped from rule was seen as a *de facto* property and payroll formula for government contractors. As such, there was little concern of distortion arising from the "shipped from" rule since it would result in the attribution of receipts to the location of the property and payroll factors responsible for producing the products.

In contrast to the manufacturers in existence during the 1950's, Ceradyne's receipts are not being assigned to the location of the property and payroll factors responsible for producing the products. Instead, Ceradyne's California property and payroll factors are being hyper weighted to the detriment of Ceradyne's out of state government production facilities, when applying the "shipped from" rule under CRTC Section 25135(b)(1). This incongruous result is why the standard formula results in distortion that must be remedied under CRTC Section 25137.

In your April 1, 2010 letter, you stated that "*Microsoft* is factually distinguishable from this petition." While it is true that the government sales rule invokes different distortion considerations than those present in the treasury receipts cases, the rule of law enunciated in *Microsoft Corp. v. Franchise Tax Board* remains applicable to this petition. In *Microsoft*, the California Supreme Court found that the relief provisions of CRTC Section 25137 may apply where the formula does not fairly represent a unitary business's activities in a given state... (*Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4th 750, 770, *citing In the Matter of the Appeal of Crisa Corp.* (June 20, 2002) [2000-2003 Transfer Binder] Cal.Tax.Rptr. (CCH). As a result of applying the above stated rule to Microsoft's facts, the California Supreme Court held that "application of the standard formula does not fairly represent the extent of Microsoft's business in California." (*Microsoft, supra* at 771.)

The assignment of Ceradyne's government sales representing between 52% and 76% of Ceradyne's total receipts during this period to California systematically dilutes the armor production activities occurring in Kentucky just as the inclusion of receipts generated by a low margin treasury function conducted outside of California systematically diluted the contributions of Microsoft's software receipts attributable to California when the treasury receipts were 73% of the total receipts.

Your most recent response claims that "staff is unable to agree that manufacturing in two states, with final assembly, inspection and shipping from one, but not the other, is an unusual fact situation distinguishing this taxpayer enough to warrant granting relief on that basis." (FTB Response Letter, dated April 1, 2010, p. 2) Ceradyne maintains that their production and shipping situation is unique and would welcome a showing by the FTB of a similarly situated taxpayer generating between 52%-76% of its receipts from the sale of a single product to the United States government that happens to also be manufactured in multiple states. However, as we discussed at our protest hearing on February 25, 2010, Ceradyne also disputes the FTB's reliance on *Appeal of Crisa Corp.* to require that any party wishing to invoke CRTC Section 25137 be factually unique from its colleagues. In fact, this requirement was expressly rejected by the California Supreme Court in *Microsoft*. In an unsuccessful attempt to preclude the FTB from invoking CRTC Section 25137 under the Board of Equalization's decision in *Appeal of Crisa Corp.*, Microsoft argued that there was nothing unique about maintaining a corporate treasury department in one state and generating large trading receipts includable in the California sales factor denominator. In response, the California Supreme Court stated, "[w]hile Revenue and Taxation Code section 25137 'ordinarily' applies to nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains an inquiry into whether the formula 'fairly represents' a unitary business's activities in a given state, and when it does not, the relief provision may apply." (*Microsoft, supra* at 770.)

Ceradyne has also provided the FTB with a detailed, quantitative analysis showing that the distortion caused by the application of the government sales rule to Ceradyne's unique set of facts results in a relative change to Ceradyne's apportionment factor of more than 100%. In the *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (*"Merrill Lynch"*), the Board of Equalization found that a relative change in the taxpayer's overall apportionment factor of less than 36% was, as the Supreme Court noted in *Container Corp.*, "a far cry from the more than 250 percent difference which led us to strike down the state tax in *Hans Rees' Sons, Inc.*, and a figure certainly within the *substantial margin of error* inherent in any method of attributing income amongst the components of a unitary business." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* 89-SBE-017, citing *Container Corp. v. Franchise Tax Board* (1980) 463 U.S. Unlike the taxpayer in *Appeal of Merrill Lynch, et. al.*, Ceradyne's relative apportionment percentage change of more than 100% can not be said to be within the substantial margin of error inherent in any method of attributing income and is more akin to the gross distortion found in *Hans Rees*.

Remedy

Ceradyne has offered two reasonable alternative remedies designed to cure the systematic distortion caused by the application of CRTC Section 25135(b)(1) to government products manufactured in two states but assembled and shipped from one state. Ceradyne's initial remedy of removing government sales from the California numerator would have the effect of eliminating the sales responsible for the distortion from California consideration.

Ceradyne would also accept a remedy that removes the government sales from both the California sales factor numerator and denominator. This alternative avoids the potential for nowhere income and results in a California sales factor that accurately represents the market for Ceradyne's goods.

Conclusion

We sincerely hope that the FTB recognizes the inherent distortion in assigning 100% of Ceradyne's government sales, representing between 52% and 76% of Ceradyne's gross receipts, to California when California is neither the market nor the sole production state of the ceramic plates sold to the U.S. Government.

Thank you for your consideration, and we look forward to hearing from you soon.

Sincerely,

Jon A. Sperring

Partner, NTS - SALT

cc The Honorable John Chiang, Chair, Franchise Tax Board
The Honorable Betty T. Yee, Member, Franchise Tax Board
The Honorable Ana J. Matosantos, Member, Franchise Tax Board

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Date: 11.03.10

Case: 6920373994215256
Case Unit: 6920373994215416
In reply refer to: 410:BCM

Jon Sperring
PricewaterhouseCoopers
400 Capitol Mall, Suite 600
Sacramento CA95814

Regarding: Ceradyne, Inc. Section 25137 Petition Reconsideration
Taxable Years: 2003, 2004, 2005, 2006 and 2007

Dear Mr. Sperring:

This letter is to inform you that the Franchise Tax Board (Department) staff, after due consideration of new and renewed arguments you submitted on behalf of your client Ceradyne in a letter dated August 18, 2010, reaffirms denial of your client's Section 25137 Petition. While staff appreciates that the taxpayer continues to disagree with this determination, the information and argument provided in your recent letter does not provide a basis for staff to change its determination as set forth in the Department's letter of December 15, 2009, and reaffirmed in the Department's April 1, 2010 letter.

Your letter of August 18, 2010 states that the drafters of the Uniform Division of Income for Tax Purposes Act (UDITPA) "never anticipated a single product being produced in two states but shipped entirely from one state" when crafting the U.S. government sales destination rule. (Rev. and Tax Code section 25135(a)(2).) You also state in the letter that UDITPA was created during an era when products were mostly manufactured in one state, and that most states apportioned income without reference to a sales factor. You did not, however, provide any supporting evidence for these claims. Department staff did not find anything in the record to support your claims about the creation of UDITPA and historic business practices of that era.

Your August 18, 2010 letter also asserts that your client's operations are unique, and states that you would "welcome" a showing by Department staff to disprove your assertion. As petitioner, your client bears the burden to prove with clear and convincing evidence that it is entitled to relief under Section 25137. Department staff does not bear the burden to disprove your client's unsupported assertions.

In addition, I believe you misconstrue the staff analysis of this issue. By pointing out that the taxpayer has not shown anything unusual about its business, staff is determining that the standard rule in this case is working as intended, in a fact pattern it was intended to address, and that the taxpayer has not shown anything about its facts that lead to an unintended result.

The taxpayer's position in this matter essentially seeks to change the rule for U.S. government sales to a market (destination) rule because it finds it unfair to assign government sales to the state of shipping. By attacking the standard rule in this way, the taxpayer is in effect arguing that the standard formula, when operating as intended, is causing distortion. This calls into question whether the standard rule can be overridden solely because it is not a market rule. As staff has explained, the Legislature sets the standard rules and in this situation the Legislature determined that a market rule was not the best way to assign receipts for sales to the U.S. government. Staff cannot override this determination merely because a different rule would provide a result that is more acceptable to the taxpayer.

Rather, the taxpayer must show that the standard rule, when applied to its facts, causes an unfair representation of the extent of its business activities in this state. By putting the "shipped from" rule in the Code, it is clear that the Legislature did not find assigning receipts for sales to the U.S. government to the shipping location to result in an unfair representation for most taxpayers.

The petitioner must therefore show something in its facts that leads to unfair representation, something that shows that the rules are not working as intended. The taxpayer has not done so in this matter. The facts of this petition illustrate a typical situation where sales are made to the U.S. government and the goods are used by the government in locations outside California. Any perceived unfairness is therefore a result of the rule itself and relief cannot be granted on that basis.

You also state in the letter that your client would be willing to remove government sales gross receipts from the sales factor numerator. As I stated in my April 1, 2010 letter, removing receipts from the sales factor numerator creates nowhere income and therefore, even if the taxpayer had met its burden to show an unfair representation of its activities in the state, its alternative formula would be unreasonable.

In addressing your second alternative, removing the receipts from the numerator and the denominator, the letter of April 1, 2010 explained that throwing out the receipts from the sales factor numerator and denominator results in assigning income from the taxpayer's largest revenue generating activity to states that had nothing whatsoever to do with the manufacturing and sale of body armor. This is also an unreasonable alternative.

In summary, application of the U.S. government sales rule to Ceradyne, whose business is predominately the sale of products to the U.S. government, does not result in an unfair representation of the extent of Ceradyne's California business activity. While I appreciate the opportunity to once again reexamine Ceradyne's Section 25137 Petition, Department staff regretfully must continue to recommend that the petition be denied.

Very truly yours,

Carl Joseph
Assistant Chief Counsel,
Chief, Multistate Tax Bureau

cc: Brian Miller, Tax Counsel III

PRICEWATERHOUSECOOPERS

November 29, 2010

Ceradyne's Response to FTB Staff Summary and Recommendation[1]

FTB Argument #1 - Staff believes that the standard formula is functioning as intended.

Ceradyne's Response - The standard formula is not working as intended in Ceradyne's factual situation because it results in an artificial inflation of California activities and does not capture Kentucky's contribution as an equivalent manufacturing state. The general sales factor destination rule is designed to give weight to the market states as opposed to the property and payroll factors, which reflect the income attributable to the manufacturing and producing states. However, sales to the U.S. government follow the origin rule based on the theory that "[the sales] are not necessarily attributable to a market existing in the state to which the goods are originally shipped." (UDITPA § 16 (comment).) In this situation, the drafters of UDITPA decided to "throw back" the government sales to the state of origin, which is the manufacturing and producing state. (*See generally*, Hellerstein, State Taxation (WG&L), ¶ 8.06.) Thus, if the government sales rule is functioning as intended, it will have the effect of only reflecting activities attributable to the manufacturing and producing states with respect to government sales.

However, in Ceradyne's factual situation, the standard formula is not working as the UDITPA drafters intended. The standard formula as applied to Ceradyne is not reflective of the activity and income attributable to all of the manufacturing states. Ceradyne has a unique situation in which it is manufacturing government grade ceramic tiles in both California and Kentucky, but its manufacturing activities in Kentucky are not being fairly represented in the standard formula because Kentucky produced goods are sent to California for finishing, final inspection and shipment. This results in an unfair amount of income being apportioned to California by overstated activities that bear little to no relationship to the manner in which the income was actually generated.

FTB Argument #2 - It is unreasonable to believe that at the time UDITPA was drafted the drafters would have included in the standard formula a rule that, when functioning

[1] "Staff Summary and Recommendation, Section 25137 Petition, Ceradyne, Inc." dated December 2, 2010 (released prior to 12/2/2010).

as intended, operated to unfairly represent the activities of the taxpayer in this state such that relief may be granted under section[2] 25137.

Ceradyne's Response - As explained in the response to FTB Argument #1 above, the standard formula is not working as intended in Ceradyne's factual situation because it results in an artificial inflation of California activities and fails to appropriately capture Kentucky's contribution as an equivalent manufacturing and producing state. The drafters of UDITPA recognized from the very beginning that there would be situations like this in which the standard formula (including the government sales rule) would not fairly represent the activities of the taxpayer. That is why the drafters of UDITPA included a "safety valve" provision, Section 18 of UDITPA, which was adopted verbatim by California under CRTC section 25137.

FTB Argument #3 - Taxpayer argues that the sales factor should reflect the market and the government sales rule is not a market rule.

Ceradyne's Response - Ceradyne agrees that the government sales rule is not a market rule and has never advocated to the contrary. Taxpayer's petition is based on the fact that standard apportionment formula does "not fairly represent the extent of the taxpayer's business activities in this state." Under UDIPTA there are three activities used to apportion income - property, payroll and sales. If the standard apportionment formula (including the government sales rule) functions as intended, it should have the effect of reflecting the activities attributable to the manufacturing and producing states with respect to government sales. However, in Ceradyne's situation, the amount of income being apportioned to California under the standard apportionment formula far exceeds the relative proportion of Ceradyne's property, payroll or sales in California. *The problem is not the sales factor in isolation but the overall percentage attributed to California under the standard formula.* Taxpayer is asking for distortion relief available under CRTC section 25137 in this situation because Ceradyne's California sales factor fails to reflect neither the market for the government sales nor the location of the activities responsible for generating those government sales.

FTB Argument #4 - Staff believes there are tax policy reasons that support the use of shipping location for the assignment of U.S. government sales. Perhaps most obvious of these is that there really is no easily definable "market" for sales to the U.S. government.

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[2] Unless otherwise specified, all section references are to the California Revenue and Taxation Code.

<u>Ceradyne's Response</u> - Ceradyne does not contest that there are legitimate policy reasons for an "origin" rule for sales to the U.S. government. Since there is no easily definable market for sales to the U.S. government, the drafters of UDITPA decided to "throwback" the sales to the manufacturing and producing states. Ceradyne's petition is based on the fact that the standard apportionment formula does "not fairly represent the extent of the Ceradyne's business activities in California" given that half of the armor plates sold to the U.S government are manufactured outside of California, yet all of the sales of those armor plates are attributed to California. As a result, the activities in Kentucky are systematically undervalued compared to the same activities in California. Ceradyne's unique business model of shipping armor plates manufactured in Kentucky for final assembly in California is causing the origin rule to malfunction with respect to its government sales. Moreover, Ceradyne's proposed remedy of removing the government sales from the sales factor entirely is fully consistent with the stated staff view that there is no "easily definable market" for government sales.

<u>FTB Argument #5</u> - Staff has concerns about the remedy that the taxpayer has suggested. The taxpayer seeks to remove the sales from the California numerator while maintaining the sales in the denominator.

<u>Ceradyne's Response</u> - Ceradyne agrees that this remedy is meant to reflect the market but can potentially lead to government sales escaping assignment to any state. Therefore, Ceradyne has proffered its alternative remedy which would "throw out" the government sales from the numerator and the dominator and thus avoid the "nowhere" income problem.

<u>FTB Argument #6</u> - With regards to throw out, while this could potentially avoid the "nowhere income" issue raised by the numerator exclusion (assuming the taxpayer were to file amended returns in all of the states where it does business to reflect the new denominator), it results in assigning income from the taxpayer's largest revenue generating activity to various locations that had nothing whatsoever to do with the manufacturing and sale of body armor. This is also unreasonable.

<u>Ceradyne's Response</u> - The issue before your Board is the fair apportionment of Ceradyne's income to California. As established above, the government sales rule applied to Ceradyne's unique factual situation prevents the fair apportionment of Ceradyne's income to California. On the other hand, removing the government sales from Ceradyne's sales factor altogether would leave Ceradyne with a sales factor based on its remaining business operations. This is not an unfair result because Ceradyne's government sales activities originated from and continue to rely on Ceradyne's commercial activities. In fact, Ceradyne would have no government sales income to speak of if it weren't for the research and development conducted in the commercial arena and the consistent revenue streams recognized during years in which Ceradyne sold little to no materials to the United States Government. Under California's method of taxation, each revenue stream recognized by a unitary group of corporations is considered to be dependent upon the activities conducted by each corporation. Therefore, it is clear that the sales factor that would remain upon the implementation of Ceradyne's "throwout" remedy would necessarily relate to the manufacturing and sale of body armor to the United States Government.

FTB Argument #7 - The taxpayer has refused to amend its Kentucky return to file consistent with its proposed California remedies.

Ceradyne's Response - Ceradyne's petition is based on the fact that the standard apportionment formula does "not fairly represent the extent of the taxpayer's business activities in this state". The only question for your Board's consideration in a 25137 distortion petition is whether the standard apportionment formula fairly represents the taxpayer's business activities in California. (Rev. & Tax. Code Section 25137) It is within Kentucky's purview to determine what the correct filing method is for Ceradyne under Kentucky's own taxing system and should not be a consideration in a 25137 distortion petition in California.