tax justice network

The Use of Combined Reporting by Nation States

By Michael J, McIntyre, in Chapter 8 of Arnold Sassevelle & Zolt (eds.) *The Taxation of Business Profits Under Tax Treaties* (2003).

Combined reporting is a relatively simple, transparent, and effective method for taxing multinational corporations. It has been used successfully by California and several other U.S. states for several decades. Most of the important technical issues that arise in administering a combined reporting system have been confronted and solved. McIntyre states:

> "Combined reporting would result in a fairer sharing of tax revenue among nation-states, would reduce substantially the opportunities for tax avoidance and evasion that MNEs enjoy under the current system, and would simplify compliance for tax departments and taxpayers."

No nation state has tried to employ a combined reporting system. Moving that system from the subnational level of government to the national level undoubtedly will present new challenges. The U.S. states are helped in administering their corporate income taxes by the presence of the national tax. Also, the U.S. Supreme Court and the U.S. Congress put some internal pressures, albeit weak ones, on the states to promote uniformity. Still, the successful use of combined reporting by some U.S. states should be encouraging to those who are prepared to consider its use by nation states. California, after all, would be the world's fifth largest economy if it were organized as an independent nation state.

Many commentators have defended the traditional Arm's Length system and disparaged Combined Reporting. After years of experience, however, the case for continuing the Arm's Length system is not easily made. To make that case, its supporters need to provide persuasive answers to the following questions:[1]

- What is the reason for giving decisive weight, in the allocation and apportionment of the profits of a multinational enterprise, to intra-company ownership rights and contractual arrangements that have almost no legal or economic significance?

- Why should the form of organization of a multinational enterprise be given substantial weight in determining which countries should tax the income derive by that enterprise?

- Why should a system that encourages multinational enterprises to deflect income to tax havens be preferred over a system that gives no tax benefit for that action?

- Why should a system that effectively allows multinational enterprises to elect whether to pay taxes be preferred over one that imposes taxes under clearly stated and generally applicable standards?

- Why should a system that is choking on its own complexity be preferred to one that is relatively simply and transparent?

- Why should a system that obviously is failing be preferred over one that has been highly successful?

The last question is the critical one. If the current system is failing, then an alternative has to be found to replace it. There are only two plausible alternatives, short of abandoning corporation taxation entirely. One is combined reporting. The other is a major overhaul of the current system.

Countries that are serious about reform can draw lessons from the success of the U.S. states with combined reporting. In McIntyre's opinion, the following three features of combined reporting are keys to its success.

- Multinational business are required to report their entire worldwide income to the tax authorities and are made taxable on an amount computed by reference to that worldwide income.

- Income is attributed only to taxing jurisdictions where substantial economic activity takes place, and the amount of income attributed to each location is determined by referring to an indicator of how much of that activity is located unambiguously in particular place and is subject to easy measurement.

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[1] All of these questions include unstated premises that supporters of an arm's-length/source-rule system might reject. They are posed to invite discussion, not to preclude it.

- Formal features of a common enterprise, such as intra-member contracts and form of organization as a branch or affiliate, are given little or no weight in determining the income taxable in a particular jurisdiction.

These features of combined reporting cannot be replicated in an arm's-length/source-rule system without the de facto adoption of combined reporting.

This article explains how a combined reporting system such as California's would work if it were employed by a nation state.[2] Combined reporting is a full or partial substitute for four sets of rules that are applied in the arms'-length/source rule systems currently used by all Nation States: the residency rules[3], the tax accounting rules, the transfer-pricing rules, and the source rules[4].

Part 1 describes the way a combined reporting system actually operates. This discussion provides the necessary background for the rest of the paper. Part 2 addresses the theoretical foundation for combined reporting, building primarily on the author's prior work. Part 3 compares the combined reporting method to the arm's-length/source-rule currently used by Nation States.

Part 4 discussed a variety of practical issues that must be addressed in designing a combined reporting system for nation-states. Most of those issues have been solved in a satisfactory manner by those states in the United States that have adopted some form of worldwide combined reporting. The article discusses those solutions and explains, when necessary, how they might be adapted to deal with the use of combined reporting in an international setting.

The article also addresses some practical problems that arise when combined reporting is applied only to a regional group of national states, such as the European Union or the members of the North American Free Trade Agreement (NAFTA). A brief conclusion is provided in part 5. The conclusion suggests, inter alia, some lessons that can be drawn from the success of combined reporting for the reform of the current system for taxing multinational enterprises.

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[2] It is possible to have a tax system that embraces combined reporting but does not apportion income by formula. The income of the combined group could be attributed to particular taxing jurisdictions using source rules (see note 4, below), for example. On the other hand, formulary apportionment without combined reporting is also a possibility. The key feature of the California system is not the fact that an apportionment formula is used, but that related entities engaged in a common enterprise must file a combined report.

[3] These are rules for determining the residence of the taxpayer, such as how many days the taxpayer has spent in the jurisdiction, or the location of the taxpayer's principal residence or abode.

[4] These are rules for determining the source of a particular income, such as where various income-generating events occur, where the taxpayer's property is located.