Combined Reporting with Formulary Apportionment: The Transfer Pricing System of the US States

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TRANSFER PRICING: ALTERNATIVE METHODS OF TAXATION OF MULTINATIONALS

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OECD's Attack on US State System

CLAIMS COMBINED REPORTING DOES NOT WORK

- OECD Staff Report (current and former staffers) claims that combined reporting with formulary apportionment (CR/F) works badly and cannot work in the international context.
- Also claims that OECD's arm's length method with source rules (AL/S) does work, with relatively minor flaws.
- OECD has it backwards. Combined Reporting works reasonably well, and Arm's Length is a complex failure.

Features of Combined Reporting

COMBINED REPORTING RULE OF JUST OVER HALF US STATES

- All members of a "consolidated group" (defined broadly) engaged in a common enterprise ("unitary business") are required to file a combined report.
- The income taxable in any state is a portion of the total taxable income of the consolidated group, as determined by the apportionment formula.
- All income is apportioned to states able to tax the income (eliminates "no where income").

The Goals of Combined Reporting

A Plan for Substance over Form

- *Basic goal*: Tax a business enterprise on the share of the total income of the enterprise derived from the state.
- *Secondary Goal*: Ignore business forms — treat branches and subsidiaries the same and ignore all "internal" transactions (e.g., intercompany loans, sales, royalty agreements "insurance" contracts).
- *Mechanism*: Apportion (by formula) the total income of the enterprise (unitary business) based on a political division of the tax base.

Consolidated vs. Combined

No substantive difference

- Taxing each member of a group on its share of the total income if the group attributable to a state is functionally the same as taxing the consolidated group on its total share of the income attributed to a state. E.g., $a/3 + b/3 = 1/3(a + b)$
- There may be some legal advantages in making group members (companies) taxable rather than the consolidated group itself, which is not a legal entity.

Contrast to Arm's Length System

Attributing Income Among Tax Jurisdictions

- In an arm's length system, the goal is to attribute income to legal entities. Other mechanisms (e.g., source rules) must be used to attribute a share of that income to particular taxing jurisdictions.
- A combined reporting system has only one mechanism. It allocates by formula the aggregate income of a multinational enterprise to particular taxing jurisdictions.

A Helpful Analogy

Dividing Up Claims to Lake Water

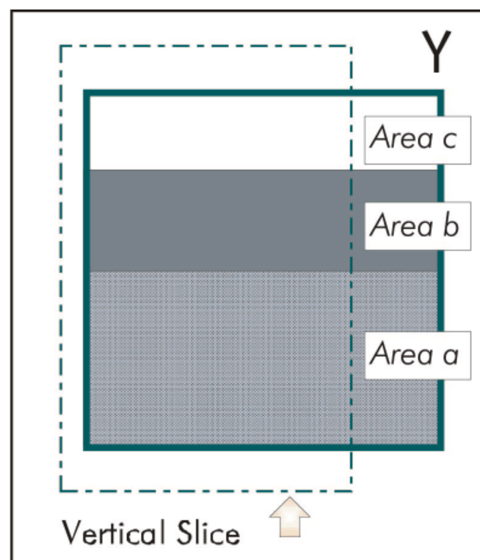
- *Facts*: Countries A and B have a lake on their common border. They want to share net increases in the lake water but not deplete the lake.
- *Arm's Length Approach*: Determine how much new water each state contributed to the lake (by rainfall, underground springs, streams, etc.).
- *Combined Reporting Approach*. Determine total amount of new water and split the amount by a political deal, presumably a 50:50 split.
  - 50:50 split likely under veil of ignorance (Rawls).

Vertical Slice Example

Contrasting Methodologies

- *Facts*: A MNE has 3 companies, ACo, BCo, and CCo. ACo produces goods in Country A and sells the output to BCo and CCo. BCo sells the goods in Country A and CCo sells the goods in foreign jurisdictions.
- *Issues*: Where is the income taxable? Does it matter whether the companies are foreign or domestic? Would it matter if they "check the box" and are treated as branches? Answers under control of the MNE.

Y = income
c = foreign sales (CCo)
b = domestic sales (BCo)
a = domestic production (ACo)



Choice of Formulas

BASED ON PAYROLL, PROPERTY AND SALES (RECEIPTS) : UDITPA

- US states traditionally used a three-factor formula
  - **Payroll** (total amount paid as compensation for services)
  - **Property** (value of *tangible property* used in the production of goods or services)
  - **Sales** (sales proceeds and other receipts)
- Now there are multiple formulas. A Double Weighted Sales formula gives half to the production state and the other half to the market state. A Sales Only formula has become common.

Theory of the Formula

PAYROLL, PROPERTY, AND SALES ARE MERE PROXIES

- The point of the formula is to divided the net (taxable) income of an enterprise according to some political goal that needs to be articulated.
- The UDITPA 3-factor formula was "arbitrary" — no particular policy goal other than uniformity.
- A sales-only formula is foolish, as it tends to convert the corporate income tax into a sales tax.
- I favor half to market state, half to production state — see analogy to sharing water.

Choice of Formulas (1)

APPORTIONMENT TO PRODUCTION STATE

- *Payroll and Property* can serve as proxies for location of production when production occurs in more than one state.
  - **Payroll** — total amount paid (to employees or independent contractors) to produce goods and services. Exclude payments to sales people.
  - **Property** — value of *tangible property* used in the production of goods or services. Inventory property should NOT be included. Intangible property, which has no set geographical location, is ignored (generally).

Choice of Formulas (2)

APPORTIONMENT TO MARKET STATE

- **Sales** — sales proceeds and certain other receipts. Again, the point is to find a proxy for the contribution of the market state, so sales not relevant for that purpose (e.g., intercompany sales, some financial "sales") should be ignored (but are not by US states).
- **Double Weighting of Sales**. To give equal weigh to the production state and the market state, a double weighted sales factor is appropriate.

Characteristics of Combined Reporting

IT IS NOT JUST ABOUT FORMULAS

- The entire corporate family engaged in a common enterprise (with important exceptions) is treated as a unit — substance over form.
- The Source of income (Nexus to tax) is based on Where the Important Economic Activity Occurs (e.g., place of sale and place of production).
- Internal Accounting Has No Tax Effect.
- Residence is Ignored.
- Transfer Prices are Ignored (mostly).

Arm's Length Int'l Tax Rules

FOUR SETS OF RULES

- *Transfer Pricing*. Complex, easily manipulated, ignores special "monopoly" profits of MNEs.
- *Residence Rules*. We let MNEs control residence separate for each affiliate.
- *Source*. Source is not a functional concept — we often allow income from intangibles to be sourced based on "location" of legal ownership.
- *Accounting Rules*. Flexible, few real standards, no real penalties for nonsense.

Relative Simplicity of CR/F

ALL APPORTIONMENT SYSTEMS HAVE SOME COMPLEXITY

- The information required to operate a combined reporting system is far less than that required to operate the OECD's Arm's Length system.
- Mostly, the information is global and often is available from the books of account of the MNE.
  - Total payroll, property and sales, and payroll, property and sales in the country as issue.
  - Total taxable income of the enterprise.
- In contrast, the OECD transactional methods require information on ALL MNE transactions.

Cost of Compliance under CR/F

COMPARE TO THE MILLIONS FOR AN AL/S AUDIT

"The evidence presented at trial in the *Barclays* case showed that the bank's costs in preparing its combined report for each of the three years at issue in the case ranged from a low of $900 to a high of $1,250."

Worldwide Combined Reporting

THE ORIGINAL CALIFORNIA SYSTEM, AND BEST IN THEORY

- The combined group (unitary business) is defined as all related persons (under a control test), wherever incorporated.
- The entire income of the group (called "pre-apportionment income") is determined, ignoring internal transactions.
- That amount is apportioned to states by formula.

Limiting the Combined Group

THE SO-CALLED WATER'S EDGE SYSTEM

- Since 1986, California limits the combined group under pressure from US Treasury and MNEs.
  - Certain foreign corporations engaged in a unitary business are excluded if they do not have substantial activities with California (excluded companies)
  - Anti-Avoidance rules are adopted to limit abuses.

Excluded Companies

COMPANIES ALLOWED TO MAKE A "WATER'S EDGE" ELECTION

- In general, foreign companies having only a small amount of business activity in the state or community of states can elect to be an excluded company.
  - In California, the foreign company must have less than 20% of its activities in the US to be excluded.
  - Holding companies and other entities used for tax-avoidance are not excluded.
- Both apportionment factors and income excluded.

Unitary Business Concept

DETAILS SET BY CASES INTERPRETING US CONSTITUTION

- A unitary business is some common enterprise. Whether two companies are engaged in a common enterprise is both a question of fact and a question of the appropriate level of generalization.
  - NO for a bank and an airline.
  - YES for a producer of goods and a seller of those goods.
  - UNCLEAR for a hotel and an airline. Are they both in the tourist business?

Anti-Avoidance and Unitary Business

RULE PREVENTS MIXING HIGH AND LOW VALUE BUSINESSES

- **Facts:** PCo is a highly profitable pharmaceutical company operating in high-tax countries. It purchases MCo, a grocery store chain having low margins and many employees, all located in low-tax countries.
- **Tax Plan:** PCo wants to shift income to low-tax countries under the apportionment formula.
- **Result:** The businesses are not unitary, and the formula is applied separately to each business.

Common Base Helpful, Not Essential

US STATES DO NOT HAVE A COMMON BASE

- In principle, California applies California law in determining income of an member of a combined group.
- In practice, it simply makes adjustments to the company's books in extreme cases.
- OECD Staff Report incorrectly claimed that the US states have a common tax base because all of the states use Federal income as their starting point. Many, many major deviations from that starting point.

Common Tax Base and OECD

OECD OVERSELLS NEED FOR COMMON TAX BASE

- Harmonization always helps in the difficult job of apportioning income among countries.
- Benefits come from common base, common rates, country-by-country reporting, common accounting rules, common incentive policies, etc.
- US experience shows that none of above are essential to a well-working CR/F system.
- OECD does not consider common base essential for its TNMM or Profit Split Methods.

OECD Inconsistency

TNMM and Profit Split benefit from common base

"The OECD, despite all of its discussion of the need for a common tax base in implementing a combined reporting system, has never acknowledged that its most important pricing method, the misnamed transactional net margin method (TNMM), presents exactly the same argument for a common tax base."

Continued Relevance of Arm's Length

Arm's Length Method Applies in Some Cases

- The arm's length method still must be used in the following situations:
  - Transactions between related unitary businesses — usually simple cases because, if not, the businesses would be unitary.
  - Transactions between members of the group and excluded companies.
  - Transactions with companies taxable on an allocation method (e.g., nonbusiness income).

Some Special Problems

No apportionment system is easy

- Combined reporting is inconsistent with most existing international tax treaties.
- Combined reporting works best when all relevant trading partners use the same system.
- The PE system does not mesh well with combined reporting unless having apportionment factors in a state is enough to have a PE.

Advantages of Combined Reporting

AT LEAST IT IS A SYSTEM THAT CAN WORK

- By any reasonable measure, the arm's length system is failing, and failing badly.
- Combined reporting works in theory, contrary to arm's length, and it has been effective in practice.
- Administrative costs, for tax office and taxpayers, are far lower under combined reporting.
- Combined reporting asks and answers the proper question — how much income of an enterprise is taxable in each country?

OECD's Trivial Goal: No Double Tax

DOUBLE TAXATION CAN BE ELIMINATED BY ELIMINATING THE TAX

"If the goal is simply to eliminate double taxation, then the OECD can claim success. That goal, however, is rather unambitious. A far more worthy goal would be to make multinational enterprises report something close to the income they actually earn in each country in which they operate."

Discussion and Questions

Product Comparison

OECD's Arm's Length Method with Source Rules (AL/S)

vs.

Combined Reporting with Formulary Apportionment (CR/F)

No.	Features	AL/S	CR/F
1.	Facilitates shifting of hundreds of billions of dollars annually to tax haven companies, avoiding tax in the countries where the income was actually earned	Yes	No
2.	Substitutes taxation by negotiation for the rule of law	Yes	No
3.	Promotes the development of a secret tax law (e.g., secret APAs, secret arbitrations, secret competent authority agreements)	Yes	No
4.	Often requires the "discovery" of comparable transactions that do not exist	Yes	No
5.	Treats branches and affiliates the same, letting substance prevail over form	No	Yes
6.	Imposes astronomical costs on taxpayers and tax departments	Yes	No
7.	Treats paper transactions that are internal to a multinational enterprise as having substance by a false analogy to real transactions between unrelated persons (e.g., internal "loans", internal "insurance" and other "risk-shifting" arrangements)	Yes	No
8.	Is not perfect but works reasonably well	No	Yes
9.	Allows MNEs to deprive developing countries of much-needed tax revenues	Yes	No
10.	In the words if Jimmy Carter, is "an insult to the human race"	Yes	No

Michael J. McIntyre, June 4, 2012

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