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Challenging the Status Quo: The Case for Combined Reporting

The author makes the case for combined reporting with formulary apportionment, addressing criticisms raised by current and former officials of the Organization for Economic Cooperation and Development.

By Michael J. McIntyre

An Oct. 20 article by one current and two former staff members of the Organization for Economic Cooperation and Development[1] asserts that developing countries would be ill-advised to give up the arm's-length system promoted by the OECD in favor of combined reporting with formulary apportionment as used by California and many other U.S. states. The basic claim of the article is that combined reporting presents so many serious problems that it cannot be made to work effectively.

While combined reporting undeniably presents some challenges for tax administrators and tolerates a certain lack of precision, this argument misses the forest for the trees. Apportioning income among tax jurisdictions is an inherently complex undertaking. The simple fact, however, is that California and many other U.S. states actually have been operating a combined reporting system effectively and fairly, at moderate cost, for many years. In contrast, the arm's-length system promoted by the OECD, after years of tinkering and major reforms, has worked poorly or not at all for both developed and developing countries. The great sign of the general failure of the arm's-length system is that it has permitted multinational enterprises to divert uncounted billions of dollars annually to tax havens.[2]

The Oct. 20 article notes, correctly, that the function of a combined reporting system with formulary apportionment is to apportion the income of multinational enterprises among the countries in which they engage in substantial economic activities. The article is less clear about the function of transfer pricing rules based on the arm's-length principle. Contrary to occasional comments in the report, the transfer pricing rules do not apportion income among countries. Their function is to allocate income among affiliated companies and other related persons. To apportion income among countries, the system favored by the OECD requires three additional sets of rules: source rules, branch accounting rules, and residence rules.[3]

Assume, for example, that a company, ACo, makes sales to a related company, BCo. Under the OECD's arm's-length system, the companies' declared sales price might be adjusted using one of the several pricing methods recommended in the OECD guidelines.[4] After such adjustments, it should be possible to compute the taxable income of ACo and BCo. How much of the income of ACo and BCo may be taxed by a particular country, however, is not determined by the pricing rules.

To see how ACo and BCo are taxed by particular countries, it frequently is necessary to determine where those companies are residents because many countries try to tax their resident corporations on at least some of the worldwide income of those corporations. In contrast, countries typically tax foreign companies only on the income sourced within their borders. It also is necessary to determine the source of the income of ACo and BCo because some countries generally tax their resident companies only on income sourced within their borders. (Virtually all countries try to tax foreign

Michael J. McIntyre is a professor of law at Wayne State University Law School and senior adviser to the Tax Justice Network.

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[1] Joseph L. Andrus, Mary C. Bennett, and Caroline Silberztein, ''The Arm's-Length Principle and Developing Economies,'' 20 *Transfer Pricing Report* 495, 10/20/11.

[2] See Nicholas Shaxson, *Treasure Islands: Uncovering the Damage of Offshore Banking and Tax Havens* (2011) at pp. 13-16.

[3] See Michael J. McIntyre, ''The Use of Combined Reporting by Nation States,'' in chapter 8, Arnold, Sasseville, & Zolt, eds. *The Taxation of Business Profits Under Tax Treaties* (2003) at pp. 267-272, revised and reprinted in 35 *Tax Notes International* 917-948 (9/6/04) (hereafter ''McIntyre, Nation States'').

[4] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (2010).

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companies on income earned within their borders.) In addition, if either ACo or BCo operates within a country through a branch, it must employ that country's branch accounting rules to allocate income between that branch and the rest of the corporation.

What the Critics Say

The Oct. 20 article suggests that developing countries (and, one would assume, other countries as well) should not reject ''transfer pricing approaches based on the arm's-length principle without a critical review of the alternatives.''[5] That advice certainly is sound. In making that critical review, it is important for a country to understand that combined reporting directly apportions income among countries, whereas the arm's-length approach does so only after the application of source rules, residence rules, and branch accounting rules.[6] All of these rules involve serious complications, with the possibility of double taxation and, much more likely, opportunities for significant under-taxation. The OECD system for allocating income is sometimes called the ''arm's-length/source-rule system'' to reflect the fact that the transfer pricing rules alone do not result in the allocation of income to particular countries.

A critical review of alternatives to the arm's-length approach ought to begin with a fair-minded and informed assessment of how that approach is actually working in the real world. In what must be viewed as an incredible understatement, the Oct. 20 article concedes that there is ''undoubtedly some truth'' to the claim that ''the arm's-length principle can sometimes be difficult to apply.''[7] Yes, some truth indeed.

A more complete statement would be that the arm's-length principle is almost always difficult to apply and frequently is nearly impossible to apply at an acceptable cost when a multinational enterprise (a parent company and its affiliated companies) is earning a substantial portion of its income from the exploitation of proprietary intangible property. Because much of the income of many multinational enterprises comes from the exploitation of proprietary intangible property, the failure of the OECD rules to deal effectively with such income is a major, perhaps fatal flaw.

The U.S. states that have adopted combined reporting have not adopted a common tax base; yet, they have been successful in operating their preferred system without serious complaints about double taxation.

The Oct. 20 article asserts that ''[t]he transfer pricing rules are intended to establish a common rule book for the resolution of disagreements among countries over the allocation of income and expense for taxation purposes.''[8] Whatever the intent, the reality is that those rules, when applied to the allocation of income from intangible property, simply offer a rough framework for negotiations between taxpayers and tax administrators. In brief, the transfer pricing rules do not work as intended in developed countries and barely work at all in developing countries.

Much of the Oct. 20 article is devoted to a discussion of the experience of the U.S. states employing combined reporting with formulary apportionment. The authors conclude that the experience of those taxing jurisdictions with combined reporting ''calls into question the assertion that a global transfer pricing system based on formulary apportionment would be less complex than a system based on the arm's-length principle.''[9] This conclusion is not supported by the evidence. In fact, the experience of the states strongly supports the fact that combined reporting with formulary apportionment is far less complex than an arm's-length system.

To be sure, the authors of the Oct. 20 article are correct that a combined reporting system with formulary apportionment poses some conceptual and administrative challenges. Apportioning income among competing tax jurisdictions, after all, is a difficult task. No system can expect to accomplish that task without facing definitional problems at the margins and some administrative challenges as well. The authors of the Oct. 20 article have lost perspective, nevertheless, if they believe the challenges presented by combined reporting are anywhere near as serious as the horrific problems presented by the arm's-length/source-rule system.

The sections below discuss many of the alleged flaws in a combined reporting system with formulary apportionment that the Oct. 20 article claims to have identified. Some of these alleged flaws are overstated or have been addressed effectively by the U.S. states (with solutions or work-arounds). Most of the rest have been addressed in the growing body of literature. Some of the problems that the Oct. 20 article claims are debilitating for a combined reporting system are even more serious problems in an arm's-length system.

Common Tax Base?

The OECD position, shared by a number of commenters, is that combined reporting with formulary apportionment cannot work without creating a serious risk of double taxation unless all of the relevant countries adopt a common tax base. The American experience with combined reporting suggests the contrary. The U.S. states that have adopted combined reporting have not adopted a common tax base; yet, they have been successful in operating their preferred system without serious complaints about double taxation. True,

[5] Andrus et al., p. 496.

[6] A combined reporting system, if applied globally, would obviate the need for the foreign tax credit and for controlled foreign corporation legislation. It probably would require its own set of anti-avoidance rules, although those rules are unlikely to be anywhere near as complex as the CFC rules of the United States.

[7] Andrus et al., p. 496.

[8] *Id*. As noted above, the transfer pricing rules, by themselves, do not allocate income among countries.

[9] *Id*. at 500. As explained above, a combined reporting system with formulary apportionment is not a transfer pricing system. It is a system for apportioning income directly among a relevant group of taxing jurisdictions (sub-national jurisdictions or nation states, as the case may be). The proper comparison is between a combined reporting system and an arm's-length/source-rule system (that is, the sum of the complexity of the transfer pricing rules, the source rules, the branch accounting rules, and the residence rules).

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double taxation is a theoretical possibility. In practice, however, that problem surfaces infrequently. When it does surface, most of the combined reporting states are able to address the issue through their ad hoc measures for adjusting for various distortions.

Although the Oct. 20 article never acknowledges explicitly that some of the U.S. states have successfully implemented a combined reporting system, it has done so implicitly by trying to explain why the experience of the states does not discredit the need for a common tax base. According to the article, ''state governments . . . rely on federal income tax rules to define a common tax base.''[10] The article acknowledges that states depart from the federal rules, but it claims that the departures are ''generally minor.''[11] In fact, the departures are not minor. For example, many states have decoupled from the federal rules that provide what the states view as excessive depreciation deductions. These deductions are significant. More importantly, many of the states have a panoply of their own tax incentives, typically adopted to attract investments from other states. In addition, the list of other adjustments to federal taxable income can be extensive.[12]

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 . . . presents exactly the same argument for a common tax base.

The members of the European Union, which typically rely heavily on the books of account of taxpayers in computing the income of their corporate taxpayers, are probably closer to a common tax base than the U.S. states. They also do not have to worry about special industry incentives creating a lack of uniformity because of the EU prohibition against state aid. The movement toward a convergence of accounting standards, moreover, is likely to move EU countries closer to a common tax base. The books of account of businesses also would become more useful for many tax purposes, including income apportionment, if the movement to require country-by-country reporting is successful.[13] The Tax Justice Network has been a major player in that movement. Under country-by-country reporting, a multinational enterprise would disclose to its shareholders, regulatory agencies, and the general public the gross income, deductions, taxable income, and taxes paid for each country in which it operates.[14]

From around 1967 to 1986, California required all corporate groups to include all of their affiliates, including foreign affiliates, in the combined report. That system was commonly referred to as worldwide combined reporting. It was upheld by the U.S. Supreme Court in *Container Corp. of America v. Franchise Tax Board*[15] and in *Barclays Bank PLC v. Franchise Tax Board*.[16] In 1986, California, under intense political pressure from the Reagan administration and certain foreign governments, adopted a water's-edge election. Under that election, a multinational enterprise could elect to exclude certain foreign corporations not engaged in substantial business directly in California from the combined report. All of the other states that had adopted worldwide combined reporting preceded or followed California in allowing a multinational enterprise to exclude some foreign affiliates from its combined report.[17]

In computing the apportionable income and apportionment factors of a multinational enterprise that includes one or more foreign affiliates, California sometimes has relied on the books of account of the enterprise. In the typical case, the parent company is foreign. As the Oct. 20 article contends, the net pretax income shown on a company's books is an imperfect proxy for its taxable income. Still, book income, with adjustments, often is a decent proxy for taxable income and may well be the best proxy available.

Critics of combined reporting often contend that a multinational enterprise would incur unacceptable costs in preparing a combined report. Barclays Bank made that claim in the famous case bearing its name. In that case, the bank had prepared its combined report using California's alternative books-of-account method. 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

[10] *Id*. at 499.

[11] *Id*.

[12] Richard D. Pomp, *State and Local Taxation*, 6th ed. (2009) at 10-1, n. 1: ''Other differences between federal and state taxable income typically involve interest, state and local taxes, net operating losses, dividends, expenses related to exempt income, and payments to related entities.'' California provides a 15-page booklet listing departures from federal taxable income (for corporations and individuals). See FTB Pub.1001: Supplemental Guidelines to California Adjustments (2009), available on line at https://www.ftb.ca.gov/forms/2009/09_1001.pdf.

[13] U.S.-based multinationals allocate the worldwide pretax income of themselves and their domestic and foreign affiliates between the United States and foreign jurisdictions in reporting their book profits to their shareholders and to the Securities and Exchange Commission. In most cases, these allocations seem reasonable—they probably are based on formulas. But some enterprises seem to allocate their worldwide profits between the United States and foreign jurisdictions based on something closer to what they report on their tax returns. Due to shareholder indifference, there are currently no book reporting rules that would enforce an accurate allocation of book profits between the United States and foreign jurisdictions.

[14] The United States recently adopted legislation requiring publicly traded resource extractive companies to report annually to the SEC the foreign income and taxes of themselves and their affiliates on a country-by-country basis. See Section 1504 of the Dodd-Frank Act (Pub. L. No. 111-203).

[15] 463 U.S. 159 (1983) (U.S. parent corporation).

[16] 512 U.S. 298 (1994) (foreign parent corporation).

[17] The water's-edge rules vary considerably from state to state. For discussion of the design of water's-edge rules, see Michael J. McIntyre, Paull Mines, and Richard D. Pomp, ''Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana,'' 61/4 *Louisiana Law Review* 699 (2001), pp. 732-738, reprinted 21/10 *State Tax Notes* 741-769 (9/3/01) (hereafter McIntyre, Mines, and Pomp, Combined Reporting); McIntyre, Nation States, supra note 3.

ranged from a low of $900 to a high of $1,250.[18] These numbers seem rather low in comparison with the millions of dollars that multinational enterprises typically incur to comply with the arm's-length standard.

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,[19] the misnamed transactional net margin method, presents exactly the same argument for a common tax base. TNMM, referred to in the United States as the comparable profits method (CPM), estimates the income a company has derived from dealings with a related company by reference to certain profit indicators (for example, the ratio of profits to assets or profits to sales) of an unrelated company engaged in a similar line of business.[20] The following example illustrates, in highly simplified form, the operation of TNMM.

Assume that PCo and SCo are affiliated companies engaged in the manufacture and sale of audio equipment. PCo, the manufacturing affiliate, reports income of 800 on its books of account, and SCo, the distribution affiliate, reports income of 400. Applying TNMM, the tax authorities of country A recompute the income of SCo by reference to a profit indicator of XCo, an unrelated company engaged in the distribution of electric guitars (a similar but different line of business). The profit indicator selected is the ratio of profits to assets. XCo has profits of 45 and assets of 150, for a ratio (R) of 0.3. SCo has assets of 100. SCo's recomputed profits under TNMM would equal 30, computed according to the following formula:

$$\text{Profits of SCo} = \text{R } (0.3) \times \text{Assets of SCo } (100) = 30.$$

Thus, country A would reduce the income of SCo from 400 to 30.

SCo in the above example is referred to in the OECD guidelines as the target company. The target company typically is selected on the ground that its activities are less complex than those of the related company (PCo) with which it is dealing. If country A wishes to compute the income of PCo under TNMM, it would add 370 (400 − 30) to the reported income of PCo, resulting in income of 1,170 for PCo (800 + 370). That same result could be achieved by adding together the reported incomes of PCo and SCo and subtracting the recomputed income of SCo (800 + 400 − 30 = 1,170).

In the typical case, SCo and XCo (the tested party and the unrelated comparable company) would be organized in the same country, so the issue of different tax bases typically would not arise. That issue frequently would arise, however, for SCo and PCo (the tested party and the other related party) because the two parties typically would be operating in different countries. It arises for the same reason it can arise in a combined reporting system—the separate income of related companies operating in different countries with different tax systems are being aggregated.

Without a common tax base, two countries computing the aggregate income of two related companies under TNMM may come to different results, creating the possibility of double taxation.[21] The OECD has never suggested, however, that the use of TNMM should wait until all relevant tax jurisdictions have adopted a common tax base.

The OECD and other opponents of combined reporting have argued that a common tax base is a prerequisite for the successful operation of combined reporting with formulary apportionment. These opponents of combined reporting are wrong. The U.S. experience demonstrates that combined reporting can work well without a common tax base. The EU, which has discussed seriously the possibility of adopting combined reporting, appears to have stalemated due to its failure to reach agreement on a common tax base. The EU, however, appears to have been misled on the importance of agreement on that issue. It ought to take a good look at the success of the U.S. states in implementing combined reporting without such agreement.

Consistent Apportionment Formulas

The OECD always has placed an inordinate emphasis on the alleged need for consistency in international tax rules.[22] Of course, harmonization of tax rules would have many benefits. For example, the complex problem of apportioning income among tax jurisdictions would be simplified enormously if all of the relevant tax jurisdictions had identical rules. Consistency, however, cannot be the highest value.

Admittedly, the lack of consistency in the apportionment formulas used by the U.S. states that employ a combined reporting method is a negative, and the Oct. 20 article is justified in criticizing that lack of uniformity. For more than 30 years, almost all of the states (Iowa was the notable exception) did in fact use the same general apportionment formula—the three-factor evenly weighted formula endorsed in the Uniform Division of Income for Tax Purpose Act (UDITPA). UDITPA was developed by the Uniform Law Commission in 1957 and has been enacted, in whole or in part, by 34 states. In recent years, beggar-thy-neighbor policies of the states have resulted in the proliferation of formulas. Some states have retained the UDITPA formula. Some states have moved to a sales-only formula, and some have retained the three-factor

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[18] *Barclays*, 512 U.S. at n. 16.

[19] Unfortunately, the OECD does not collect or publish data on the use of particular pricing methods by its member states. It does appear that the transactional net margin method (TNMM) has become the method of choice for many countries when the income of a multinational enterprise is derived in substantial part from the exploitation of proprietary intangible property. The three transactional methods—comparable uncontrolled price, resale price, and cost plus—are not applicable by their own terms when the income to be allocated comes mostly from the exploitation of proprietary intangible property.

[20] For a simplified explanation of the workings of TNMM, see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2d ed., (2002), pp. 66-68 (hereafter "Arnold and McIntyre, Primer").

[21] As the OECD has acknowledged, the lack of a common tax base would be an issue in applying its approved profit split method. See OECD guidelines, para. 2.114, at p. 95: "[I]t may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies."

[22] See Oct. 20 article, p. 496 ("developing countries should not underestimate the importance of consistency with global norms").

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formula but have given additional weight to sales, most commonly giving sales a double weight.

The double-weighted sales formula actually is an improvement over the UDITPA formula. The UDITPA formula was somewhat arbitrary, in the sense that it was a political compromise unsupported by theory. In contrast, the double-weighted sales formula reflects a policy decision to assign one-half of the taxable income of an enterprise to the production states and the other half to the market states. Some commenters have suggested that the equal sharing of income by the market states and the production states reflects a reasonable compromise of competing interests that is likely to have some stability, all else being equal.

In an arm's-length/source-rule system, the total income of the multinational enterprise is never even calculated. It is no wonder that so much of that income ends up in tax havens where little or no meaningful economic activity occurs.

The lack of uniformity in the choice of apportionment formulas presents a risk of either excess taxation or under-taxation. For example, if state A uses a double-weighted sales formula and state B uses a sales-only formula, then 150 percent of the income derived from the sale of goods produced in state A and sold in state B may be subject to tax. But if income is derived from the sale of goods produced in state B and sold in state A, then only half of it will be taxed. Data are not available showing the amount of double taxation and under-taxation that actually occurs. The low level of complaints from the multistate companies strongly suggests that the problem of double taxation is not serious.

The Oct. 20 article argues that the experience of the U.S. states in failing to agree on a uniform general apportionment formula is likely to be repeated if a group of developing countries were to move from the arm's-length/source-rule system favored by the OECD to combined reporting with formulary apportionment. Of course, the U.S. states did agree on a uniform formula for more than 30 years. It is not foreclosed that developing countries could find common ground, perhaps on the double-weighted sales formula. They might even develop a model statute to promote uniformity.[23]

The U.S. states using combined reporting gave up the goal of perfect consistency due to the pressures of what the OECD used to refer to as ''harmful tax competition.'' The United States has produced something very close to a perfect common market. Goods, services, capital, and labor move freely from one state to another. This common market has lots of benefits, but it unquestionably undermines the effective taxing power of the states. The states have become susceptible to the political pressures of the multistate enterprises, which put pressure on state legislatures to offer these enterprises lower taxes, often in exchange for vague promises to remain in the state or to move into the state from a sister state.

As noted in the Oct. 20 article, many states have special formulas for specialized industries, such as transportation and banking. In many cases, the formulas have been designed in consultation with the relevant businesses under the auspices of the Multistate Tax Commission, an organization that is funded by the states and often promotes uniform tax rules for the states. The Oct. 20 article implies that the existence of these formulas should be viewed as another potential source of non-uniformity. The point, at best, is rather trivial. Specialized formulas often make a lot of sense. A workable formula, acceptable to industry, is unlikely to be a source of disharmony among nations considering the adoption of combined reporting with formulary apportionment.

The key element in a system of combined reporting with formulary apportionment is the combined report. If the income of a multinational enterprise is to be apportioned fairly among the nations in which it engages in meaningful economic activity, the amount of that income must be known. In an arm's-length/source-rule system, the total income of the multinational enterprise is never even calculated. It is no wonder that so much of that income ends up in tax havens where little or no meaningful economic activity occurs.

Although the combined report is primary, the formula (or formulas) is also of major importance. Nations seeking to use a combined reporting system ought to work hard to adopt a sensible and uniform apportionment formula. They also should modify their tax treaties to be consistent with their choice of formulas. That is, income attributed to a country by the formula should be taxable under the treaty exclusively in that country. Yes, such a modification in the treaty permanent establishment rules would upset the consensus that the OECD has achieved over the past 50 odd years. A loss of that particular consistency, however, would be a gain.

The experience of the U.S. combined reporting states shows that agreement among states on a uniform formula, however desirable, is not a prerequisite for the successful operation of a combined reporting system. The U.S. system of combined reporting works effectively, notwithstanding the lack of uniformity in the choice of apportionment formulas.

Branch Accounting

One of the strengths of combined reporting and the weaknesses of the arm's-length/source-rule method is that the former treats branches and affiliated companies the same, whereas the latter does not. In a combined reporting system, the legal form of organization does not matter because it is simply irrelevant. The incomes of all of the entities that compose the enterprise—branches, affiliated companies, hybrid entities, and sometimes joint ventures and partnerships—are aggregated, and that aggregated income is then apportioned among the countries where the apportionment factors are located. There is no need in a

[23] The Multistate Tax Commission has developed a model statute for combined reporting with formulary apportionment. See Multistate Tax Commission Proposed Model Statute for Combined Reporting (approved by MTC 8/17/06), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf.

combined reporting system for transfer pricing rules, residence rules, or branch accounting rules as such. It is the income of the enterprise that is apportioned; the legal forms employed in earning that income are properly irrelevant.

In contrast, legal forms matter in the U.S. states that do not use combined reporting (referred to as separate reporting states). A separate reporting state applies its tax rules to each separately incorporated member of a corporate group on the share of the member's income attributed to that state. An apportionment formula is used to allocate the income of a company between the state and the rest of the world. In effect, the apportionment formula in a separate filing state operates as a branch accounting rule. Branches located within the state are taxed on their income, as determined by the apportionment formula, and the branches located outside the state are not taxed.[24] Contrary to the suggestion of the Oct. 20 article, the apportionment formula does not operate as a transfer pricing rule in a separate reporting state.

Transfer pricing rules are used in a separate reporting state, however, when members of a corporate group engage in transactions among themselves. For example, assume that ACo and BCo are related companies subject to tax in state S, a separate reporting state. Any dealings between ACo and BCo would be subject to adjustment under the arm's-length approach. In a combined reporting state, transactions among members of a common enterprise are simply ignored.

The OECD has attempted from time to time, without notable success, to unify its transfer pricing rules and its branch accounting rules. It has suggested, for example, that the arm's-length principle should be applied by analogy when a company manufactures goods in one country and sells them to unrelated persons through a branch located in another country. The problem is that the application of the various transfer pricing methods depends on the assumptions made about the nature of the transfer from the manufacturing branch to the sales branch. Should the company assume that its manufacturing branch made a sale to the sales branch? Under that assumption, the comparable uncontrolled price (CUP) method might apply. Or should the assumption be that the sales branch acted as an independent distributor? In that case, the resale price method might apply. What if the tax authorities assume the sales branch operated as an independent agent? Or that the manufacturing branch operated as a contract manufacturer? In each hypothetical, the transfer pricing method to be applied by analogy would change.[25]

The problems of applying the arm's-length principle, by analogy, to branches are far more intractable than the simple example above might suggest. The really difficult problems arise when the application of a pricing method depends on ownership rights, particularly ownership rights to proprietary intangible property. A branch, by definition, cannot own anything. All ownership rights reside in the company of which the branch is a part. To apply the arm's-length principle, by analogy, among branches when a pricing method depends, in whole or in part, on the owner of property, it is necessary to assign ownership rights to a company's property to one or more of its branches. The easy way to make such an assignment is by formula, not by reference to the arm's-length principle.

The OECD has offered some guidance in the Commentary to Article 7 of its Model Tax Convention on how to apply the arm's-length principle to branches. Unfortunately, that guidance is not very useful. In general, the OECD would rely on the books of account of the taxpayer. That reliance obviously is misplaced. A company typically would not include various hypothetical transactions on its books of account for the purpose of reporting its income accurately to its shareholders. It would do so only for tax reasons. Information about those hypothetical transactions would receive no public scrutiny and would be of no interest to almost all investors.[26]

Identifying the Common Enterprise

In the parlance of the U.S. states, a group of related entities conducting a common enterprise is called a ''unitary business.'' It is the unitary business that must prepare a combined report. A unitary business is simply a common enterprise conducted by related companies and other legal entities. In a substantial majority of cases, the common enterprise would be composed of the entire group of related entities. In some cases, nevertheless, the enterprise would be a subset of that group. The common enterprises of particular interest to a nation considering the adoption of combined reporting are the multinational enterprises—that is, the common enterprises engaged in activities both within and without the nation.

Identifying related entities that are engaged in a unitary business often is trivially easy. For example, two affiliated companies would be unitary if one manufactured certain goods and the other sold those goods. Similarly, two affiliated companies would be unitary if the first company manufactured and sold goods and the second company owned the trade name for those goods

[24] The term ''branch'' does not have a clear definition in the tax literature. Usage suggests that it is a set of activities conducted by a corporation in some specified location. For example, if a company engages in substantial and regular activities in a country, it has a branch in that country.

[25] Applying the arm's-length principle when a pricing method depends on ownership rights is particularly problematic because a branch never has ownership rights. See Arnold & McIntyre, Primer, supra note 20, pp. 73-77. The OECD's decade-long attempt to apply the arm's-length principle, by analogy, to the branches of multinational banks was an abject failure, in significant part due to its failure to get agreement on the presumed owner of the equity capital of a bank. See *id.* at 77. The OECD initially made the sensible proposal to allocate the equity capital by formula, but it withdrew that proposal, presumably in response to pressure from the banks and their supporters among the OECD member states.

[26] The Oct. 20 article argues that the income reported on the books of account of a multinational enterprise cannot be relied upon for the purpose of applying an apportionment formula in a combined reporting system. As discussed above, advocates of combined reporting contend that book profits provide a reasonable work-around when information on taxable profits is unavailable or is unreliable. It is extraordinary for the OECD to take the position that book entries dealing with hypothetical transactions by branches—entries that get no public scrutiny and have no relevance for investors—are reliable, whereas the audited and widely reported profits shown on the public books of account of a multinational enterprise are unreliable.

and licensed it to the first company. In general, a group of related entities is unitary if there is some flow of value among the entities in that group.

Most of the combined reporting states in the United States exclude income from the combined report that they have identified as ''nonbusiness income.'' The definition of nonbusiness income varies somewhat from state to state. This exclusion has been provided in response to certain language in decisions of the U.S. Supreme Court. It is not integral to the concept of a unitary business and should not be provided in a combined reporting system adopted by a nation. Providing the exclusion would facilitate tax avoidance and would serve no useful public purpose.

The Oct. 20 article criticizes the use of the unitary business concept primarily because of its alleged complexity. According to that report, the U.S. states employing combined reporting are forced to audit affiliates ''that have no contact'' with those states.[27] In fact, a U.S. state would violate the negative Commerce Clause of the U.S. Constitution if it attempted to tax a company that had *no contact* with that state. Indeed, a fundamental purpose of the unitary business concept is to ensure that the income of an affiliate is included in the apportionable income of a corporate group only if that income has ''some definite link, some minimal connection'' with the state.[28] For affiliates that have no physical presence in a state and no direct dealings in the state, the ''definite link'' is provided by their engaging in a common enterprise with affiliates that do have direct dealings in the state.

A successful attack on the tax haven abuses of multinational enterprises must require those enterprises to be taxable on their entire income.

As indicated in the Oct. 20 article, a country employing the combined reporting method would be required to obtain information about the income of a member of a common enterprise that has its headquarters in a distant country and does much of its business in that country.[29] This same issue can and should arise commonly for countries employing the arm's-length method. For example, neither method can operate properly without information about profits that a common enterprise has shifted artificially to a tax haven. As discussed above, a country using the combined reporting method often can get a decent approximation of the income of foreign affiliates from the books of account of the enterprise of which those affiliates are a part. Reliable information needed to apply the arm's-length method, however, typically would not be available from the books of account of an enterprise.

One of the purposes of the unitary business concept is to take account of the effects on a company's profits of its relationships with affiliates engaged with that company in a common enterprise. Those benefits might include common management, functional integration, economies of scale, mutual interdependence, and sharing or exchange of value not capable of precise identification or measurement. In principle, these flows of value ought to be taken into account in an arm's-length system. In practice, some of these flows of value are taken into account, but mostly they are ignored.

Another purpose of the unitary business concept is to prevent a common enterprise from enjoying the distorted results that otherwise might be obtainable under the apportionment formula. Assume, for example, that a pharmaceutical enterprise that is highly profitable wishes to cause a substantial portion of its profits to be attributed to low-tax countries. To that end, it purchases a supermarket chain that operates primarily in low-tax countries, has many employees, owns many stores, and has significant sales in those low-tax countries. If the supermarket chain and the pharmaceutical enterprise were included in the same combined report, the apportionment factors relating to the supermarket business would cause the super profits from the pharmaceutical business to be apportioned to the low-tax countries. The unitary business concept would prevent that abuse by requiring each of the two unrelated business enterprises to prepare its own combined report.

A similar problem of distortion could arise if a manufacturing enterprise also conducts a substantial financial services enterprise. Assume, for example, that ACo, a manufacturing enterprise, has sales of 100 in country X. It also trades in bonds through a branch located in country H, a low-tax jurisdiction. The buying and selling of bonds results in no net income to ACo but produces gross receipts (sales) of 10,000. Obviously, including the receipts from the bond sales in the sales component of ACo's apportionment formula would produce an improper result. That result could be avoided by excluding the bond sales from the formula used to apportion ACo's taxable income.[30]

The U.S. Supreme Court and various state courts have played a major role in the definition of a unitary business. As a result, the concept of a unitary business is not crisply defined and presents issues of interpretation at the margins. A country considering the adoption of combined reporting obviously is not bound by U.S. court decisions. It should be able to define a unitary business that provides clarity and reduces significantly the opportunities for tax avoidance.[31]

Wave of the Future

According to the Oct. 20 article, ''[t]he administrative challenges implicit in a unitary formulary apportionment system have led nearly two-thirds of U.S. states to apply formulary apportionment only on what is referred

[27] Oct. 20 article, p. 497.
[28] *Miller Bros. v. Maryland*, 347 U.S. 340, at 344-345 (1954).
[29] Oct. 20 article, p. 497.

[30] The U.S. states have not fully solved the problem illustrated by the example in the text. One answer is to revise the apportionment formula based on the facts and circumstances of a particular case, as occurred in the *Microsoft* case. See *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750; 139 P.3d 1169 (2006). The court in that case stated, ''The stipulated evidence establishes that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity seriously distorts the standard formula's attribution of income to each state.''
[31] For discussion of the definition of a unitary business, see McIntyre, Mines & Pomp, Combined Reporting, supra note 17 at pp. 716-725.

to as a 'separate reporting' basis.''[32] The authors are correct that many states do not use combined reporting. It is incorrect that these states have adopted a separate reporting method due to concerns about the alleged ''administrative challenges'' of combined reporting. The experience of the U.S. states is that combined reporting not only raises more revenue but also is much easier to administer than separate filing.

The Oct. 20 article also is incorrect that ''nearly two-thirds'' of the states use separate reporting. The actual percentage currently is a little less than half (49 percent), due to a wave of adoptions of combined reporting in recent years.[33] Since 2004, the following states and other subnational jurisdictions have adopted combined reporting: Vermont (2004), Texas (2006), Michigan (2007), West Virginia (2007), Massachusetts (2008), New York (2009), Wisconsin (2009) and the District of Columbia (2011). As of January of 2012, 23 of the 45 states (plus the District of Columbia) having a corporate income tax have adopted combined reporting, and, in many other states, advocates are arguing in favor of a move to combined reporting.

If the goal is simply to eliminate double taxation, then the OECD can claim success. . . . 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.

Combined reporting was developed in the 1930s by California to deal with aggressive tax avoidance and possible tax evasion in the movie industry. That industry was centered in California, most notably Hollywood. Yet, much of the profits from that industry seemed to end up in distribution companies located outside of California.[34] Following the success of the California experiment with combined reporting, 15 states joined the combined reporting ranks prior to 1984. The movement toward combined reporting stalled in the early 1980s, in the face of fierce opposition from the business community. The claim was—and is—that combined reporting, by increasing the tax burden on multistate corporations, creates an unfavorable business climate. There are no published studies supporting that claim.

If states have declined to adopt combined reporting due to a fear of its ''administrative challenges,'' as the Oct. 20 article asserts, one would expect that at least a few states that experimented with combined reporting would revert to their former system. In fact, only one state, Florida, has ever given up combined reporting, and that action (only six months after adopting combined reporting) was for political reasons.[35] In contrast, 22 states and the District of Columbia have followed California's lead and given up separate reporting. In 2010, the newly elected Republican governor of Wisconsin campaigned for office on a promise to repeal combined reporting, which had been adopted by a Democratic legislature and governor in 2009. Once in office, however, the governor changed his mind, allegedly due to the large revenue loss that would result from repeal.

Whether combined reporting will be adopted by members of the European Union or by some group of developing countries remains to be seen. What does seem clear, however, is that a successful attack on the tax haven abuses of multinational enterprises must require those enterprises to be taxable on their entire income. For example, tax reformers in the United States have argued for the end to the so-called deferral privilege by making U.S.-based multinationals taxable currently on the income earned through their foreign affiliates.[36] In such a regime, a U.S.-based multinational that deflected income to a tax haven under the arm's-length approach would not escape taxation because the multinational would be taxed currently on its worldwide income.

Conclusion

The arm's-length principle was developed in the 1930s under the auspices of the League of Nations. Over the past 50 years, the OECD has carried the torch for that principle. It has worked hard to forge a consensus among its members in support of that principle and has been successful in exporting that principle to many countries outside its narrow fraternity of wealthy nations. The OECD can justifiably boast that the arm's-length principle has become the international standard for allocating income among related companies.

The Oct. 20 article asserts that a core principle of its transfer pricing rules focuses on ''the importance of minimizing or eliminating double taxation.''[37] 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. The OECD's arm's-length approach does not come close to achieving that goal, as is clear from the trillions of dollars that multinational enterprises have

[32] Oct. 20 article, pp. 497-498.

[33] Combined reporting is employed in Alaska, Arizona, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, West Virginia, and Wisconsin. Institute on Taxation and Economic Policy, *Combined Reporting of State Corporate Income Taxes: A Primer* (August 2011), available online at http://www.itepnet.org/pdf/pb24comb.pdf.

[34] See Benjamin F. Miller, ''Worldwide Unitary Combination: The California Practice,'' in Charles E. McLure, Jr., *The State Corporate Income Tax: Issues in Worldwide Unitary Combination* (1984), pp. 132-166, at p. 137.

[35] Florida adopted combined reporting in 1983, at the height of the campaign against combined reporting conducted by multinational corporations, some foreign governments, and the Reagan Treasury Department. It repealed combined reporting six months later under intense political pressure.

[36] Such a proposal exists in both the recently released Obama budget for 2013 and in a tax reform discussion draft released in October 2011 by House Ways and Means Committee Chairman David Camp (R-Mich.). See 20 *Transfer Pricing Report* 911, 2/23/12; 20 *Transfer Pricing Report* 512, 11/3/11.

[37] Oct. 20 article, p. 496.

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deflected to tax havens over the years. In contrast, a combined reporting system with formulary apportionment is designed specifically to achieve that goal.

The OECD knows better than most the difficulties that must be overcome to get consensus on any significant principle of international taxation. As a result, it gives a high, almost mystical value to any consensus it has achieved. That the OECD would cling fiercely to the arm's-length principle is understandable. The time has come, however, to start to let go. The arm's-length method simply is not working, and 50 years of tinkering and major revisions have revealed that it cannot be made to work. It offers little more than a general framework for negotiations—negotiations in which the multinational enterprises hold the upper hand. The arm's-length method is numbingly complex and so expensive that it provides a royal living to thousands of accountants, economists, and lawyers. It has facilitated the shifting of trillions of dollars to offshore tax havens. The time has come to seek an alternative.

The Oct. 20 article obviously is intended to demonstrate that combined reporting with formulary apportionment is not a viable alternative to the arm's-length method. Various articles, essays, blogs, newsletters, and reports of nongovernmental organizations appearing over the past several years have accepted the idea that combined reporting actually has worked well in the U.S. states. For many commenters, including the Tax Justice Network, the real question is whether that success could be repeated on the international stage. The Oct. 20 article seeks to squelch this enthusiasm for combined reporting.

Fortunately for the proponents of international tax reform, the Oct. 20 article fails to make its case, for the reasons discussed in detail above. Combined reporting remains the best hope of the world for moving past the failed system based on the arm's-length principle to a system that actually apportions income exclusively to the countries where meaningful economic activity occurs.