The Use of Combined Reporting by Nation States

by Michael J. McIntyre

The typical multinational enterprise is made up of many separate corporations and has ties to many different countries. Countries have a difficult time in determining the portion of the income of a multinational enterprise that is properly taxable by them. The method used by all nation states is to determine the separate income of each member of the multinational enterprise by applying the arm's-length principle and then attributing the income of each member to particular countries using source rules, branch accounting rules, or some combination of both. This method has proven to be difficult to implement and the problems of implementation seem to be getting worse rather than better. Also, serious theoretical issues have been raised against the use of that method when the income being apportioned has been derived in substantial part through the exploitation of intangible property.

In this article, I set forth the basic elements of an alternative method that is used by a few of the states of the United States — the most important being California. This alternative method is commonly referred to as combined reporting with formulary apportionment. As a shorthand, I use the term “combined reporting” to refer to this method. The objective of this method is to impose taxes on a portion of the income of a multinational enterprise without reference to the form of organization of that enterprise. As a result, multinational enterprises with the same total income generally are treated the same under this method. As with any method of taxation, some compromises with the basic theory are needed to accommodate political realities and to reduce administrative burdens.

Part I below describes how a combined reporting system actually operates. The discussion provides the necessary background for the rest of the article. Part II...
addresses the theoretical foundation for combined reporting, building primarily on my own prior work. Part III compares the combined reporting method to the arm's-length/source-rule method used by nation states. In my view, combined reporting is vastly superior to the current system, assuming, of course, that nation states could agree to implement it. In particular 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 multinational enterprises enjoy under the current system, and would simplify compliance for tax departments and taxpayers. I do not address efficiency issues in this article. \(^2\) Given the gross inefficiencies resulting from the tax planning permitted under the current system, however, it is plausible that a combined reporting system would result in major efficiency gains.

Part IV discusses 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 the U.S. states that have adopted some form of worldwide combined reporting. I discuss those solutions and explain, when necessary, how they might be adapted to deal with the use of combined reporting in an international setting. I also address 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. A brief conclusion is provided in part V. 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 multinationals.

This article discusses formulary apportionment only in the context of a combined reporting system. It does not address the use of formulary apportionment in a separate filing system. The Canadian provinces, the Swiss cantons, and the majority of U.S. states apply formulas to determine the taxable income of a single corporation that is engaged in business in their jurisdiction. The income of the related corporations engaged in a common enterprise is not combined. This use of formulary apportionment in a separate filing system is merely a form of branch accounting. It maintains without change the transfer pricing issues and tax haven issues that combined reporting is designed to avoid. Separate filing with formulary apportionment is a variation on the current method for taxing multinational companies and is inconsistent with the theory that supports combined reporting.

My goal in this article is to set forth a workable plan for taxing the income of multinational companies in a fair, transparent, and effective manner. I do not address the political obstacles to reform in this article, although I do understand them to be formidable. Multinational companies understandably prefer tax regimes that tax them lightly or not at all, and, so far, they have been successful in getting what they prefer. The point of this article is to offer a fair, transparent, and effective alternative to the current international tax regime — a regime that is dysfunctional, or nearly so. I believe there is significant value in knowing that the international tax regime can be fixed even if the political prospects for reform may be unfavorable at the moment.

I. Operation of a Combined Reporting System

A. The Combined Report

In a worldwide combined reporting system, the members of a related group of corporations engaged in a common enterprise are required to file a combined report. The combined report is an accounting document prepared on behalf of a group of corporations engaged in the common enterprise. \(^3\) It contains a tabulation of the aggregate taxable income derived by the members of the group from that common enterprise. In the parlance of the U.S. states, the common enterprise is referred to as a unitary business.

The initial step in preparing a combined report is to determine the scope of the group's common enterprise. \(^4\) In computing the aggregate taxable income of group members from that common enterprise, transactions between members of the group generally are eliminated. The combined report also includes a tabulation of each group member's apportionment factors used in the apportionment formula. In most of the U.S. states, the factors are property, payroll, and revenue (sales). The corporations that are in a combined report are sometimes referred to as a combined group or a unitary group. The term “combined group” is used in this article. Although the combined report would be


\(^4\) It is possible that some or all of the members of a group of entities would be engaged in more than one common enterprise. In that event, a combined report typically would be prepared for each enterprise.
A major difference between a combined report and a consolidated return is that the consolidated return typically may be elected regardless of whether the included corporations conduct a common enterprise.

To be included in the combined group, a corporation must be engaged in a common enterprise with the other members of that group. Also, the corporation must be controlled, directly or indirectly, by a common parent corporation or by some consortium of related owners. States using combined reporting generally determine control by reference to a minimum ownership of voting stock.

Having a rigorous control test that is not easily avoided is an important aspect of a combined reporting regime. The more-than-50-percent stock ownership rule used by most U.S. states is a good starting point. I would buttress the rule, however, by giving the tax authorities the power to include a corporation in a combined group when a failure to include the corporation in the combined group would result in a distortion of its income. For example, a corporation should be included in some cases when there is control in fact or when ownership is divided 50-50 with an unrelated person. In addition, ownership of more than 50 percent of the value of stock should be sufficient to establish control in appropriate cases.

A combined report is not a consolidated tax return. In a combined reporting regime, each group member files its own tax return and pays tax on its determined share of the income of the combined group. In a consolidated return, a single tax return typically is filed on behalf of all of the members of the consolidated group. A major difference between a combined report, as used by the U.S. states, and a consolidated return is that the consolidated return typically may be elected regardless of whether the included corporations conduct a common enterprise.

The rules that determine whether corporations and other entities are included or excluded from the combined report should be neutral. That is, they should not have a systematic bias in favor of the taxpayer or the state. The interests of the taxpayer and the government to include or not include a particular corporation in the group depend on the facts and circumstances of the particular case. In some cases, a group of corporations may want to include a particular corporation in the control group. The paradigm case is when one corporation has a loss and the other corporations have a gain. In other cases, the corporate group may want to exclude a corporation from the group. For example, the members of a group would not want to include a holding company to which they have deflected most of their profits.

B. Apportionment of Income by Formula

A combined reporting system does not need to be paired with formulary apportionment. On the one hand, 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, for example. On the other hand, formulary apportionment without combined reporting is also a possibility. Virtually all of the U.S. states use formulary apportionment, although only a minority use combined reporting. Also, the Canadian provinces and the Swiss cantons use formulary apportionment without combined reporting. U.S. states apportion income by formula, whether or not they use combined

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5See part IV.A. below for discussion of what constitutes a common enterprise.

6A properly designed combined reporting statute should provide that a combined group might exist if the members are owned by one or more individuals acting in concert.


8California has a “stapled stock” rule that treats two or more corporations as members of a control group if more than 50 percent of the shares of stock are “stapled” together as a result of restrictions on their transfer. The stock of two companies is stapled if a person acquiring a share of stock in one corporation must also acquire a share of stock in the other corporation. Cal. Rev. & Tax. Code section 25105(b)(3) (West Supp. 2001). The California rule is a good one.

9Some U.S. states permit corporations that file — or could have filed — a federal consolidated return to file a similar state return. The taxpayer is not required to file a consolidated return; indeed, a mandatory rule probably would be unconstitutional in some situations because the common enterprise principle both empowers and limits the tax jurisdiction of states.
reporting, out of practical necessity — they simply cannot administer the arm’s-length method.

1. Three-Factor Formula

The Uniform Division of Income for Tax Purposes Act (UDITPA), promulgated in 1957 by the National Conference of Commissioners on Uniform State Laws and the American Bar Association, is the basic document used by the U.S. states to promote uniform corporate tax rules. It does not have provisions on combined reporting. It does include a recommendation for an evenly weighted three-factor apportionment formula. The three factors are property, payroll, and sales. The term “sales” is not fully descriptive because receipts other than sales are included in that factor. It is referred to as the “revenue” factor in this article.

Probably the most common deviation from the UDITPA apportionment formula is the use of a formula that double-weights the revenue (sales) factor.10 The effect of the double-weighted revenue formula for manufacturing and merchandising businesses is to apportion roughly half of the apportionable income to the market state and the remaining half to the production state. I favor this formula because I think there are no compelling reasons for favoring the production state over the market state, or vice versa, in apportioning income. Also, I think the formula has important political advantages over alternative formulas. The most important political advantages are that the formula is more likely than competing formulas to elicit widespread support among tax jurisdictions and it is more likely to be a stable resolution of the apportionment issue.

The three-factor formula, double-weighted for revenue (sales), is set forth in algebraic form below. It would be used to apportion the worldwide taxable income (TI) of a common enterprise between a taxing state and the rest of the world.

\[ TI_{State} = \frac{TI_{WW}}{4} \times \left(2 \times \frac{Revenue_{State}/Revenue_{WW}}{} + \frac{Payroll_{State}/Payroll_{WW}}{} + \frac{Property_{State}/Property_{WW}}{} \right) \]

In this formula, \( TI_{State} \) is the amount of taxable income of the common enterprise apportioned to the state; \( TI_{WW} \) is the worldwide taxable income of the common enterprise; \( Revenue_{State}/Revenue_{WW} \) is the ratio of the gross income of the common enterprise derived from sales and other transactions taking place within the state to its gross income derived from worldwide transactions; \( Payroll_{State}/Payroll_{WW} \) is the ratio of compensation paid by the common enterprise within the state to its worldwide compensation; and \( Property_{State}/Property_{WW} \) is the ratio of production assets of the common enterprise located within the state to its worldwide production assets.

As an illustration of the operation of the formula, assume that ACo manufactures widget parts in State A and sells them to BCo, which assembles the widgets both in State A and in State B. BCo sells the completed widgets in State A and in other jurisdictions. Some of the sales are made directly and some are made through CCo, domiciled in a state that imposes no income taxes. ACo, BCo, and CCo are all commonly controlled and engaged in a common enterprise.

The combined worldwide taxable income of the combined group, computed under the laws of State A, is $1,000. The total revenue of the combined group from sales of widgets is $8,000; BCo derives $4,000 from sales within State A and $2,000 from sales in other jurisdictions. CCo derives $2,000 from sales outside State A.

ACo, BCo, and CCo have a total of 10 employees worldwide, with a total payroll of $4,000. ACo has four workers in State A and pays them compensation of $2,000. BCo has two workers in State A and pays them compensation of $1,000; it has two workers outside State A and pays compensation of $800 to them. CCo has no workers in State A; it has two workers outside that state and pays them compensation of $200.

The combined production assets of ACo and BCo are valued at $20,000. ACo has assets worth $2,000 located in State A. BCo has assets worth $3,000 located in State A and assets worth $15,000 located outside State A. CCo has no production assets. Under those facts, $625 of the combined taxable income of $1,000 would be taxable by State A, computed as follows:

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<tr>
<td>(1) Revenue from worldwide sales</td>
<td>$8,000</td>
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<td>(2) Revenue from State A sales</td>
<td>$6,000</td>
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<tr>
<td>(3) Ratio of State A revenue to worldwide revenue ($6,000/$8,000)</td>
<td>3/4</td>
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<tr>
<td>(4) Total worldwide payroll</td>
<td>$4,000</td>
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<td>(5) State A payroll ($2,000 + $1,000)</td>
<td>$3,000</td>
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<td>(6) Ratio of State A payroll to worldwide payroll ($3,000/$4,000)</td>
<td>3/4</td>
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<tr>
<td>(7) Total worldwide production assets</td>
<td>$20,000</td>
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<tr>
<td>(8) State A production assets($2,000 + $3,000)</td>
<td>$5,000</td>
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<tr>
<td>(9) Ratio of State A assets to worldwide assets ($5,000/$20,000)</td>
<td>1/4</td>
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<tr>
<td>(10) Worldwide taxable income</td>
<td>$1,000</td>
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<tr>
<td>(11) Apportionment percentage</td>
<td>62.5%</td>
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<td>(12) Income apportioned to State A ($1,000 x 0.625)</td>
<td>$625</td>
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2. Intrastate Apportionment

The three-factor apportionment formula discussed above is used to determine the taxable income of the combined group that is apportioned to a particular state. A modified version of that formula is then used to attribute the income taxable by the state to particular members of the combined group. To minimize collection problems, only those members of the combined group that have independent nexus with the state are taxable by the state.11 The amount they are taxable on is determined by using a pro rata intrastate apportionment formula.

Under the intrastate apportionment formula, the income assigned to each taxable member is the income of the combined group apportioned to the state multiplied by a fraction. The numerator of that fraction is the state apportionment percentage of the individual group member, and the denominator is the aggregate state apportionment percentage for the combined group. For example, if a corporation’s own apportionment percentage is 20 percent and the apportionment percentage of the combined group is 80 percent, then 25 percent (0.20/0.80) of the combined income would be taxable to that corporation.

In practice the above formula can be simplified. The state taxable income of a unitary group (\(A\)) equals the total taxable income of the group as shown on the combined report (\(B\)) multiplied by the state apportionment percentage shown on the combined report (\(C\)). That is, \(A = B \times C\). The state taxable income of a group member (\(D\)) equals \(A\) multiplied by the state apportionment percentage of that group member (\(E\)) divided by \(C\). That is, \(D = A \times E/C\). Simple algebra shows that \(D = (B \times C) \times E/C = B \times E\). That is, the taxable income of a group member equals the total taxable income of the unitary group multiplied by the group member’s state apportionment percentage.

The operation of the intrastate apportionment formula can be illustrated by extending the previous example. As shown in that example, the state apportionment percentage for the combined group is 62.5 percent (10/16). If the apportionment formula is applied only to ACo (that is, the formula is applied using only ACo’s state factors in the formula), ACo’s state apportionment percentage is 15 percent (0.15), computed as follows:

\[
\text{(1) Ratio of ACo’s State A revenue to worldwide sales (}$0/$8,000)$] = 0
\[
\text{(2) Ratio of ACo’s State A payroll to worldwide payroll ($2,000/$4,000) =} 1/2
\[
\text{(3) Ratio of ACo’s State A production assets to worldwide assets ($2,000/$20,000) =} 1/10
\[
\text{(4) ACo’s apportionment percentage (1/4 x ((2 x 0) + 1/2 + 1/10)) =} 15%
\]

If the apportionment formula is applied only to the state factors of BCo, BCo’s apportionment percentage is 47.5 percent (0.475), computed as follows:

\[
\text{(5) Ratio of BCo’s State A revenue to worldwide sales ($6,000/$8,000) =} 3/4
\[
\text{(6) Ratio of BCo’s State A payroll to worldwide payroll ($1,000/$4,000) =} 1/4
\[
\text{(7) Ratio of BCo’s State A production assets to worldwide assets ($3,000/$20,000) =} 3/20
\[
\text{(8) BCo’s apportionment percentage (1/4 x ((2 x 3/4) + 1/4 + 3/20)) =} 47.5%
\]

CCo has no State A factors, so its apportionment percentage would be zero. Under these facts, $625 of the group’s income would be apportioned to State A ($1,000 x 0.625). Of that amount, $150 ($1,000 x 0.15) would be taxable to ACo and $475 ($1,000 x 0.475) would be taxable to BCo. None of the taxable income of the combined group would be taxable to CCo ($1,000 x 0.0). Indeed, under these facts, it is unlikely that CCo would have any reporting obligation to State A.

3. Basic Design Features of Formulary Apportionment

As illustrated above, there are four separate steps that the members of a combined group must take to determine the amount of income they are taxable on in a state. Those steps may be summarized as follows:12

- The members of the combined group prepare a combined report that calculates the worldwide taxable income of the group under state law. In the tax parlance of the states, this amount would represent the combined group’s preapportionment income.
- The combined group calculates its apportionment percentage by applying the appropriate

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11I am using the term “independent nexus” to mean that the corporation has sufficient contacts with the state to give the state nexus to tax that corporation without considering the corporation’s connection to the common enterprise.

12This list is provided for illustrative purposes and is not to be exhaustive.
apportionment formula, using the aggregate factors of the combined group and the aggregate taxable income of the combined group. Only factors that helped generate the preapportionment income enter into the formula.

- The combined group multiplies its preapportionment income, calculated in the first step, by the apportionment percentage calculated in the second step. The resulting amount is the combined group’s taxable income apportioned to the state.

- The members of the combined group make the calculations necessary for intrastate apportionment. Under that process, the income taxable by the state is apportioned pro rata among the members of the combined group having independent nexus with the state in proportion to their respective shares of the apportionment factors. Only those members of the combined group having independent nexus with the state are taxable by the state. Members of the group that do not have factors located in the state or otherwise lack nexus with the state typically are not required to file a tax return with the state.

A major advantage of apportionment by formula rather than by source rules is that the formula can associate income with factors that can be located geographically without great difficulty. As discussed in part II.B. below, assigning a geographical location to income using source rules is fraught with difficulties.

The locations of the three items in the typical apportionment formula — property, payroll, and revenue — are not always unambiguous.

The locations of the three items in the typical apportionment formula — property, payroll, and revenue — are not always unambiguous. Reasonable rules can be devised, nevertheless, for resolving or sidestepping those ambiguities. For example, many states exclude intangible assets, such as stocks, bonds, copyrights, and goodwill, from the property factor due to the obvious difficulty of determining the geographical location of an asset that has no important physical attributes. Based on similar considerations, some states exclude receipts from the sale of intangible property from the sales factor.13 Issues that arise in specifying what to include in the apportionment factors are addressed in part IV.B. below.

It is sometimes said that the designers of formulary apportionment have made the implicit assumption that the income of a common enterprise is earned uniformly among the corporations that make up that enterprise.14 In fact that assumption is not made, explicitly or implicitly. It is true that the typical apportionment formula apportions income uniformly to the apportionment factors. As a result, two related companies having the same apportionment fraction are taxable on the same amount of income, irrespective of their profitability as determined under an arm’s-length/source-rule system. It is fallacious, however, to conclude that the designers of a formulary apportionment system have indulged in some counterfactual assumption about the way income is earned within a corporate group.15 A major point of combined reporting is that corporate structures should be ignored in assigning income to particular jurisdictions. Whatever else a combined reporting system may do, it does not assign income on the basis of assumptions about how income is earned within a corporate group.

Of course, a taxing jurisdiction that has adopted combined reporting should recognize that an effect of this methodology is to apportion income in proportion to the apportionment factors. It is fallacious, however, to conclude that those adopting combined reporting have assumed that income derived in a particular jurisdiction is always or usually proportional to the factors located in that jurisdiction. Tax jurisdictions agree to participate in the combined reporting system because they believe that, on average, it is unlikely to favor one jurisdiction over another in any predictable way and that it is very likely to produce a fair division of the tax base over a reasonable period.

The following example illustrates the type of deal that the tax jurisdictions participating in a combined

13MTC, Reg. IV.18.(c).(3).
15The apparent logic of the critics of formulary apportionment is that the designers of a formulary apportionment system must have assumed that income is always earned proportional to the apportionment factors because that result is the anticipated one under formulary apportionment. By that faulty logic, the designers of an arm’s-length/separate-accounting system can be accused of assuming that multinational enterprises earn much of their income in tax havens. See Martin A. Sullivan, “Economics Analysis: Data Show Big Shift in Income to Tax Havens,” Tax Notes Int’l, Dec. 2, 2002, p. 876, Table 1 (reporting that for 1999, U.S.-based multinationals shifted over $92 billion in profits to the top 46 tax havens and held over $1 trillion in assets in those countries).
As this example illustrates, countries may be justified in setting up a sharing arrangement based on ex ante expectations rather than on ex post results. In the context of sharing the potential tax revenue from income earned by multinational businesses, the ex ante approach is particularly appealing because of the known difficulties that arise in the arm’s-length/source-rule system of measuring ex post the income of particular members of a multinational enterprise. Instead of getting involved in those measurement issues, the governments adopting the combined reporting approach have gone straight to the important issue of how they want to divide up the tax base of a group of related companies earning income from activities in their country and in other countries. They make that decision before they know what the results might be of a division of the tax base under the arm’s-length/source-rule method. Indeed, they might never know what those results may be and would have no particular reason to want to know. They would have adopted a different, perhaps superior system. They would have no more reason to evaluate the results achieved under the alternative arm’s-length/source-rule system than those governments using that alternative system would have for computing the size of their tax base under a combined reporting system.
the combined group having independent nexus with the taxing jurisdiction. Intrastate apportionment, however, is a practical rule for collection. It might be viewed as an accommodation because the members of the combined group have legal status, whereas the enterprise itself might not have legal status.

Several general rules can be derived from the proposition that the tax liability of members of a combined group should be determined by reference to the total income of the group and the total characteristics of the group. I have set forth below three corollary rules that are particularly interesting in comparing a combined reporting system to an arm’s-length/source-rule system.

- The form of organization of a corporate group engaged in a common enterprise is not relevant in determining the amount of income taxes that the members of that group should pay to the various taxing jurisdictions in which the enterprise is conducted. Income is taxed the same whether it is derived through the operation of branches, subsidiaries, brother/sister companies, domestic entities, or foreign entities.

- The allocation within the combined group of ownership rights to property used by the group in earning income is not relevant in apportioning the income among the taxing jurisdictions in which the combined group operates. Assume, for example, that ACo and HCo, a tax haven company, make up a combined group engaged in a common enterprise in Country A. If Country A is using a combined reporting system, its tax collections would not be reduced if ACo shifted the ownership of property used in the common enterprise to HCo.

- The source of the income of the combined group or of any member of that group is irrelevant in determining the amount of the income that is taxed by the taxing jurisdictions in which the common enterprise operates. For example, a taxing jurisdiction would tax the income apportioned to it under a combined reporting regime, even if that income is assigned a foreign source under the source rules.

Although source rules are not used in a combined reporting regime, the apportionment rules serve a function that is analogous to the function sometimes served by source rules. As a result, the basic guidelines that ought to govern the design of source rules are highly relevant, with some minor adaptations, to the design of the features of an ideal combined reporting regime. I have previously identified five general guidelines for the design of source rules.16 Those guidelines, adapted to apply to combined reporting, are set forth below.

- **Administrative Simplicity.** The apportionment rules should facilitate the assessment and collection of taxes. In general the apportionment rules used by U.S. states are a model of simplicity, especially in comparison with the complexity of source rules.

- **Good-Neighbor Policy.** A government generally should not unilaterally adopt an apportionment formula or other apportionment rules that it would find objectionable if adopted by another sovereign government. That is, it should be a good neighbor. One minimum requirement for being a good neighbor is to adopt tax rules that are internally consistent — that would not result in double taxation if adopted by other countries.17 Adopting an internally inconsistent tax is incompatible with the goal of a mutually agreeable sharing of a tax jurisdiction among the relevant governments. Although combined reporting might be adopted by a government without any coordination with other taxing jurisdictions, the ideal situation is for all relevant governments to agree to use combined reporting and to use a common apportionment formula and uniform rules for specifying the apportionment factors.

- **Economic Nexus.** To the extent possible, income should be apportioned to a country where it has some economic nexus. That objective is achieved by using economically significant factors in the apportionment formula. The three-factor formula used by U.S. states generally meets the economic-nexus guideline. In accordance with this guideline, intangible property and other mobile assets either should be excluded from the property factor or their location should be fixed with some type of usage test. For example, a patent for technology used to manufacture goods might be located, for apportionment formula purposes, in the place where the manufacturing occurs.

- **Inclination to Tax.** To the extent feasible, income with an economic nexus in more than one state should be apportioned to a state that would subject the income to taxation. For the most part, this guideline is met under the three-factor formula typically used by the U.S.

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17Internal consistency generally is a requirement for a constitutional state tax statute under the Commerce Clause of the U.S. Constitution. See *Container Corp. of America v. Franchise Tax Bd. of California*, 463 U.S. 159, 192, 103 S. Ct. 2953, 2954 (1983) (hereafter “Container”).
states because a state government typically is inclined to tax income arising either from manufacturing activities or sales activities occurring within its borders. In the case of sales, however, a state government typically is not inclined to impose tax unless the taxpayer has some minimum presence within the taxing jurisdiction. To address that situation, U.S. states typically employ a throwback rule that treats goods manufactured in one state and sold in another as sold in the place of manufacture if the enterprise does not have the requisite minimum contacts in the state of sale. The throwback rule is discussed in part IV.C.

- **Sovereign Control Over Tax Jurisdiction.** Taxpayers should not be allowed to determine a state’s jurisdiction to tax their income, except by choosing where to conduct their economic activities giving rise to the income. That is, the application of apportionment rules should be under the control of sovereign governments, not taxpayers. The apportionment rules used by U.S. states get good marks under this guideline, whereas some of the source rules used by nation states allow the taxpayer to effectively elect the country of source. The passage-of-title test used by some countries for locating the source of sales income is a famous example of an elective source rule. Many other source rules are elective, although in many cases, the taxpayer must engage in substantial tax planning to make the election.

It has been suggested that a combined reporting system is a type of “source-based” or territorial system. If the point is that the system is properly used only to tax domestic-source income, as that term is generally understood, the point is wrong. A combined reporting system establishes the nexus to tax on an entirely different basis. It is correct, however, to describe combined reporting as territorial in the sense that it does not attempt to impose a residence-based tax on corporations. Tax jurisdiction is based exclusively on a linkage between the taxing jurisdiction and the income earned by the common enterprise. That linkage is established through the apportionment formula. There is no jurisdictional overlap comparable to the overlap of source jurisdiction and residence jurisdiction that typically occurs in the arm’s-length/source-rule method. Therefore, it would be inappropriate to suggest that a combined reporting system is, or should be, restricted to taxing domestic-source income as that term is generally understood. As discussed above, a combined reporting system takes no account at all of the source of income.

Although it is plausible to characterize a combined reporting system as a type of territorial system, it is also plausible to characterize it as a global system. In effect, a combined reporting system treats a common enterprise as a single entity with branches located in every taxing jurisdiction where apportionment factors are located. Those branches are taxable on all of the income attributed to them under the apportionment formula, without reference to source. The amount of income attributed to these ersatz branches might be more or less than the income that would be attributed to them in an arm’s-length/source-rule method. This quasi-residence jurisdiction over ersatz branches is treated as primary, with no deference to the tax claims of other jurisdictions. For example, a pure combined reporting system would not grant a tax credit for taxes paid to another taxing jurisdiction. In theory a credit is not needed because the apportionment formula gives each taxing jurisdiction an exclusive claim to some portion of the total income of the common enterprise.

**B. Problems With the Source Concept**

Governments have traditionally recognized two valid grounds for exercising jurisdiction to tax income — source and residence. To tax income on the basis of residence, a country needs to adopt residency rules. To tax on the basis of source, it needs to adopt source rules. Residency rules establish links between the taxpayer and the taxing jurisdiction, based on factors such as days spent in the jurisdiction in the current year, days spent in other recent years, location of the taxpayer’s principal residence or abode, legal status under immigration and nationality laws, and family ties to the country. Source rules establish links between a taxing jurisdiction based on many factors, including where various income-generating events occur, where the taxpayer’s property is located, and where the taxpayer

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18A state might not only be disinclined to tax that income, it might be prohibited from doing so under the Due Process and Commerce Clauses of the U.S. Constitution or under P.L. 86-272 (a federal statute prohibiting taxation by a state of income from the sale of tangible personal property when the taxpayer is present in the state merely for solicitation of orders for that property).


21In practice, a combined reporting system might adopt some territorial limit. As discussed in part IV, D, U.S. states have been forced to permit a water’s-edge limitation on their tax jurisdiction. The result is a hybrid system in which a foreign tax credit mechanism might be appropriate.
earning the income is a resident. I doubt that any tax specialists believe that the designers of residency rules should be seeking to uncover the “true” residence of a taxpayer. I contend that it is equally unrewarding to seek the true source of income.

In a combined reporting system, the assignment of income is accomplished through the apportionment formula. The rules governing the formula, therefore, are the source rules in that system if source rules are understood to be the rules that assign income to particular geographical areas. As discussed in detail in part III below, income is assigned to particular tax jurisdictions in an arm’s-length/source-rule system through the complex interplay of four sets of rules: the transfer pricing rules; the branch accounting rules; the residency rules; and source rules. In this latter context, the term “source rules” describes an important subset of the rules that link items of income to particular geographical regions.

Many critics of the combined reporting/formulary apportionment method believe that this method is defective in theory because it makes no attempt to determine the true source of income. They view combined reporting as a second-best system, to be adopted only if their first-best alternative, the arm’s-length/source-rule method, proves impossible to implement. This line of reasoning is faulty because an item of income arising from cross-border activities does not have a true source if “true” source means one unambiguous geographical location. There often are important links between items of gross income and geographical regions. Those links are reflected in good apportionment formulas and in good source rules. Only in relatively unimportant cases, however, does the income of a multinational company have significant links to only one location, and, in those cases, the results under a formula approach and under a source-rule approach are likely to be nearly the same.

Designing good source rules is difficult because of the many relationships, some complex, that may exist between an item of income and particular geographical areas. Many of these relationships merit consideration in determining the source of the income item. Yet they cannot all be taken into account, for they sometimes conflict. For example, it is at least plausible that the source of income is the place where the revenue generated by the profit-seeking activities is obtained. So defined, the source of income is likely to be in the tax jurisdiction where goods or services are marketed. It is also plausible, however, to view the source of income as the place where the goods or services originated. That concept of source would lead to the assignment of income to the production state or states. Even if the second concept of source were accepted as the true source of income, the conceptual problems would continue. An origin test for source is inherently vague in many cases because the place of origin will differ depending on how far back in the chain of causality one decides to go. For example, services might be said to have their origin in the place they are performed, or in the place where the performer resides, or the place where the performer mastered the skills that allowed for the performance.

Analysts get no help in determining the true source of income from the income concept itself because taxable income, as it is traditionally defined, has no geographical place. It is a number, calculated by adding and subtracting other numbers. In Henry Simons’s famous formulation, income is defined as the sum of consumption and net change in savings over some period. Income so defined cannot have a physical location, for it is merely a number. A number is a quantity that has shed its accidental properties of time, place, color, and so forth. This abstraction from all accidental properties other than quantity is a prerequisite to the mathematical manipulation that is necessary to specify a taxpayer’s taxable income.

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22For a similar functional definition of source rules, see Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, “What’s Source Got to Do With It? Source Rules and U.S. International Taxation,” 56 Tax Law Review 81-155, at 83, note 2 (2002) (“we regard source taxation and sourcing rules as constituting a system for allocating income taxing rights between source countries and residence countries”). A source country in this context is a country that is imposing its tax based on its relationship to the income of a taxpayer, not to the taxpayer itself. See McIntyre Treatise, supra note 1, at section 1/A (“Transnational income may be taxable . . . because of a nexus between [a country] and the activities that generate the income. According to international usage, a jurisdictional claim based upon such a nexus is called ‘source jurisdiction.’”).

23See, e.g., McLure and Weiner, “Deciding,” supra note 14, at 258 (“Formulary apportionment is conceptually inferior to separate accounting if separate accounting can be applied. First, FA does not attempt to determine the true source of income.”).


25Income is “merely an arithmetic answer and exists only as the end result of appropriate calculations.” Id. at 51. Simons also criticizes the “folly” of “describing income as a flow and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc.” Id. Of course, “income” remains a number whether it is defined according to the Haig/Simons concept or some other model. That is, taxable income, however defined, has no geographical attributes.
Because taxable income, as traditionally defined, is a number with no geographical location, the location assigned to an item of income is not a fundamental characteristic of the income itself. Every taxing jurisdiction, however, must accept some geographical limitations on its reach even if those limitations are not implicit in its definition of taxable income. Those limitations are found in the rules defining residence jurisdiction and source jurisdiction. The proponents of combined reporting disagree with the proponents of an arm’s-length/source-rule system on how those rules should be specified, whether or not they agree on how income should be defined.

When commentators assert that income has a true source, they are almost certainly making a statement about the geographical source of the various items of gross income — dividends, royalties, business profits, and so forth — that are added together to determine the taxpayer’s taxable income. In some cases, these various items of income might have some definite links to particular geographical areas. Those links might justify the exercise of tax jurisdiction by a particular sovereign government over some or all of a taxpayer’s taxable income.

The components or ingredients of income, in the language of Haig/Simons, are usually referred to as the “sources” of income. The term “source” in this context means the set of activities or investments that generated the income, not the geographical origin of the income. By using the term “component of income” in this article, I seek to avoid the confusion otherwise resulting from the equivocal use of the term “source.”

Whether a country uses formulary apportionment or source rules, it is using some proxy to assign a source to items of taxable income.

It might seem a matter of no great importance whether the link between taxable income and a geographical area is based on the link to taxable income itself or to the components of income. The point is worth making, however, to make clear that a combined reporting regime, in ignoring the source of the components of income, is not ignoring anything fundamental about income. It is simply using a different convention to assign income to a geographical area than the convention used in an arm’s-length/source-rule method. And, in using an alternative linking mechanism, it is not forgoing some more fundamental linkage. As the U.S. Supreme Court has famously noted, dividing up income according to its geographical attributes in an arm’s-length/source-rule system is like “slicing a shadow.”

Whether a country uses formulary apportionment or source rules, it is using some proxy to assign a source to items of taxable income. Neither method can fairly claim to have discovered the true source of the taxable income because taxable income, as explained above, has no source. The rules for assigning income to a particular geographical area might reflect political, legal, economic, and administrative realities, or they might ignore those realities. That is, they might be good assignment of income rules or bad ones. In the end, however, they are legal rules and can be defended only by reference to the policy goals that they seek to achieve.

In some cases, gross income items can be assigned to a particular geographical area without much controversy. Assume, for example, that a taxpayer earns a salary of $20,000 from teaching school in a rural community. The taxpayer was born in that community, educated locally, does all of his or her teaching in that community, and has no meaningful economic ties to any other community. Under those circumstances, the
association of her employment income with the location of her employment is strong. Also, it does not appear from the facts that the income has significant links with any other geographical area. Under these circumstances, it seems entirely appropriate to assign jurisdiction to tax that employment income to the government of the country where the teacher carries on her teaching activities.\(^3\) This happy result almost certainly would be achieved in a tax system using source rules and in a tax system using some type of formulary apportionment.\(^3\)

In other cases, the place where the activities occurred that generated income is not a good indicator of where income should be assigned for tax purposes. Consider, for example, a taxpayer that engages in whaling operations on the high seas. It hunts the whale, boils down its blubber on a factory ship, and sells the whale oil without entering the territorial waters of any country.\(^3\) Under those facts, all of the income-producing activities occurred on the high seas. It would be inconsistent with the function of source rules, however, to assign the source of the income to the high seas because no government has sovereignty over the high seas. Recognizing that the purpose of source rules is to allocate income to taxing jurisdictions, the United States generally assigns the source of income derived from the activities of a taxpayer conducted on the high seas or in outer space to the country of residence of the taxpayer.\(^3\)

The most important issues in determining the source of income arise when an enterprise earns income that has some important links with more than one country. Consider, for example, the source of the income of an enterprise that produces goods in one country and sells those goods in another country. In this example, both the country of production and the country of sale are likely to make a claim to tax at least some portion of the income of the enterprise based on the source of the income. Both countries can rightly claim that significant economic activities took place within their borders and that those activities were necessary for the enterprise to earn the income. Although it might seem obvious that not all of the income has its source in one or the other country, it is not at all obvious how the source of the income in this example should be determined.

In practice, the source of income is determined under the particular tax laws of particular countries. Because the source of income is not obvious in many cases, the source rules adopted by various countries sometimes conflict. When source rules conflict, a taxpayer might find itself subject to tax in more than one country, or it might find it is not taxable on its income in any country. Well-designed source rules would mitigate the risks of overlapping and underlapping claims to tax jurisdiction over particular items of income.

In many cases, countries incorporate formulas into their source rules. For example, many countries apportion gross income from services performed in more than one country based on the time of performance in each country. Telecommunications gross income is often apportioned by formula between the country of origin of the telecommunication signal and the country of destination. The OECD has been promoting, with the support of the financial services industry, the use of a formula for assigning financial services income derived from global trading of financial instruments to particular taxing jurisdictions. The United States uses a two-factor formula (property and sales) for apportioning income from the production and sale of goods.\(^3\) Some countries make extensive use of formulas for allocating the cost of goods sold to particular gross receipts (for example, the LIFO, FIFO, or average costing formulas) and for allocating deductions to particular items of gross income. The use of formulas to assign a source to a particular item of income is an implicit recognition that the income item does not have an ascertainable true source.

For the most part, the source rules that appear in tax statutes are ex ante rules, not ex post rules. That is, the drafters of a tax statute are assigning a source to various categories of income before the transactions generating that income have actually occurred. The resulting legal rules abstract from the taxpayer earning the income and from the period over which which the income is measured. That is, source rules that appear in a taxing statute typically state that the source of an item of income falling within a particular category is to be determined by reference to certain characteristics of

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30That assignment of the right to tax might not be an exclusive right because source is only one possible basis for assigning the right to tax. If the teacher is resident in some other country, for example, then the country of residence might also claim the right to tax.

31Combined reporting is a system for taxing corporations, particularly multinational corporations. Thus, the taxation of employment income is not an issue in a combined reporting regime. If the schoolteacher in the example has earned the income through the use of a personal service corporation, however, the income of that corporation almost certainly would be attributed to the place of employment.

32The example is drawn in part from Spermact Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958), aff'd 281 F.2d 646 (6th Cir. 1960).

33U.S. Internal Revenue Code section 863(d)(1) (specifying that income derived from a “space or ocean activity” has its source in the country where the person deriving the income is located). That rule, adopted in 1988, changes the result reached in Spermact Whaling & Shipping Co., supra note 31.

34IRC section 863(b)(2).
that income item but without reference to the person earning the income or the period during which the income arose. For example, a source rule may provide that dividends are sourced in the country of the payer or that income from services is sourced in the country where the services are performed. Those rules are to be applied by all taxpayers for all taxable periods without reference to the economic circumstances of those taxpayers or to the economic conditions that might prevail in a particular taxable period.

Analysts have occasionally suggested that the source of income is an economic fact that can be determined, at least in principle, through economic analysis. One popular economic theory is that, in a world of perfect competition, profits would simply reflect a normal return on capital plus some risk premium for entrepreneurial activities. In that world, it is argued, the economic source of income is the place where the capital is located.\(^\text{35}\) Obviously, the world we live in is not a world of perfect competition. Indeed, without much exaggeration, one might define the multinational enterprise as a legal structure for obtaining economic rents on a global scale, particularly marketing rents and rents from intangible property.

But even if we did live in a world of perfect competition and even if we could agree that all corporate income arises from capital and entrepreneurial activity,\(^\text{36}\) we still would not know the economic source of the income in many important cases. As indicated above, the implicit premise seems to be that income would have its economic source where the capital is located and where the entrepreneurial activity occurred. Much of the capital of the typical multinational enterprise, however, is intangible property, and that property, by definition, has no geographical location. Some rule might be adopted to assign a location to that property — to the place of use, for example,\(^\text{37}\) or to the place where the ownership rights to the intangible property are assigned by law. But that assignment rule is a legal rule, not an economic principle, although economic considerations might play a major role in the design of that legal rule.

More fundamentally, when analysts claim to have discovered the source of income in a world of perfect competition, they have simply identified what I have referred to as the components of income, not its geographical location. To determine, for example, that income is generated by a particular tangible asset (for example, a television transmittal tower) or by a set of entrepreneurial activities (for example, manufacturing and selling goods) does not necessarily reveal anything useful about the geographical location of that component of income.\(^\text{38}\) Analysts might properly decide, after applying the criteria set forth in part II.A. above, that income from tangible property should be assigned to the place where the property is located and that income from entrepreneurial activities should be assigned to the place of performance. They cannot fairly claim, however, that the economic analysis that led them to link a particular component of income with a particular asset or a particular set of activities has also determined the geographical source of that component of income.

The arm’s-length/source-rule method attempts to treat the members of a group of related corporations engaged in a common enterprise as if they were actually independent corporations pursuing independent goals.

In the real world of imperfect competition, multinational enterprises have flourished through their ability to exploit what are commonly called economic rents. Those rents might be present on either the production side or the marketing side. They generally are not visible or tangible. They might be described as a type of intangible property that allows the holder to extract profits above the average return on capital. Economists often detect the existence of economic rents by observing that above-average profits are being earned. Here, economic rents serve a function for economists that is analogous to the function that goodwill serves for accountants. That is, the rent is a residual asset that explains why profits are greater than might otherwise be anticipated by economic theory. That residual asset obviously has no definite geographical location.

In some cases, an economic rent might arise from ownership rights to real property. In those cases, the economic rent might be associated with the geographical location of the real property. For example, assume


\(^{36}\)In fact it is at least as plausible to argue that income arises both from production (property) and from marketing (sales) in a world of perfect competition.

\(^{37}\)The place of use of intangible property is not clear in many cases, most importantly when the property is a secret process not protected under the laws of any country. See McIntyre Treatise, supra note 16, at section 3/A/1.3.

\(^{38}\)See, e.g., William Vickrey, “The Corporate Income Tax in the U.S. Tax System,” Tax Notes, Nov. 4, 1996, p. 597, at 602 (“[H]ow can one determine the source of the income of a radio station in Luxembourg advertising a product made in Belgium that is sold in France? One can easily squander all of the revenue involved in costs of fruitless disputation.”).
that a person owns the subsurface rights to real property and an oil field is discovered under that property. The income received from the exploitation of that legal right, to the extent it can be ascertained, is easily associated with the location of the oil field.39 This strong association of the oil profits with the country where the oil was extracted is not due, however, solely to the location of the economic rent. The association is based on a cluster of factors, all of which provide a linkage to the place of extraction. Included in those factors is that the administration of a tax on the oil in the place of extraction is relatively easy, the likelihood of another country asserting the right to tax the income is small, and the government of the country where the oil field is located is very likely to want to tax that income.40

Most multinational enterprises in the extractive industries do not earn the bulk of their income from exploiting ownership rights in real property. In most countries, the government owns the extractive rights to natural resources, and it is the government that is positioned to earn an economic rent from the exploitation of those rights. In the oil industry, for example, the income of the multinational enterprise is typically derived in substantial part from lifting and refining the oil and selling refined oil products in foreign markets. Its income, therefore, is likely to have nexus with many countries and not just with the country of extraction.41 Similar examples can be given for other types of income from real property, such as farm income, income from operating a hotel, and income from coastal fishing.42

For the reasons explained above, it is often difficult to associate an economic rent with a particular geographical area. Even when that association can be made, it typically cannot be made prior to the earning of the income. Only in a few rather isolated cases, such as income derived solely from the exploitation of a right to real property, is it possible to make an ex post assignment of an economic rent to a particular place. A source rule, however, is always an ex ante rule. It must be drafted and inserted into the tax laws to determine the source of income derived after its enactment. If the location of an economic rent is ascertainable only after the income from that economic rent has been earned, then that information is not particularly useful in drafting a source rule.

In summary, taxable income itself has no geographical place. It can be assigned a geographical place by a taxing statute based on nexus between a country and the assets and activities that generate its components. In some relatively infrequent cases, the location of an economic rent can be predicted with some reliability. In such a case, it might be sensible to link the income generated by that economic rent with the country where the rent is located, because that country can tax the income efficiently and is likely to do so. In many important cases, however, the income earned by a multinational enterprise is likely to have links with many countries, and the importance of those links with particular countries will be difficult to ascertain ex post and impossible to ascertain ex ante.

The rules that assign income to a particular place might be called source rules or might be given some other name, such as income apportionment rules or income assignment rules. As noted in section II.A., economic factors ought to be given significant weight in the design of those rules whenever possible. In the end, however, the rules used for assigning income to a particular geographical place are legal rules, not economic rules. They should be judged not by some absolute standard or by some principles of economics, but by the contribution they make to the goals of the tax system of which they are a part.

39See McLure, “Replacing Separate Accounting” supra note 35, at 593 (discussing what he characterizes as “location-specific economic rents”). See also McLure and Weiner, “Deciding,” supra note 14, at 259. The authors of the latter article recount a case in which a U.S. state attributed less income to the country where an oil field was located, for purposes of the state income tax, than was paid to that country in national income taxes. Id. at n. 27. In general a diversion between the results under combined reporting and the arm’s-length/source-rule methodology is not suspected and certainly is not discrediting to combined reporting. To discredit the results under combined reporting by reference to the results under the arm’s-length/source-rule methodology is to assume, improperly, that the latter system has primacy of place.

Absent some qualifying details not provided by the authors, the case they are complaining about might give support for the use of combined reporting. It is well-known that many oil-producing countries disguise what are, in substance, royalty payments so that they appear, for purposes of the U.S. PTC, as a genuine income tax. In the absence of a tax-avoidance motive, a country owning a natural resource generally would extract the economic rent from that ownership right by charging an extraction fee (royalty) to the multinational corporation that is engaged in the extraction, refinement, and sale of the oil. The fact that an extraction country and a multinational corporation have conspired against the U.S. law by disguising that fee as an income tax should not result in any increase in the amount of income that a state government treats as arising in the extraction country. What the authors seem to be complaining about implicitly is that a combined reporting system is not susceptible to this type of manipulation.

40See section II.A. above for a list of factors that should be taken into account in assigning an item of income to a particular area. All five of those factors suggest that income derived solely from the extraction of a natural resource should be assigned to the country of extraction.

41Oil lay beneath the sands of Arabia for millions of years without generating any income. Obviously, there is much more to earning income from oil than the mere existence of the oil.

42For discussion of the possible linkages between income from real property and countries other than the country where the property is located, see Brian J. Arnold and Jacques Sasseville, “Source Rules for Taxing Business Profits under Tax Treaties” in Brian J. Arnold, Jacques Sasseville, and Eric Zolt, eds., The Taxation of Business Profits Under Tax Treaties, Toronto: Canadian Tax Foundation (2003).
III. Comparison With Arm’s-Length/Source-Rule Method

As explained in part I, the combined reporting method requires the members of a common enterprise to determine their combined worldwide taxable income and then to pay tax on an apportioned share of that income in each of the taxing jurisdictions that is using the combined reporting method. In effect the combined reporting method treats a corporate group engaged in a common enterprise as if it were a single corporation operating in various countries through branches. A formula is used to determine the income of each branch. The particular formula, however, is not essential to a combined reporting system. Indeed, some alternative type of branch-accounting rule might be adopted without changing the essential nature of a combined reporting system.

In contrast the arm’s-length/source-rule method attempts to treat the members of a group of related corporations engaged in a common enterprise as if they were actually independent corporations pursuing independent goals. Typically, the common enterprise has no reason to compute its total worldwide income under that method. In general that computation would be made only if the common enterprise is organized as a single corporation and that corporation is resident in a country that taxes its residents on their worldwide income. In the far more common case of an enterprise conducted by a group of related corporations, each member of the corporate group is taxable on none, some, or all of its own income, the actual treatment depending on a wide variety of factors.43

Some consolidation of the accounts of a group of corporations would occur under the arm’s-length/source-rule method if the group is filing a consolidated tax return. In that case, the consolidated group generally is treated, in effect, as if it were one resident corporation for purposes of computing the consolidated taxable income of the group. Only resident corporations typically are included in the consolidated group. The source of income typically is determined separately for each corporation and not for the group as a whole.

A. Operative Features of Arm’s-Length/Source-Rule Method

Under the arm’s-length/source-rule methodology, corporations resident in a country typically are treated quite differently from foreign corporations. In general resident corporations are taxable on their worldwide income, whereas foreign corporations are taxable only on the portion of their income that is attributable to that country. Some countries, however, do not tax their resident corporations on their worldwide income. In those countries, the applicable rules are similar to the rules described below for taxing foreign corporations.

In computing its worldwide taxable income, a resident corporation typically would take the following four steps. Obviously there are some variations in these steps from country to country.

- Step 1: Books-of-Account Income. A resident corporation typically uses its worldwide income, as reported on its books of account, as its starting point in computing its domestic-source and foreign-source taxable income. Many adjustments typically must be made to book income in accordance with the tax jurisdiction’s applicable tax accounting rules.

- Step 2: Transfer Pricing Rules. When a resident corporation has had dealings with a related person, the amount determined in step 1, above, must be adjusted by applying the tax jurisdiction’s transfer pricing rules. The OECD transfer pricing guidelines44 provide for five distinct methods for determining the arm’s-length price on transfers of tangible property. Other methods must be used to determine the proper transfer price on transfers of intangible property and on the sharing of various corporate resources.

- Step 3: Source of Gross Income. After determining its worldwide taxable income in steps 1 and 2, a resident corporation typically must determine the amount of its domestic-source and foreign-source gross income. This calculation, plus the calculation in step 4, is required to determine the amount of the taxpayer’s allowable foreign tax credit. The function of the credit is to relieve the double taxation otherwise resulting from the taxation of foreign-source income by both the residence jurisdiction and the source jurisdiction.

- Step 4: Allocation of Deductions. As the final step in determining its domestic-source and foreign-source taxable income, a resident corporation must subtract its allowable deductions either from foreign-source gross income or from domestic-source gross income. Taxing jurisdictions are not at all uniform in their rules for determining the source of deductions. The general rule is that deductions should be matched with the income they help produce.


Deviations from the general rule, however, are commonplace, and application of that general rule is often difficult, especially for expenses that are hard to associate with particular categories of income, such as interest and research and development expenses.

The steps involved in computing the taxable income of a foreign corporation (or a domestic corporation not taxable on its foreign income) differ in some respects from those set forth above for resident corporations. The main differences are summarized below.

**Adjustments to Step 1.** A foreign corporation engaged in business in a taxing jurisdiction is not required to report its worldwide income. Foreign corporations entitled to the protection of a tax treaty need only report their taxable income that is attributable to a permanent establishment (PE) located within the taxing jurisdiction. The starting point in determining the amount of that income is the books of account of the PE. The rules applicable to a foreign corporation that is not entitled to treaty benefits depend on the laws of the taxing jurisdiction. Some countries use the PE concept unilaterally. Other countries might employ various source rules to determine the taxable income of a foreign corporation.

Transfer pricing rules are extremely complex, to the point, perhaps, of being incapable of fair administration. They are also easy to manipulate.

**Adjustments to Step 2.** A foreign corporation typically is taxable by a country only on the portion of its income that is attributable to a branch operating in that country. Transfer pricing rules do not apply to transactions between parts of a single corporation (that is, between branches). Some countries apply rules analogous to transfer pricing rules, however, in determining the income of a branch of a foreign corporation. The normal transfer pricing rules apply if a branch of a foreign corporation engages in transactions with related persons.

**Adjustments to Step 3.** As noted above, some taxing jurisdictions use source rules to determine the income of a domestic branch of a foreign corporation. The source rules applicable to foreign persons, however, might not be the same as the rules applicable to domestic persons. In some cases, a foreign corporation might be allowed to exclude from domestic taxable income some book income of the branch that does not have a domestic source.

**Adjustment to Step 4.** A foreign corporation engaged in business in a taxing jurisdiction is taxable on its net business income attributed to that jurisdiction. Thus, it must determine the amount of its allowable deductions that are attributable to its business operations in the taxing jurisdiction. The rules for attributing deductions to a branch of a foreign corporation might differ in some respects from the rules used to attribute deductions to the domestic-source income of domestic corporations. For example, a country might have different interest allocation and apportionment rules for foreign and domestic corporations.45

As the above summary indicates, the operation of the arm’s-length/source-rule methodology depends on four sets of rules — residency rules, source rules, accounting rules, and transfer pricing rules. Residency rules are simple, but they are also easily manipulated. Many countries determine a corporation’s residence by the place of incorporation. Place of incorporation is a historical fact, so it cannot be changed, at least formally. In practice, however, a corporation can change its residence by organizing a new corporation wherever it wants to be resident and then merging itself into the new corporation. The other common residency rule is the place of management. In principle that rule might have some substance. In practice, however, the place of management generally is determined by easily manipulated ceremonial events, such as the place where the board of directors meets.46

Source rules are sometimes simple and sometimes quite complex. Some are difficult to manipulate, whereas others invite manipulation. The U.S. rule that determines the source of income from the sale of goods by reference to the place where title to the goods passes is a well-known example of a source rule that is easily manipulated. Some source rules depend on the taxpayer’s residence. Because residence is easily manipulated, those source rules also are easily manipulated.

Accounting rules are not really rules, in the legal sense. In many important situations, they are no more than loose guidelines, subject to substantial manipulation by the taxpayer. The recent scandals involving Arthur Anderson and Enron have rocked the international accounting fraternity. The Enron case and the many other scandals that have followed in its wake have made clear to just about everyone that accounting rules are subject to manipulation and almost certainly will be manipulated in at least some cases when the stakes are even moderately high.47

45 E.g., the U.S. interest allocation and apportionment rules applicable to U.S.-based multinationals, found in Treas. reg. sections 1.881-8 et seq., apportion interest deductions pro rata to the taxpayer’s assets, whereas the interest rules applicable to foreign-based multinationals, found in Treas. reg. sections 1.882-5, use a modified tracing method. For a detailed discussion of those rules, see McIntyre Treatise, supra note 16, at section 3/B/2.


Transfer pricing rules are extremely complex, to the point, perhaps, of being incapable of fair administration. They are also easy to manipulate, for their operation depends on factual matters typically under the control of the taxpayer. Also, the rules are not uniform. Many different arm’s-length pricing methods are arguably applicable to the same set of transactions. As discussed below, the transfer pricing rules also are flawed conceptually.

Because of weaknesses in the residence rules, source rules, and transfer pricing rules, and the flexible nature of accounting rules, many countries have adopted antiavoidance rules to limit abuses arising under the arm’s-length/source-rule methodology. One important set of antiavoidance rules is the controlled foreign corporation rules. The details of those rules differ from country to country. In general, however, the rules are designed to tax some income that has been deflected to a tax haven, typically through the manipulation of the residency rules, source rules, branch accounting rules, and transfer pricing rules. A worldwide combined reporting method does not use any of those sets of rules, except, perhaps, incidentally, so it has little need for CFC rules.

Combined reporting also has no need for FTC rules. Those rules are needed under the arm’s-length/source-rule methodology because that method recognizes two separate and conflicting principles of taxation — the source principle and the residence principle. In combined reporting, only the income apportioned to a taxing jurisdiction by the apportionment formula is subject to tax in that jurisdiction. Overlapping tax claims are not inherent under combined reporting. Double taxation can occur if competing tax jurisdictions do not employ the same apportionment formula. That possibility, however, is reason for seeking common agreement on an apportionment formula, not for providing a foreign tax credit.

B. Contrasting Methodologies

The relative simplicity of a combined reporting system is due to its basic operating assumption that the income derived by a common enterprise is the income of the enterprise itself and that branches and affiliates engaging in that enterprise are merely instruments for earning that income. Under that assumption, it makes no sense to attribute particular items of income to the parts of the common enterprise. What they earn is an undivided interest in the total income of the enterprise.

In contrast, an arm’s-length/source-rule system treats the income of a common enterprise as derived by its constituent parts. That is, the branches and affiliates that make up the enterprise are treated as the exclusive owner of a part of the total income of the enterprise. That income is then comminuted into various categories for the purpose of applying source rules. For example, it might be necessary to determine whether some or all of the income of an affiliate or branch is sales income, manufacturing income, extraction income, personal services income, financial services income, transportation income, capital gains income, interest income, royalty income, and so forth. Separate source rules are then applied to each of the relevant categories of income of each affiliate and branch to determine the amount of income that is taxable by a particular nation state.

The diagram below illustrates the differences between the combined reporting methodology and the arm’s-length/source-rule methodology under a simple fact pattern. Assume that U is a multinational business (however organized) conducted in two countries, Country D and Country F. Country D is the domestic country that is imposing the income tax. Country F is some foreign country. U produces widgets in Country D and sells them in both Country D and Country F. U has only two categories of income — sales income and manufacturing income. In the diagram, the large rectangle with the dark border, labeled Y, represents the total net income of U. Net income in this context is taxable income computed without reference to income taxes paid.

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In the diagram, Area Y is subdivided horizontally into three parts:

- **Area a** represents the net income having a source in Country D, under the relevant source rules, that is attributable to the production and sale of widgets in Country D.
- **Area b** represents the net income having a source in Country D, under the relevant source rules, that is attributable to the production of the widgets in Country D and their sale in Country F; and
- **Area c** represents the net income having a source in Country F, under the relevant source rules, that is attributable to the sale of widgets in Country F.

Under the arm’s-length/source-rule tax methodology, the sum of Area a and Area b represents Country D source income, and Area c represents Country F source income. Under some simplifying assumptions, Country D would tax all of the income represented by the sum of Area a and Area b and would not tax the income represented by Area c if it adopted the arm’s-length/source-rule methodology and applied that methodology to tax a foreign-based multinational company.

The vertical slice of Y bracketed by the dotted line represents the net income that would be taxable by Country D if it adopted a combined reporting/formulary apportionment system. The diagram shows a portion of Area a, Area b, and Area c within that vertical slice. The point here is that a combined reporting/formulary apportionment system taxes a portion of each dollar of income derived by U, including income characterized as foreign-source income under arm’s-length/source-rule tax concepts.

The diagram above illustrates two fundamental differences between a combined reporting system and an arm’s-length/source-rule system. First, it illustrates that the income taxable in a combined reporting system is independent of the source of the income. If the taxpayer could arrange, for example, to shift income in the diagram from Area b to Area c, it would not be rewarded for that exercise by getting a tax reduction. In contrast, the source of income typically is important in an arm’s-length/source-rule system.

Assume, for example, that the common enterprise, U, is conducted by DCo and FCo, two related corporations. DCo is a resident of Country D. It manufactures the widgets in Country D and sells them to FCo. FCo is a resident of Country F. FCo does the selling in Country D and Country F to unrelated customers. The combined profits from U are $500. In a combined reporting system using an apportionment formula that is double-weighted for sales, one-half of the profits of $500 would be apportioned to Country D as the place of manufacture, and one-quarter — half of the remaining one-half ($500 x 1/2 x 1/2 = $125) — would be apportioned to Country D as the place where one-half of the widgets were sold. The remaining one-quarter of the combined profits would be apportioned to Country F, which was the place of sale for one-half of the widgets. After intrastate apportionment, Country D would tax DCo on profits of $375 ($250 + $125) and would tax FCo on profits of $125.

Note that the amount of income taxable by Country D in the above example is independent of the prices that DCo charged when it sold widgets to FCo. That amount also is independent of the source of the sales and manufacturing income. In an arm’s-length/source-rule system, the manufacturing income typically would be sourced in Country D (place of manufacture) and the sales income would be sourced partly in Country D and partly in Country F (places of sale). If DCo decreased the price it charged FCo for the widgets, the income sourced in Country D would decrease and the income sourced in Country F would increase. That is, a country’s tax base in an arm’s-length/source-rule system depends critically on the transfer pricing rules and the source rules.

A second difference in the contrasting methodologies illustrated by the diagram above is that the income taxable in a combined reporting system is independent of the residence of the members of the common enterprise and their legal status as corporations or branches. A combined reporting system would tax the amount of income within the vertical slice, without reference to the organizational structure of the common enterprise. In contrast, residence status matters in an arm’s-length/source-rule system in determining whether an entity is subject to worldwide taxation. The residence status of a taxpayer might also affect the source of its income. Also, the legal status of a member of a common enterprise matters in an arm’s-length/source-rule system in applying, or not applying, the transfer pricing rules and the branch accounting rules.

Assume, for example, that DCo and FCo in the above example change their organizational structure by having DCo merge into FCo. Under this new arrangement, the amount taxable by Country D in a combined reporting system still is the amount within the vertical slice. The answer would continue to be the same if FCo is merged into DCo. In contrast the amount taxable in an arm’s-length/source-rule system depends heavily on the form of organization. Under the initial arrangement — DCo doing the manufacturing and FCo doing the selling — Country D would tax the amount in Area a and Area b and would not tax the amount in Area c. If FCo is merged into DCo, however, Country D would tax all of the income in Area Y under its residence jurisdiction. If DCo is merged into FCo, the transfer pricing rules would not apply, except perhaps by analogy, because there would no longer be a transfer between related persons. The amount of income of the merged
entity, FCo, that would be taxed by Country D would depend on the branch accounting rules and on some source rules, which may or may not be the same as those applicable if the merger had not occurred.

C. Opportunities for Avoiding Taxes Under the Two Methodologies

The discussion above does not address the opportunities that taxpayers have under the contrasting methodologies to manipulate the rules to their advantage. In a combined reporting system, there are only two opportunities. First, the income subject to apportionment in a combined reporting system is the income of the common enterprise. A multinational group might attempt to include or exclude some activities from a common enterprise to minimize its taxes.

Typically, the taxpayer would want to include activities that were relatively unprofitable and to exclude activities that yield a high profit. In general the U.S. states require the taxpayer to include activities in the common enterprise if they provided synergistic benefits to that enterprise. Functional integration, centralization of management, and economies of scale are all indicia of a common enterprise. The U.S. states have many conflicts with taxpayers over the contours of a common enterprise, due in part to poor drafting of the state tax codes. If the taxpayer has more than one line of business and there are no substantial synergies between the businesses, each line is considered a separate enterprise. If the synergies are substantial, the lines are combined into a single enterprise. Disputes that arise in the gray area — synergies existing between lines of businesses that may or may not be substantial — typically are settled under reasonably well-understood criteria. A determination of the contours of a common enterprise, once made, typically is binding for future years.

In a combined reporting system, the income derived from the common enterprise by all of the entities engaged in that enterprise is included in apportionable income. In the example above, the income derived by DCo and FCo would be included in the combined report. If DCo established a foreign affiliate to create intangible property for the common enterprise or to hold title to that intangible property, the income of that affiliate would be included in the combined report. Similarly, an affiliate set up to loan money to members of the common enterprise would be included in the enterprise. In general horizontal divisions (for example, aircraft business and banking business) of an enterprise are permitted in appropriate cases, but vertical divisions (marketing, manufacturing, research, and accounting) of an enterprise are not permitted.

The second opportunity that taxpayers have in a combined reporting system for manipulating the rules to their advantage is in the application of the apportionment formula. Taxpayers might attempt to include or exclude, inappropriately, various items of their property, payroll, and revenue from the apportionment factors. Those opportunities are major if the apportionment factors are poorly defined. For example, if inventory is included in the property factor, the taxpayer can shift some portion of its income out of the production state by shipping its inventory outside of that state. If the factors are properly defined, however, the opportunities for manipulation are fairly minor. For example, only tangible assets used in production should be included in the property factor. The proper design of the apportionment formula is addressed in part IV.B.

Whereas the opportunities for gaming a well-designed combined reporting system are severely restricted and combated relatively easily, those opportunities are plentiful and difficult to restrict in an arm’s-length/source-rule system. There are many reasons why nation states have encountered major difficulties in operating that system. The following is a fair sample of those reasons:

- Taxpayers have substantial control over the transfer pricing rules, the source rules, the branch accounting rules, and the residency rules. As should be expected, they use that control to minimize their worldwide taxes. The multinational firms annually spend billions of dollars in legal, accounting, and consulting

Footnote continued in next column.)
fees in their successful efforts at manipulating the arm’s-length/source-rule system.

- Many of the rules used to implement the arm’s-length/source-rule system have major design flaws.
- The source rules, the transfer pricing rules, and occasionally the branch accounting rules elevate form over substance. The source of income frequently depends, for example, on the taxpayer’s organizational structure. The transfer pricing rules often give decisive weight to organizational structure and to intragroup contract arrangements that have little relevance outside the corporate group.
- The transfer pricing rules embody a badly flawed model of how income is earned by a multinational enterprise. Those rules implicitly assume that the members of a multinational enterprise, operating in concert, earn the same amount of income as would a group of unrelated entities operating in their own self-interests. This assumption is unsustainable. The multinational firms did not come to dominate international markets by earning the same profits as their local competitors.52
- The transfer pricing rules are not really rules of law that provide definite answers to legal questions; they are mere guidelines that suggest how a transfer pricing issue should be discussed and that offer a range of plausible answers. That problem of indefiniteness, moreover, is nearly impossible to remedy because prices in a market economy are set through the negotiations of the parties, with only the seller’s minimum price and the buyer’s maximum price actually set by market forces.53
- The arm’s-length/source-rule system is buttressed by international tax conventions and other agreements that have institutionalized some of the major techniques used by multinational businesses to avoid taxes. In particular tax treaties facilitate “entity isolation” — the use of an affiliated company to hold nexus-creating assets so that a related entity can engage in business in a tax jurisdiction

without giving that jurisdiction the nexus to tax its income derived in that jurisdiction.54
- Finally, the transfer pricing rules, source rules, branch accounting rules, and residency rules interact with each other to increase the complexity of an arm’s-length/source-rule system by many magnitudes. As a result, no one actually knows with any certainty how the system actually operates except perhaps in particular cases after intense study. The complexity makes administration of the system extremely difficult even when a country’s tax department is well staffed.

As an illustration of some of the common tax-planning opportunities available in an arm’s-length/source-rule system, consider DCo and FCo in the examples above. In that system, their respective incomes would be determined using one of the five transfer pricing methods approved by the OECD transfer pricing guidelines.55 One of those methods is the comparable uncontrolled price (CUP) method. That method, which is the paradigm for the arm’s-length approach, generally would set the prices charged on sales between DCo and FCo based on the prices changed by independent companies making comparable sales of comparable products.

To apply the CUP method, additional facts must be provided. Assume that DCo manufactured 10 widgets at a unit cost of $10 and sold the widgets to FCo at the arm’s-length price. FCo sold the widgets to unrelated customers at a unit price of $70 and had selling costs per unit of $10. Under these facts, the price per widget for the combined enterprise would be $50 ($70 - $10 - $10) and the total profits would be $500 ($50 x 10 widgets). The allocation of profit between DCo and FCo depends on the price used for the transfer of widgets between those two companies. If the facts showed that independent manufacturers of widgets were selling them to distributors for $35 each, then $35 would be the arm’s-length price under the CUP method and DCo should charge FCo that price per widget. As a result, DCo would earn profits of $250 (($35 - $10) x 10 widgets), and FCo would earn profits of $250 (($70 - $35 - $10) x 10 widgets).


55OECD transfer pricing guidelines, supra note 44. For a straightforward discussion of the various pricing rules approved by the OECD, see Arnold and McIntyre, International Tax Primer, supra note 47, at chapter 4.
This result is reasonably favorable to Country D. It would have jurisdiction to tax the $250 of manufacturing income on a residence basis and, presumably, on a source basis. Also, it might have jurisdiction on a source basis to tax FCo on that portion of its income derived from sales in Country D. Whether Country D could tax the income from those sales would depend on how the sales were accomplished and on the source rules adopted by Country D. If the sales were made over the Internet, with title passing in Country F, Country D would not have jurisdiction to tax under the source rules of many countries. If the sales were made through a bricks-and-mortar store located in Country D, however, then Country D almost certainly would be able to tax the sales made by that store. Thus, it could tax one-half of the sales income, or $125. This result is precisely the result achieved in the combined reporting system using the apportionment formula that was double-weighted for sales. There is harmony in the results because, under both systems, the sales activities and the manufacturing activities are treated as equally profitable.56

The result achieved above, however, would occur only rarely in real life because taxpayers would engage in tax planning to avoid it. One possible way of achieving a better tax result for the common enterprise would be for DCo to compute the arm’s-length price on its sale of widgets to FCo under the cost-plus method. That method, also approved in the OECD transfer pricing guidelines, would provide the manufacturer with a profit equal to some percentage of its production costs. That percentage would be determined by reference to the profit percentage earned by unrelated manufacturers engaged in comparable manufacturing activities. The remaining profits of the common enterprise, including the entrepreneurial profits, would be attributed to FCo, the sales affiliate.

Assume, for example, DCo produces evidence tending to show that unrelated manufacturers earn a profit percentage equal to 20 percent of their costs. In that event, DCo should have profits of $20 ($100 costs x 0.20) on its sales of 10 widgets to FCo under the cost-plus method. To earn that profit, it would need to charge FCo $12 ($10 cost + $20/10 profit) per widget. That $12 charge would be the arm’s-length price under the cost-plus method. The remaining profits of $480 would be attributed to FCo, and its source would be determined under the source rule applicable to sales rather than the source rule applicable to manufacturing. As discussed above, the portion of the sales income earned by FCo from sales in Country D might be taxable or not taxable by Country D, depending on the way the sales are made and the source rules adopted by Country D.

Moving some of the income of the common enterprise from DCo to FCo and changing its character from manufacturing income to sales income might not produce a favorable result for the taxpayer if Country F taxes its resident corporations on a worldwide basis and applies the same rules as those applied by Country D. Many countries, however, do not make any serious effort to coordinate their tax rules with those of their trading partners. It is possible, for example, that DCo and FCo could compute their income in Country F using an OECD-approved transfer pricing method, such as the retail sales method, that attributes all of the entrepreneurial income to the country of production.

A taxpayer, of course, is not totally free to pick the pricing method that serves it best. Indeed, most countries would take steps to prevent DCo and FCo from using blatantly inconsistent methods in Country D and Country F for the same transactions if they understood what was happening. Many countries would require the taxpayer to justify its choice of method and would challenge the choice if it seemed unsupported. Still, as noted above, the transfer pricing rules are more in the nature of guidelines than hard and fast rules of law. The choice of the appropriate method depends on the facts and circumstances of the case, and the taxpayer has substantial control over those facts and circumstances.

The examples above involved a common enterprise with only two members, each of which was organized in a country that might have some intention of taxing it. A more realistic example would include a corporate group with one or more members organized in a tax haven. Assume, for example, that DCo and FCo arrange for the establishment of HCo in a country that does not impose an income tax and does not assist other countries in enforcing their income taxes. Assume also that the corporate group arranges for HCo to own the rights to proprietary intangible property used by DCo to produce widgets. HCo is also made the owner of trademarks and other intangible property used by FCo in selling widgets. The common enterprise of DCo, FCo, and HCo is now positioned to use the arm’s-length/source-rule system to shift to HCo the manufacturing and sales income that was taxable to DCo and FCo in the above example.

Assume, for example, that DCo is using the CUP method to set the arm’s-length price on sales to FCo. Under that method, the arm’s-length price per widget is $35. Before the transfer of the intangible property to

56In general a combined reporting/formulary apportionment system treats all parts of a common enterprise as contributing significantly to its success. The justification for that treatment is that a common enterprise seeking to maximize its profits would not run an operation at a loss for an extended period unless its managers concluded that the operation was contributing to the enterprise in ways that were not appearing on the company books.
HCo, DCo was earning a profit of $25 on each widget sale to FCo. Under the arm’s-length/source-rule system, however, DCo must pay a royalty to HCo for the use of HCo’s property. Assuming a royalty charge of $20 per widget sale, DCo’s profits are reduced to $5 per widget. If HCo imposes a similar change on FCo for the use of the marketing intangibles, FCo’s income similarly will be reduced from $25 per widget to $5. HCo will have income from the payments from DCo and FCo of $40 per widget, which represents 80 percent of the income derived by the common enterprise from the manufacture and sale of widgets.

Country D and Country F are not helpless to respond to the earnings-stripping transaction described above. One possible defense would be for each country to impose a withholding tax on the payments made to HCo. Indeed, most countries do have in place a withholding tax on royalties, although the rate of the tax is typically lower than the normal rate applicable to corporate income. One problem with the withholding tax is that countries typically give it up, in whole or in part, in their tax treaties. Treaties that follow the OECD model convention, for example, have a zero withholding rate on royalties. In theory a country could decline to enter into a treaty that provided for a concessional rate on royalties unless the treaty partner would impose a full tax on those royalties. Virtually every country, however, has a treaty with at least one country that is a tax haven for royalties or is linked through its treaty network with such a country. As a result, royalties that are stripped out of a country typically end up being deflected to a tax haven through various treaty-shopping devices.

The above examples are highly stylized to illustrate some specific points. They are not realistic examples of how international tax specialists actually operate to manipulate the arm’s-length/source-rule system. In real life, the fact patterns are many, many times more complex, and the tax-avoidance techniques used are far more targeted. The examples above illustrate frontal attacks on the basic system. In real life, tax planners typically attack only so much of the system as is necessary to achieve their planning objectives. They exploit hitherto obscure features of the tax system of nation states and some anomalies in the way two particular tax systems interrelate. In many cases, their tax-avoidance plans are flawed and would be subject to attack if the victimized government understood what was occurring. Tax planners recognize, however, that governments have severely limited administrative resources and are able to pursue only a small percentage of their potentially meritorious cases.

The point of the examples presented above is to illustrate the differences between the tax-avoidance opportunities presented under a combined reporting system and an arm’s-length/source-rule system. Neither system is close to perfect. The flaws in a combined reporting system, however, are largely technical, and the solutions to those problems are easy to visualize. In contrast the problems with the arm’s-length/source-rule system, as the examples above suggest, result from the complex interplay of many seemingly unrelated sets of tax rules and can be addressed effectively only through the coordination and major reform of each of those sets of rules. Moreover, the reforms needed for the arm’s-length/source-rule system to operate effectively are at best uncertain.

IV. Some Practical Design Issues
A. Defining a Common Enterprise

The U.S. states are prohibited under U.S. constitutional law from taxing the income of a corporation unless the income has “some definite link, some minimum connection” between the state and the corporation’s income that the state seeks to tax. This necessary connection or relationship is referred to as nexus. Nexus is present when the income of the corporation is attributable in a meaningful way to a common enterprise, part of which is conducted in the taxing state. That is, the income derived by a group of corporations from the operation of a common enterprise has nexus with all of the states in which that enterprise is conducted. The type of income earned, its source under federal-source rules, and the reasons for earning the income are all irrelevant for establishing nexus. The simple rule is that a taxing state has nexus to tax an apportioned share of the separately stated income attributable to activities that otherwise might be viewed as occurring outside the taxing state when those activities are a part of the common enterprise conducted, in whole or in part, within the taxing state.

A corporate group, or even a single company, might simultaneously conduct more than one common enterprise. In some cases, only one of those enterprises would have activities in the taxing state. In that case, the state would tax an apportioned share of the income from the enterprise that is conducted in part within the state. The corporate group would determine the taxable income of that enterprise and would apply the apportionment formula using only the property, payroll, and revenue (sales) factors regarding that enterprise. A corporation might conduct two enterprises, each of which was conducted in the state. In that case, the state should calculate the taxable income of each enterprise separately. It would then apply a separate apportionment formula for each of the enterprises.

Whether the activities of one member of a corporate group are related to the business of another member of

that group can depend on how that latter corporation’s enterprise is described. A corporation’s enterprise can be described in many ways, from the most specific to the most general. For example, assume that PCo manufactures widgets for use in the aerospace industry and that SCo, its subsidiary, manufactures widgets for the automotive industry. If PCo’s enterprise is described very specifically as manufacturing widgets for the aerospace industry, then the activities of SCo might not appear to be related to that enterprise. Moving to a slightly higher level of generality, PCo’s unitary enterprise might be described as manufacturing widgets. Under that definition, SCo’s activities and PCo’s activities would more likely be considered to be part of a common enterprise. Even more generally, PCo’s enterprise might be described as manufacturing. In that event, the activities of all of PCo’s manufacturing subsidiaries might be part of a common enterprise. On the highest level of generality, PCo could be described as in the business of allocating its resources to maximize its internal rate of return. At that level of generality, any activities of a subsidiary of PCo might be part of a common enterprise.

The U.S. states are not permitted to define a common enterprise so broadly that it would include all of the potential activities of a group of commonly controlled entities. A fairly broad definition, however, is desirable and is permitted under controlling U.S. constitutional doctrines. A broad definition also would be appropriate for a nation state that adopted a combined reporting system. The big practical advantage of a broad definition is that it obviates the need in many cases for allocating income between two enterprises conducted by the same group of controlled entities.

The following factors should be considered in determining whether a group of commonly controlled entities are conducting a common enterprise:

- the participants in the enterprise contribute or are expected to contribute in a nontrivial way to each other’s profitability;
- sharing or exchanging value occurs among the participants in the enterprise;
- the prices charged by one member of the corporate group on transfers of assets or services to other members are inconsistent with the arm’s-length principle;
- a member of the controlled group is dependent on other participants for achieving some nontrivial business objectives;
- the functions of a group member are integrated with the functions of one or more other group members;
- the activities of a group member are managed by some central authority of the controlled group; or
- a group member offers some economies of scale or economies of scope that benefit the group as a whole.

In addition to the general factors listed above, some presumptions should be established to help a country’s tax department and its taxpayers determine the existence and scope of a common enterprise. The following recommended presumptions are drawn from the experience of the U.S. states with combined reporting:

- A taxpayer or corporate group should be presumed to be engaged in a common enterprise when all of its activities are in the same general line.
- A taxpayer or corporate group should be presumed to be engaged in a common enterprise when its various divisions, segments, branches, or affiliates are engaged in different steps in a vertically structured enterprise.
- A taxpayer or corporate group that might otherwise be considered as engaged in more than one common enterprise is presumed to be engaged in one common enterprise when there is a strong central management, coupled with the existence of centralized departments or affiliates for such functions as financing, advertising, research, or purchasing.
- A taxpayer operating different business segments within the organizational structure of the single business entity generally should be presumed to be engaged in a single common enterprise with respect to the business segments.

The problem of identifying the common enterprise in a combined reporting system has an analog in an arm’s-length/source-rule system. As that latter system has evolved to include profit-split methods, it has had to confront the problem of identifying a line of business. The issue arises in determining the arm’s-length price

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60 This list of factors, with some minor changes, is taken from McIntyre, Mines, and Pomp, “Designing a Combined Reporting Regime,” supra note 3, at 721-722.
61 This list of presumptions, with some minor changes, is taken from McIntyre, Mines, and Pomp, “Designing a Combined Reporting Regime,” supra note 3, at 723-724.
on transfers of tangible and intangible property from one controlled corporation to another. Assume, for example, that ACo designs and manufactures golf shoes and golf clubs and sells both products to BCo, a related company, which markets the products in various countries. To apply the profit-split method, ACo and BCo must determine whether they are engaged in one business (golf equipment) or two businesses (golf shoes and golf clubs).

B. The Apportionment Formula

Taxpayers can manipulate the apportionment formula by inappropriately including or excluding items from the apportionment factors. The basic problems are summarized below for each of the three apportionment factors. Some states have adopted special apportionment rules to deal with particular industries or unusual circumstances.

1. Property Factor

As discussed in part I, only property used by a combined group for the production of its goods and services should be included in the property apportionment factor. For example, inventory property and accounts or notes receivable for sales to customers would not be included in the property factor. Only property that can be located with some definiteness in a particular location should be included. Also, property that can be moved without any significant impact on the operation of the combined business should be excluded. For example, cash deposits should not be included even if the deposits represent working capital. Intangible property, such as a patent or know-how, should be included only if some rule is adopted to fix its location at the place where that property is actually used for production purposes, without reference to the location of the ownership rights.

A taxpayer might reduce its property factor inappropriately by leasing property rather than owning it if the property factor is defined in terms of ownership of property. The typical rule used by the U.S. states is to include leased property in the property apportionment factor if the property is used by the common enterprise in producing goods or services.

Assume, for example, that a common enterprise, U, produces widgets in Country D and Country F. The tax rate in Country D is higher than the rate in Country F, so U would like to shift income from Country D to Country F. To achieve that goal, U arranges that the assets used in Country D are not owned by any members of the combined group but, instead, are leased from an unrelated person. The goal is to minimize the income apportioned to Country D by minimizing the property apportionment factor located in Country D. This tax dodge is blocked by treating leased property as the property of the enterprise in computing the property apportionment factor.

Conversely, a taxpayer might attempt to increase inappropriately its property factor located in a particular jurisdiction. In the example above, the common enterprise, U, might try to beef up the property located in Country F rather than reducing the property located in Country D. For example, it might acquire real property for investment but claim the property relates to its business. The tax authorities should be given the power to exclude items from the property factor when necessary to prevent a distortion in the apportionment of income.

In principle, the value of property used in the apportionment formula should be determined by reference to market prices. As a practical expedient, nevertheless, most of the U.S. states use original cost as a proxy for value. If the value of rental property is unknown and cannot be ascertained, then its value would be estimated from the rental payments due under the rental agreement.

2. Payroll Factor

The payroll factor should include all wages, fringe benefits, and other emoluments paid to workers involved in the production of the goods and services produced by the common enterprise. The classification of workers as employees, partners, managers, directors, or independent contractors should not matter in determining whether the payments they receive should be included in the payroll factor. Wages and other compensation paid to perform sales activities should not be included in the payroll factor. For activities that serve both a production and sales function, some allocation of the compensation amount would be required.

65The U.S. rule is to exclude leased property except in abuse cases. Treas. reg. section 1.863-3(c)(1)(iv)(Ex. 3) (1998).
Taxpayers should not be permitted to artificially deflate the amount included in the payroll factor through the use of so-called independent contractors who, in substance, act as employees. These independent contractors may be viewed as leased employees, and their use by a taxpayer presents problems similar to the problems that arise under the property factor from the use of leased property. Unfortunately, the U.S. states generally do not treat leased employees the way they treat leased property. Instead, they typically omit contract employees from the payroll factor, thereby providing taxpayers with an opportunity to game the system.

3. Revenue Factor

The revenue factor would include all of the receipts derived by the common enterprise from the marketing of its goods and services. Many U.S. states refer to this factor as the sales factor because the most common items included in the factor are the proceeds from sales. Some states use the term “receipts factor” to signal that amounts received as lease payments, royalties, payments for services, and such are also included in the factor. The term “revenue factor” is used here to make clear that some receipts, such as repayments of a loan, are not included in the factor but that the factor is substantially broader than the term “sales factor” would suggest.

A taxing jurisdiction should eliminate opportunities that taxpayers may have for creating nowhere income by coordinating the apportionment rules with the nexus rules.

Problems arise under the revenue factor because some types of revenue, like software royalties, are received net of expenses, whereas other types of revenue, like sales receipts, include the cost of goods sold and other costs that would be excluded in computing the income derived from those sales. In principle, revenue received net of expenses should be grossed up to get a number comparable to gross receipts on sales, or the gross receipts number should be deflated to get a number more comparable to net income. The U.S. states do not make those adjustments except, on occasion, in cases of abuse.

The failure to make the adjustments suggested above can result in a distortion in the amount of income apportioned to a particular jurisdiction. Assume, for example, that U, a common enterprise, has developed valuable intangible property used to produce energy-efficient motors. It exploits that technology in Country D by manufacturing 100 motors and selling them in Country D. It also leases the technology to an unrelated manufacturer for production of 100 motors outside of Country D, receiving a royalty on each sale of a motor by the unrelated person. The denominator of the revenue fraction in the apportionment formula would include the gross receipts from the sales in Country D and the royalty payments received on sales outside of Country D. Some adjustment in the denominator would be appropriate, however, because the revenue derived from sales in Country D includes the cost of goods sold, whereas the revenue derived from sales outside Country D excludes the cost of goods sold.

U.S. states generally do not attempt to make the types of adjustments to the revenue factor suggested above, although many reserve the right to make adjustments in cases of abuse. As a result, the revenue factor is less precise than it should be, and, more importantly, it is subject to manipulation by taxpayers. Assume, for example, that U, a common enterprise operating in Country D, wishes to dilute the amount of income apportioned to Country D by inflating its revenue derived outside of Country D. To that end, U engages in a hedging transaction that generates a billion dollars of gross revenue outside of Country D, offset by a billion dollars of expense. If the gross receipts from the hedging transaction are treated as part of the common enterprise and the transaction is not ignored as a sham, U will have succeeded in moving much of its income outside of Country D.

There are various ways to remedy the problem illustrated above. The simplest way, and the way adopted by many U.S. states, is to give the tax authorities the discretion to calculate some revenue on a net basis if necessary to prevent abuse. An alternative approach would be to define revenue consistently in terms of net receipts rather than gross receipts. For example, sales revenue would be computed after allowing a deduction for the cost of goods sold.

C. Throwback and Throwout Rules

The goal of a combined reporting/formulary apportionment system is to apportion taxable income to jurisdictions that have nexus to tax it. In some cases, however, taxable income might be apportioned through the operation of the apportionment formula to a taxing jurisdiction that cannot tax the income. In the common parlance of U.S. states, that income is referred to as “nowhere” income. For a combined reporting system to operate properly, nowhere income should be reapportioned to a tax jurisdiction that has sufficient nexus to tax it.

66 For an analogous solution to the problem of having gross and net income in the denominator of the apportionment fraction, see Treas. reg. section 1.861-17(c)(2) and (3) (requiring a gross-up of licensing fees when apportioning research and development deductions under the sales method).
In general a taxing jurisdiction should eliminate opportunities that taxpayers may have for creating nowhere income by coordinating the apportionment rules with the nexus rules. For example, a taxpayer should be treated as having a taxable presence in a country if it has a property, payroll, or receipts factor located in that country.

U.S. states use two mechanisms for reapportioning income away from a state that cannot tax it. One mechanism is throwback rules. A throwback rule relocates an apportionment factor that would be located in a jurisdiction that cannot tax to another jurisdiction that has some relationship to that factor and is able to tax. The second mechanism for relocating apportionment factors is throwout rules. A throwout rule eliminates an item otherwise included in an apportionment factor from both the numerator and the denominator of an apportionment fraction. The effect of a throwout rule is to reallocate income proportionally among all of the states that have nexus to tax it.

1. Throwback Rules

Some states use a throwback rule to treat a sale made by a remote seller as made in the state where the sale originated when the state where the sale actually occurred lacks nexus to tax the income from the sale. The states generally do not use a throwback rule to relocate the property or payroll components of the apportionment formula. Also, the states do not use a throwback rule when the state where the sale occurred has the power to tax but has declined to exercise that power.

For an example of the use of a throwback rule to relocate sales revenue, assume that PCo, operating out of State A, makes a mail-order sale into State B. State B does not have jurisdiction to tax the income from that sale. PCo also makes sales in State A and in State C, and both states have jurisdiction to tax. State A might use a throwback rule in that situation to “throw back” the sales income from State B to State A, so that State A, in effect, is treated as the place of sale. In that situation, PCo would include the sales made in State B and the sales made in State A in the numerator of the revenue apportionment fraction in computing the amount of income taxable by State A. The sales made into State B would already be included in the denominator of that fraction without reference to the throwback rule. As a result of the throwback rule, the sales made in State B will be taxable by State A.

The effect of the throwback rule is to treat the taxing jurisdiction where a sale originates as the residual taxing jurisdiction with respect to that sale. In this respect the throwback rule is analogous to residence jurisdiction in an arm’s-length/source-rule system. As used by U.S. states, the throwback rule only applies when the jurisdiction where the sale occurred is unable to tax. In contrast, a taxing jurisdiction typically will exercise residence jurisdiction in an arm’s-length/source-rule system whenever the state where the income arose fails to tax for any reason.

A U.S. state might not be able to tax income derived from sales made within its borders for one or more of the following three reasons:

- Taxation might be barred under the Due Process Clause of the U.S. Constitution if the seller has only minimal contacts with the state. The due process threshold, however, is a low one. It generally is enough to cross that threshold for the seller to have purposefully availed itself of a state’s market. A seller generally can avoid taxation under the Due Process Clause in a state only if its sales in that state are infrequent and casual.

- A state might also be barred from taxing a remote seller on sales made within its borders under the Commerce Clause of the U.S. Constitution. In the Quill case, the U.S. Supreme Court held that “substantial nexus” is required under the Commerce Clause. Quill was a sales tax case involving the obligation of a remote seller to collect the use tax on behalf of the state. The implications of that case for income taxes are unclear.

- U.S. federal statutory law (enacted as P.L. 86-282) might prohibit a state from taxing sales made by a corporation within the state if the corporation’s activities within the state are limited to the solicitation of business. This legislation, adopted in 1959 as a temporary measure, is criticized in highly derogatory terms by many commentators. These criticisms are eminently fair. The legislation is for the
special interests and serves no useful social purpose.

Because of the several ways that states might be deprived of the right to tax income from sales within their borders under federal law, the application of the throwback rule to the revenue apportionment factor is a critical component of a combined reporting system. Its application to the other two apportionment factors is less critical, and the theoretical grounds for applying it in those circumstances are less clear.

States employing the throwback rule have encountered administrative problems in determining when to apply it. The typical state statute provides that the rule does not apply to sales made in another tax jurisdiction if the income from the sales is subject to tax in that jurisdiction. The point of this language is to avoid the imposition of the rule when a state is empowered to impose its tax on the income but declines to do so for tax policy reasons. The administration of the rule would be simplified substantially if the throwback statute made clear that the rule applies whenever the income was not taxed in fact unless the reason it was not taxed was that the state where the sales occurred had not adopted a broad-based corporate income tax.

The rationale for the subject-to-tax rule is unclear at best. The rule might reflect some concept of comity with sister states. Commentators have criticized the rule because it results in unequal treatment of taxpayers with comparable ability to pay and prevents a combined reporting system from achieving the goal of taxing 100 percent of the income of a common enterprise once and only once.71

Although nation states using the arm’s-length/source-rule system do not use throwback rules, they occasionally have adopted rules that function like a throwback rule. For example, France provides domestic corporations with an exemption for foreign-source business income but only if the taxpayer earns the foreign-source income through a foreign PE. The apparent point of this rule is that foreign-source income earned through a PE generally is taxable in the country where the PE is located. If there is no PE in the source country, the income is thrown back, in effect, to France. Another example is the treatment by the United States of income from activities on the high seas and in outer space. Instead of applying the usual place-of-performance source rule, which would create nowhere income, the United States assigns the source of that income to the place where the performer is resident.

2. Throwout Rules

Throwout rules are rarely used by U.S. states. New Jersey is an example of a state that recently adopted a throwout rule for the revenue apportionment factor. States only occasionally use a throwout rule for other apportionment factors as a general matter, although throwout rules are often used in special circumstances for these factors.72 The Multistate Tax Commission’s (MTC) regulations under UDITPA provide for a throwout rule for business income from intangibles when the intangible income cannot be readily attributed to any particular income-producing activity of the taxpayer.73

Both the throwback rule and the throwout rule result in all income being apportioned to a tax jurisdiction that can tax it.

For an example of the use of a throwout rule to relocate sales revenue, assume that PCo engages in sales activities in State A, State B, and State C. Its revenue from sales in each state is $100. State A and State B have jurisdiction to tax the sales income; State C does not. State A, a combined-reporting state, imposes an income tax on the enterprise conducted by PCo. In computing its tax liability in State A, PCo must calculate the revenue fraction in the apportionment formula. Calculated without regard to the throwout rule, the denominator of the fraction would be $300 ($100 x 3) and the numerator would be $100. Under the throwout rule, the revenue from sales in State C is removed from the denominator of the apportionment fraction. In calculating the revenue fraction for State A, the numerator remains the same ($100), but the denominator is reduced to $200 ($300 - $100). As a result, the revenue fraction is increased from one-third to one-half.

3. Choosing Between the Throwback and Throwout Rules

Both the throwback rule and the throwout rule result in all income being apportioned to a tax jurisdic-


71See Pomp and Oldman, supra note 50, at 10-19.

72Id. at 10-14.

73MTC Reg. IV.18(c). California follows the MTC regulation. See 18 Cal. Code of Regs. section 25157(c)(1)(C) (providing that unassignable income from intangibles shall be excluded from the denominator of the revenue factor).
tion that can tax it. This result is achieved in the throwback rule by treating the factors of the jurisdiction that cannot tax as the factors of a particular jurisdiction that can tax. The throwout rule accomplishes the same result by treating the factors attributable to the jurisdiction that cannot tax as if they did not even exist. In the former case, the numerator of the apportionment fraction is adjusted. In the latter case, the denominator is adjusted.

A throwback rule is appropriate in relocating sales when the taxpayer's connections to the state where the purchaser is located are too tenuous to permit the imposition of tax by that state. A sale clearly occurred somewhere and, if sales are to be part of the basis for apportionment, that sale ought to be located somewhere. Locating the sale in the state of purchase when it cannot be taxed in that state is inconsistent with the fundamental apportionment goal of having income taxed once and only once. Using a throwout rule, which results in the sale being taxable in states where other sales occurred, avoids creating nowhere income. It is deficient, nevertheless, in that the sale generally has no nexus at all with those other states. The best result is to give full power to the state of purchase to tax sales made within its borders. If that option is unavailable, however, a rule that links the sale to a place where the sale is deemed to have occurred is probably the best option.74

A throwout rule is more appropriate than a throwback rule in relocating the property and payroll factors of a common enterprise. The throwback rule can be justified for sales because the jurisdiction where the sales originated is a convenient alternative tax collector. There is no obvious alternative-taxing jurisdiction, however, when the jurisdiction where the property or payroll is located is unable to tax. In that situation, it makes good sense to distribute the additional taxing power among all of the jurisdictions where the enterprise is being conducted in proportion to its property and payroll.

D. Water’s-Edge Limitation

California is the most important supporter among the U.S. states of worldwide combined reporting. Multinational businesses have objected fiercely to that method of taxation. Many foreign-based multinational companies brought pressure on California to modify or abandon that method. Similar pressure came from the U.S. Treasury Department,75 acting at the behest of U.S.-based multinationals.

In 1986 California succumbed to the pressure and adopted legislation that allowed a corporate group under some conditions to avoid including some foreign corporations in its combined report.76 The legislation is referred to as the water’s-edge election, and a combined group making that election computes its income according to a water’s-edge combined report. The water’s-edge election was liberalized in 1993.77 Subject to some restrictions, a unitary group making a water’s-edge election can eliminate many foreign corporations from its combined report. Both the income and the factors of those foreign corporations would not be taken into account in preparing the combined report.

Allowing some members of a combined group to exclude themselves from the combined report under a water’s-edge rule obviously opens up opportunities for tax avoidance.

A water’s-edge election has no necessary effect on the treatment of the foreign-source income of domestic corporations included in the combined group. In California, for example, the foreign-source income of included corporations remains includible in the combined group's income.78 Some other states that have provided a water’s-edge election, however, have

74In the U.S. context, a major reason for the need for a throwback rule is P.L. 86-272, which prevents a state from taxing income derived from the sale of tangible property occurring within its borders when the taxpayer's only contact with the state is the solicitation of sales. The logic of P.L. 86-272, such as it is, seems to be that the sale really occurred in the state of shipment. This view is consistent with a long-discredited position once taken by the U.S. Supreme Court. See McLeod, Comm'r of Revenues v. J.E. Dilworth Co., 222 U.S. 327, 64 S. Ct. 1023 (1944).


78Cal. Rev. & Tax. Code section 25110(a)(2) and (3) (West Supp. 2001) (including domestic corporations in the water’s-edge election without limitation as to the source of their income).
limited their taxation of foreign-source income.79 That rule has no sound policy justification and apparently has been adopted as a political expedient.

In principle a combined reporting regime should require foreign corporations to be included in the combined unitary group if they are participating in the group's common enterprise. The income of a common enterprise should be taxed without regard to its organizational structure. Substance should prevail over form. Form is elevated over substance when the income from the foreign activities of a common enterprise is excluded from the combined report if they are conducted through a foreign corporation but is included in the combined report if they are conducted through a foreign branch of a domestic company. Obviously, the operation of a common enterprise engaged in cross-border activities is not confined by the borders of a single country.

Notwithstanding the merits of the case for mandatory worldwide combined reporting, there are some circumstances when it might not be desirable. In particular if a group of nation states, such as the European Union, the NAFTA countries, or some group of developing countries, adopted combined reporting, they might want to continue to deal with the rest of the world under the arm's-length/source-rule system.80 Operating both a combined reporting system and an arm’s-length/source-rule system might be less cumbersome if the combined reporting system includes a water’s-edge limitation.

Allowing some members of a combined group to exclude themselves from the combined report under a water’s-edge rule obviously opens up opportunities for tax avoidance. The principal danger, from the perspective of a nation state, is that the entities included in the combined group will deflect income derived by members of the group to entities engaged in the common enterprise that have been excluded from the combined group by the water’s-edge rule. The following rules, which are similar in most respects to the rules adopted by California,81 would permit the use of a water’s-edge limitation on the combined report while minimizing opportunities for tax avoidance.

- Subject to the exceptions discussed below, a group of corporations engaged in a common enterprise would not include foreign corporations in the combined group. For this rule, a foreign corporation is a corporation that is resident outside the nation state or regional group that operates the combined reporting regime. The corporations and other entities required to file a combined report under the water’s-edge rule are referred to here as the water’s-edge combined group.
- All domestic corporations and all corporations resident in a nation state that is part of the regional group that has adopted the combined reporting system would be included in the water’s-edge combined report if they are engaged in the common enterprise.
- Foreign members of the common enterprise would be included in the combined report if they are engaged in substantial business activities within the regional group that operates the combined reporting regime or have a PE in any country of the regional group. The California rule, which is eminently sensible, is to include a foreign corporation in the water’s-edge combined group if 20 percent or more of its business activities, as measured by

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81California provides a useful summary of its water’s-edge rules, including copies of required forms, in California Franchise Tax Board, California Forms & Instructions, 100W: 2003 Corporation Tax Booklet, Water’s-Edge Flers (2003), available online at http://www.ftb.ca.gov/forms/03_forms/03_100Wbk.pdf (last visited July 23, 2004).

Footnote continued in next column.)
its apportionment factors, is conducted within the United States.82

- A water’s-edge regime would include anti-avoidance rules, similar in function to the CFC rules used by various countries to control tax haven abuses. California piggybacks on the federal government’s CFC rules by requiring a water’s-edge combined group to include in its income the tainted income of the foreign affiliates, as determined under the federal CFC regime. A nation state, of course, would need to develop its own CFC-type rules. Those rules should allow the tax authorities to require a combined group to include foreign holding companies and other foreign entities in the water’s-edge group when appropriate to control tax avoidance or evasion.

- In computing the income of the water’s-edge group, no deduction should be permitted for royalties, rents, interest, and other payments made to a foreign member of the common enterprise that is excluded from the water’s-edge group. That is, a strict rule against earnings stripping would apply.

- Royalties, rents, interest, and other payments should be treated as business income, subject to apportionment, if they are received from a foreign member of the combined group that is not a member of the water’s-edge group. This rule may be important or unimportant, depending on the domestic tax rules of the nation state that has adopted the water’s-edge regime. It is important for U.S. states because of constitutional limitations on the taxation of nonbusiness income.

- Members of the water’s-edge group would be required to sign an agreement consenting to taxation under the water’s-edge regime. The consent agreement would be binding on current members of the water’s-edge group and on any subsequent members that would have qualified for inclusion in the group at the time of the agreement. As part of the agreement, the water’s-edge group would be required to obligate itself to provide the tax authorities, on request, with extensive documentation of its activities.

- The water’s-edge regime should not be voluntary. That is, a combined group should not be permitted to elect to include all members of the group in the combined report or to include only the water’s-edge members. California does allow an election every five years, due partly to pressure from the multinational companies and partly to concerns about the constitutionality of a mandatory rule. An election creates an asymmetry in favor of the taxpayer because the taxpayer can be expected to exercise the election so as to minimize its taxes.

A water’s-edge rule adds to the complexity of a combined reporting system and is inconsistent with the underlying theory of combined reporting. Ideally, its use would be a temporary measure that would be eliminated as more countries adopted combined reporting. Despite its flaws, a water’s-edge system can be made to work as long as strong antiavoidance measures are included. One key to its success is the elimination of opportunities for shifting income from the water’s-edge group to foreign holding companies and other foreign affiliates under the control of the combined group. The other key is to avoid the use of source rules in determining the amount of income subject to apportionment in the water’s-edge regime. Source rules and apportionment rules are oil and water, and cannot be made to work together in an effective way.

V. Conclusion

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.

No nation state has attempted to employ a combined reporting system. Moving that system from the subnational level of government to the national level undoubtedly will present some new challenges. The U.S. states are assisted 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, is a major economic player in the world. If it were organized as a nation state, it would rank fifth in the world — ahead of France, China, Italy, and Canada and behind only the United States, Japan, Germany, and the United Kingdom — in gross domestic product.

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82 Cal. Rev. & Tax. Code section 25110(a)(3). Utah has a similar rule, except that only payroll and property are taken into account. Utah Code Ann. sections 59-7-101(26) and (33), 59-7-4012(a). Under the California system, the 20 percent rule does not apply to foreign banks.
Many commentators have defended the arm’s-length/source-rule system and disparaged combined reporting. After years of experience with the arm’s-length/source-rule system, however, the case for continuing it is not easily made. To make that case, its supporters need to provide persuasive answers to the following questions.

- 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 derived 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 simple and transparent?

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

All of the above 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. The last of the questions is the critical one. If it is true that the current system is failing, then an alternative has to be considered 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 reforming the current system can draw some lessons from the success of the U.S. states with combined reporting. In my opinion, the following three features of combined reporting are keys to its success.

- Multinational businesses 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 a particular location is determined by reference to an indicator of the amount of that activity that is located unambiguously in a particular place and is subject to easy measurement.

- 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. Still, those features can be adopted by analogy. Three changes from the current system are needed to achieve that goal:

- Resident corporations must be made taxable on their entire income, including income earned through their foreign affiliates and branches. That is, the deferral privilege must be ended. Many reformers have argued for an end to deferral for decades. It turns out they were correct.83 The alternative to a complete end to deferral would be a much more robust system for taxing CFCs on income deflected to a tax haven.84 To be effective, the CFC regime would need to be the functional equivalent of worldwide taxation.

- Corporate residency rules must be revised so that they are not so easily subject to manipulation. Redesign of residency rules is a complex issue, beyond the scope of this article. Experience has shown that a single, simple test, like place of incorporation or place of management, will not work. An appropriate test would make a corporation’s residence status permanent, or nearly so. It would ensure that the ultimate parent corporation of a multinational enterprise would be resident in a country where substantial management activities occurred.85

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85See Reuven S. Avi-Yonah, “For Haven’s Sake: Reflections on Inversion Transactions,” Tax Notes Int’l, July 8, 2002, p. 225, at 228-230 (proposing that “residence” of a multinational corporation be defined “as the place where the principal officers of a corporation (the CEO and those reporting to her) manage the corporation’s business on a daily basis”).
The residence of a subsidiary corporation should depend to a significant degree on the residence of the corporations that control it, directly or indirectly.86

- Source rules, branch accounting rules, and transfer pricing rules need to be revised so that they operate more like formulary apportionment rules when the income involved has been derived from the exploitation of intangible property. In general the revised rules should not give weight to the form of organization or to contractual arrangements between members of the common enterprise. The OECD has moved tentatively in that direction by authorizing the use of formulas to determine the arm's-length price in some cases and by promoting the use of an apportionment formula for financial services companies engaged in global trading. Formulas need to be mandatory when the conditions for their use are met, and they must be used systematically in all appropriate cases. Also, the formulas used for determining transfer prices, the source of income and deductions, and the attribution of income to branches need to be coordinated.

The reform proposals outlined above for reforming the current system are not easily achieved, due in part to technical problems and in part to political problems. The political problems, however, are no less formidable than those that would arise if governments attempted to replace the current failed system with combined reporting. In either case, a battle royal with members of the tax-avoidance community is inevitable, for they will not surrender a multibillion-dollar enterprise without a struggle.

Combined reporting has three major advantages over the proposed major reform of the current system. First, combined reporting is known to work successfully, whereas some key features of the proposed reform are untested and not fully developed. Second, combined reporting is a less complex and more transparent system to operate. The operational advantages of combined reporting over the current system are truly astounding, allowing for the elimination of some of the most complex legal rules ever devised.

Third, combined reporting rests on a much stronger theoretical foundation. The basic insight of combined reporting is that the governments of countries in which a multinational enterprise operates should divide up the right to tax the total income of that enterprise in accordance with easily detectable indexes of economic activity in each country. It does not indulge the counterfactual assumptions of the current international regime, which treats a branch (some of the time) as fundamentally different from an affiliate; that assumes, for transfer pricing purposes, that multinational enterprises earn the same income as unrelated little companies with no economic power; that treats contractual arrangements among members of a commonly controlled group that have no legal and economic significance as if they have controlling significance; and that allows the multinationals to elect to treat income derived from the exploitation of intangible property in countries where real economic activities occur as having its source in a low-tax country where only paper-shuffling occurs.

As indicated above, a study of combined reporting offers insights that can be applied to improve substantially the current system. The most important insight is that a system for taxing multinational enterprises will end up as a sham unless the enterprise is required to report its total combined income to the relevant tax authorities. Reform within the context of the existing international tax regime is possible; thoughtful reforms would greatly improve the lives of ordinary people throughout the globe, who are the real victims of tax haven abuses. But why should countries settle for better when best is within their grasp?  

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86Michael J. McIntyre, "Determining the Residence of Members of a Corporate Group," 51 Canadian Tax Journal 1567-1573 (2003) (arguing that all members of a combined group should be treated as residents of the same country).