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The Use of Combined Reporting by Nation-States

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The typical multinational enterprise (MNE) 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 current method used by all nation-states is to determine the separate income of each member of the MNE by applying the arm's-length principle and then attributing the income of each such member to particular countries using source rules, branch accounting rules, or some combination of both. This current method has proven to be difficult to implement, and the problems of implementation appear to be getting worse rather than better. In addition, serious theoretical issues have been raised against the use of the current method when the income being apportioned has been derived in substantial part through the exploitation of intangible property.

In this chapter, 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.¹ The objective of this method is to impose taxes on a portion of the income of an MNE without reference to the form of organization of that enterprise. As a result, MNEs with the same total income generally are treated the same under this method. As with any method of taxation,

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1 Some commentators refer to combined reporting as the “unitary” method. This terminology comes from the US Supreme Court requirement that a state cannot require a related corporation that does not have direct nexus with the state to include its income in a combined report unless it is engaged in a unitary business with one or more related entities that do have direct nexus with the state. A nation-state obviously is not required to adopt the unitary business concept, and it certainly would not want to adopt that concept without modification. The term “common enterprise” is used in this chapter to indicate that the companies filing a combined report are engaging in the same or related activities.

certain compromises with the basic theory are needed to accommodate political realities and to reduce administrative burdens.

Part 1 of this chapter describes the way a combined reporting system actually operates. This discussion provides the necessary background for the rest of the chapter. Part 2 addresses the theoretical foundation for combined reporting, building primarily on my own prior work. Part 3 compares the combined reporting method to the arm's-length/source-rule method currently 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 MNEs enjoy under the current system, and would simplify compliance for tax departments and taxpayers. I do not address efficiency issues in this chapter.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 4 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 American 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 (NAFTA). A brief conclusion is provided in part 5. The conclusion suggests, inter alia, some lessons that can be drawn from the success of combined reporting for the reform of the current system for taxing MNEs.

This chapter discusses formulary apportionment 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 the American 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 MNEs and is inconsistent with the theory that supports combined reporting.

2 For a discussion of some aspects of the efficiency of combined reporting in the context of the American states, see Michael J. McIntyre, "Thoughts on the Future of the State Corporate Income Tax" (2002) vol. 25, no. 13 *State Tax Notes* 931-47, at 936-38. For a somewhat different perspective, see Charles E. McLure Jr., "The Elusive Incidence of the Corporate Income Tax: The State Case" (1981) vol. 9, no. 4 *Public Finance Quarterly* 395-413.

Operation of a Combined Reporting System

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 American 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 American states, the factors are property, payroll, and revenue (sales). The corporations that are included in a combined report are sometimes referred to as a combined group or a unitary group. The term "combined group" is used in this chapter. Although the combined report would be appended to the tax return of each group member that has a tax-filing obligation in the state, it is not itself a tax return.

A combined reporting state requires the combined group to use the combined report to determine the amount of the group's taxable unitary income apportioned to the state. That amount equals the aggregate taxable unitary income of the group multiplied by the group's apportionment percentage. The apportionment percentage is determined by applying the apportionment formula. If the apportionment percentage is, for example, 25 percent, then 25 percent of the aggregate taxable unitary income of the combined group would be taxable in the state. The tax is not imposed, however, on the combined group itself. Rather, each member of the group having nexus with the state is taxable on its assigned share of the combined income apportioned to the state under the apportionment formula.

To be included in the combined group, a corporation must be engaged in a common enterprise with the other members of that group.⁵ In addition, the corporation must be controlled, directly or indirectly, by a common parent corporation

3 See Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana" (2001) vol. 61, no. 4 *Louisiana Law Review* 699-761, reprinted in (2001) vol. 21, no. 10 *State Tax Notes* 741-69.

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.

5 See the section entitled "Defining a Common Enterprise," below, for discussion of what constitutes a common enterprise.

or by some consortium of related owners.⁶ States using combined reporting generally determine control by reference to a minimum ownership of voting stock.⁷

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 states is a good starting point. I would buttress the rule, however, by giving the tax department the authority 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.⁸

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 the members of the consolidated group. A major difference between a combined report, as used by the American states, and a consolidated return is that the consolidated return typically may be elected regardless of whether the included corporations conduct a common enterprise.⁹

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 favour 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 that in which 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.

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

7 See, for example, California Revenue and Taxation Code section 25105(b) (West Supp. 2001).

8 California has a “stapled stock” rule that treats two or more corporations as members of a control group if over 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: California Revenue and Taxation Code section 25105(b)(3) (West Supp. 2001). The California rule is a good one.

9 Some American 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.

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 American states use formulary apportionment, although only a minority use combined reporting. In addition, the Canadian provinces and the Swiss cantons use formulary apportionment without combined reporting. States apportion income by formula whether or not they use combined reporting out of practical necessity—they simply cannot administer the arm’s-length method.

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 states to promote uniform corporate tax rules. It does not have any provisions on combined reporting. It does include a recommendation for an evenly weighted three-factor apportionment formula. Those three factors are property, payroll, and sales. The term “sales” is not fully descriptive because receipts other than sales are included in that factor. That factor is referred to as the “revenue” factor in this chapter.

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 favour this formula because I think there are no compelling reasons for favouring the production state over the market state, or vice versa, in apportioning income and because 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.

$$TI_{\text{State}} = TI_{\text{WW}} \times 1/4 ((2 \times \text{Revenue}_{\text{State}} / \text{Revenue}_{\text{WW}}) + \text{Payroll}_{\text{State}} / \text{Payroll}_{\text{WW}} + \text{Property}_{\text{State}} / \text{Property}_{\text{WW}})$$

10 See, for example, Cal. Stat. 946 (1993); California Revenue and Taxation Code section 25128 (West 2001). A recent trend, unwelcome in my view, is the use of a single-factor revenue (sales) formula by the American states. At last count, nine states had adopted that formula.

In the above formula, (1) TI_{State} is the amount of taxable income of the common enterprise apportioned to the state; (2) TI_{ww} is the worldwide taxable income of the common enterprise; (3) $\text{Revenue}_{\text{State}}/\text{Revenue}_{\text{ww}}$ 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; (4) $\text{Payroll}_{\text{State}}/\text{Payroll}_{\text{ww}}$ is the ratio of compensation paid by the common enterprise within the state to its worldwide compensation; and (5) $\text{Property}_{\text{State}}/\text{Property}_{\text{ww}}$ 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 A Co manufactures widget parts in state A and sells them to B Co, which assembles the widgets both in state A and in state B. B Co sells the completed widgets in state A and in other jurisdictions. Some of the sales are made directly, and some are made through C Co, which is domiciled in a state that imposes no income taxes. A Co, B Co, and C Co 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; B Co derives \$4,000 from sales within state A and \$2,000 from sales in other jurisdictions. C Co derives \$2,000 from sales outside state A.

A Co, B Co, and C Co have a total of 10 employees worldwide, with a total payroll of \$4,000. A Co has 4 workers in state A and pays them compensation of \$2,000. B Co has 2 workers in state A and pays them compensation of \$1,000; it has 2 workers outside state A and pays compensation to them of \$800. C Co has no workers in state A; it has 2 workers outside that state and pays them compensation of \$200.

The combined production assets of A Co and B Co are valued at \$20,000. A Co has assets worth \$2,000 located in state A. B Co has assets worth \$3,000 located in state A and assets worth \$15,000 located outside state A. C Co has no production assets. Under these facts, \$625 of the combined taxable income of \$1,000 would be taxable by state A, computed as follows:

Revenue from worldwide sales	\$8,000
Revenue from state A sales	\$6,000
Ratio of state A revenue to worldwide revenue ($\$6,000/\$8,000$)	3/4
Total worldwide payroll	\$4,000
State A payroll ($\$2,000 + \$1,000$)	\$3,000
Ratio of state A payroll to worldwide payroll ($\$3,000/\$4,000$) ...	3/4
Total worldwide production assets	\$20,000
State A production assets ($\$2,000 + \$3,000$)	\$5,000
Ratio of state A assets to worldwide assets ($\$5,000/\$20,000$) ...	1/4
Worldwide taxable income	\$1,000
Apportionment percentage ($1/4 \times ((2 \times 3/4) + 3/4 + 1/4)$)	62.5%
Income apportioned to state A ($\$1,000 \times 10/16$)	\$625

Intra-State 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 intra-state apportionment formula.

Under the intra-state 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 intra-state 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 A Co (that is, the formula is applied using only A Co's state factors in the formula), A Co's state apportionment percentage would be 15 percent (0.15), computed as follows:

Ratio of A Co's state A revenue to worldwide sales (\$0/\$8,000)	0
Ratio of A Co's state A payroll to worldwide payroll (\$2,000/\$4,000)	1/2
Ratio of A Co's state A production assets to worldwide assets (\$2,000/\$20,000)	1/10
A Co's apportionment percentage ($1/4 \times ((2 \times 0) + 1/2 + 1/10)$)	15%

11 I am using the term "independent nexus" to mean that the corporation itself 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.

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

Ratio of B Co's state A revenue to worldwide sales (\$6,000/\$8,000)	3/4
Ratio of B Co's state A payroll to worldwide payroll (\$1,000/\$4,000)	1/4
Ratio of B Co's state A production assets to worldwide assets (\$3,000/\$20,000)	3/20
B Co's apportionment percentage ($1/4 \times ((2 \times 3/4) + 1/4 + 3/20)$)	47.5%

C Co 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 the state A ($62.5\% \times \$1,000$). Of that amount, \$150 ($\$1,000 \times 0.15$) would be taxable to A Co and \$475 ($\$1,000 \times 0.475$) would be taxable to B Co. None of the taxable income of the combined group would be taxable to C Co ($\$1,000 \times 0.0$). Indeed, on these facts, it is unlikely that C Co would have any reporting obligation to state A.

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

- 1) 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 pre-apportionment income.
- 2) The combined group calculates its apportionment percentage by applying the appropriate 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 pre-apportionment income enter into the formula.
- 3) The combined group multiplies its pre-apportionment 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.
- 4) The members of the combined group make the calculations necessary for intra-state apportionment. Under that process, the income taxable by the state is apportioned pro rata among the members of the combined group

¹² This list is provided for illustrative purposes and is not intended to be exhaustive.

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 2, 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. Reasonable rules can be devised, nevertheless, for resolving or sidestepping those ambiguities. For example, many states exclude intangible assets, such as stock, 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. On the basis of 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 4, 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, no such assumption is 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 will be 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 counter-factual assumption about the way income is earned within a corporate group.¹⁵ A major point of combined reporting is that corporate structures

13 Multistate Tax Commission (MTC) reg. section IV.18.(c)(3) (available at <http://www.mtc.gov/news&vws/Regs072701.pdf>).

14 See, for example, Charles E. McLure Jr. and Joann M. Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income," in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000), 243-92, at 258: "[Formulary apportionment] is based on an implicit assumption that profitability, compared with whatever factors appear in the apportionment formula, is uniform across related companies operating in different jurisdictions."

15 The 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 MNEs earn much of their income in tax havens. See Martin

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 favour 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 of time.

The following example illustrates the type of deal that the tax jurisdictions participating in a combined reporting system are making. Assume that country A and country B are contiguous countries and that on their common border is a large lake from which they both take their drinking water. Assume also that the countries agree that they will only draw down water to the extent that it is replenished by rain. The two countries have reasonably good records showing that the rainfall in each sector of the lake varies significantly from year to year in unpredictable ways and that the differences tend to average out over time. On these facts, the countries might agree to draw down an agreed percentage of the total rainfall going into the lake each year without reference to the amount falling in their sector. In adopting this combined reporting approach, the two countries are not indulging a counter-factual assumption that the rainfall in each sector is the same every year. Instead, they have decided that they want the simplicity, consistency, and fairness of the sharing system they have adopted.

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 would 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 as well. They would make that decision before they knew 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,

A. Sullivan, "Data Show Big Shift in Income to Tax Havens" (2002) vol. 97, no. 7 *Tax Notes* 880-82, at 881, table 1 (reporting that for 1999, US-based multinationals shifted over \$92 billion in profits to the top 46 tax havens and held over \$1 trillion in assets in those countries).

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.

Policy Analysis of Combined Reporting

Combined reporting, as practised by California and several other American states, rests on an entirely different theoretical foundation than the arm's-length/source-rule system currently in use by nation-states. The purpose of combined reporting is not to achieve some rough approximation of the results achieved under an arm's-length/source-rule approach, as some commentators seem to believe. It is to obtain for the taxing jurisdiction some reasonable share of the income earned by a group of related corporations from a common enterprise, based upon the level of relevant economic activity conducted in that jurisdiction.

The theoretical underpinning for combined reporting is set forth in the following section. That section explains why aggregating the income of related companies is essential for fair and effective taxation of those companies. It also sets forth criteria that should be used for linking the aggregate income of a combined group with particular geographical areas. The problems that arise in assigning a geographical source to income, which is an essential element of the arm's-length/source-rule approach, are discussed in the section entitled "Problems with the Source Concept." I explain in that section why income generally does not have a geographical source in a way that is meaningful for drafting a tax statute.

The Theoretical Underpinning for Combined Reporting

The basic theory of combined reporting is that the income earned by a group of related corporations engaged in a common enterprise is, in substance, the income of the enterprise, not the income of the various members that make up that enterprise. The members of the enterprise are established for various intra-group reasons. The branches and affiliates that make up the enterprise, however, are merely tools used by the enterprise for earning income, just as ownership of equipment is a tool used by the enterprise for earning income. There may be legal reasons for attributing a portion of the income of the enterprise to one or more members, typically to facilitate collection of the taxes assessed. In an apportionment formula, there also may be a reason for linking income with equipment or other property. These attribution rules, however, are not fundamental in determining the taxes paid by the enterprise. What is fundamental is the determination of the total income of the enterprise and the attribution of that income to various taxing jurisdictions based on the characteristics (factors) of the enterprise as a whole.

As explained in part 1, above, the combined reporting system used by the American states does not impose legal liability for payment of the tax on the common enterprise. Through a method called intra-state apportionment, the legal

liability is imposed on the members of the combined group having independent nexus with the taxing jurisdiction. Intra-state apportionment, however, is a practical rule for collection. It may be viewed as an accommodation to the fact that the members of the combined group have legal status whereas the enterprise itself may 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.

- 1) 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.
- 2) 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 A Co and H Co, 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 A Co shifted the ownership of property used in the common enterprise to H Co.
- 3) 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:

16 Michael J. McIntyre, *International Income Tax Rules of the United States* (Newark, NJ: Lexis/Nexis) (looseleaf), section 3/C.

- 1) *Administrative simplicity.* The apportionment rules should facilitate the assessment and collection of taxes. In general, the apportionment rules used by the American states are a model of simplicity, especially in comparison with the complexity of source rules.
- 2) *Neutrality.* 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. Such action is incompatible with the goal of a mutually agreeable sharing of 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 utilize a common apportionment formula and uniform rules for specifying the apportionment factors.
- 3) *Economic nexus.* To the extent possible, income should be apportioned to a country where it has some economic nexus. This objective is achieved by using economically significant factors in the apportionment formula. The three-factor formula used by the American 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 in accordance with some type of usage test. For example, a patent for technology used to manufacture goods might be located, for purposes of the apportionment formula, in the place where the manufacturing occurs.
- 4) *Inclination to tax.* To the extent feasible, income with an economic nexus in more than one state should be apportioned to a state that is inclined to subject the income to taxation. For the most part, this guideline is met under the three-factor formula typically used by the American 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.¹⁷ To address that situation, the American states typically employ a throwback rule which 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 4.

17 A state may not only be disinclined to tax such income, it may be prohibited from doing so under the due process clause (Bill of Rights, Fourteenth Amendment, section 1) and commerce clause (article 1, section 8) of the US Constitution or under An Act Relating to the Power of the State To Impose Net Income Taxes on Income Derived from Interstate Commerce, and Authorizing Studies by Congressional Committees of Matters Pertaining Thereto, Pub. L. no. 86-272, 73 Stat. 555 (1959) (herein referred to as "Pub. L. no. 86-272") (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).

- 5) *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 the American 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.¹⁸ 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 dead 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 taxed by these ersatz branches may 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.¹⁹ For example, a pure combined reporting system would not grant a tax credit for taxes paid to another taxing

18 See, for example, Charles E. McLure Jr., "Toward Uniformity in Interstate Taxation: A Further Analysis" (1981) vol. 13, no. 1 *Tax Notes* 51-63, at 51: "State income taxes are inherently, unequivocally, and entirely *source-based* taxes."

19 See Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance" (1994) vol. 49, no. 4 *Tax Law Review* 769-93, at 780-81.

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.²⁰

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, and 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 even where the taxpayer earning the income is a resident.²¹ 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 3, 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 merely 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

20 In practice, a combined reporting system might adopt some territorial limit. As discussed below under the heading "Water's-Edge Limitation," the US 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.

21 For 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" (2002) vol. 56, no. 1 *Tax Law Review* 81-155, at 83, note 2: "[W]e 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 simply a country that is imposing its tax based on its relationship to the income of a taxpayer, not to the taxpayer itself. See McIntyre, *supra* note 16, 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.'"

determine the “true” source of income.²² 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, and 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 arguably 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 may 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. The reason is that 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.²³ Income so defined cannot have a physical location, for it is merely a number.²⁴ A number is a quantity that has shed its accidental properties of time, place, colour, and so forth. This abstraction from all accidental properties other than quantity

22 See, for example, McLure and Weiner, *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.”

23 Henry C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), 50.

24 Income is “merely an arithmetic answer and exists only as the end result of appropriate calculations,” *ibid.*, at 51. Simons also criticizes the “folly” of “describing income as a flow

is a prerequisite to the mathematical manipulation that is necessary to specify a taxpayer's taxable income.

The fact that taxable income, as traditionally defined, is a number with no geographical location means that the location assigned to an item of income is not a fundamental characteristic of the income itself.²⁵ 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 contained 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.²⁶

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 may have some definite links to particular geographical areas. Those links may justify the exercise of tax jurisdiction by a particular sovereign government over some or all of a taxpayer's taxable income.

and, more emphatically, of regarding it as a quantity of goods, services, receipts, fruits, etc.," *ibid.* 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.

- 25 Ault and Bradford contend, as I have, that income, as defined under the Haig-Simons income concept, has no geographical location. See Hugh J. Ault and David F. Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises," in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990), 11-52, at 31-32: "The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea. . . . [The Haig-Simons] income concept is not susceptible to characterization as to source at all. Income in this definition attaches to someone or something that consumes and that owns assets. Income does not come from some place, even though we may construct accounts to approximate it by keeping track of payments that have identifiable and perhaps locatable sources and destinations."
- 26 Ault and Bradford apparently draw from the Haig-Simons income concept an inference that income should be taxed on a residence basis, *ibid.*: "To the extent that income describes an activity, it is not that of production but that of consumption and wealth accumulation, and its location is presumably the place of residence of the person doing the consuming and accumulating." I disagree with this position. I have argued at length elsewhere that one should infer from the policy considerations leading to the adoption of the Haig-Simons income concept that consumption should be taxable to the consumer and savings should be taxable to the saver. See Michael J. McIntyre and Oliver Oldman, "Taxation of the Family in a Comprehensive and Simplified Income Tax" (1977) vol. 90, no. 8 *Harvard Law Review* 1573-1630; Michael J. McIntyre, "Marital Income Splitting in the Modern World: Lessons for Australia from the American Experience," in John G. Head and Richard Krever, eds., *Tax Units and the Tax Rate Scale*, Australian Tax Research Foundation Conference Series no. 16 (Sydney: Australian Tax Research Foundation, 1996), 1-33. I do not believe, however, that determining who should be taxable on income is helpful in determining how the revenue from taxation should be shared among competing tax jurisdictions.

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 chapter, I seek to avoid the confusion otherwise resulting from the equivocal use of the term “source.”

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 US 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.”²⁷

Whether a country uses formulary apportionment or source rules, it is using some proxy to assign a source to items of taxable income. Neither methodology 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 may reflect political, legal, economic, and administrative realities, or they may ignore those realities. That is, they may 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, was educated locally, does all of her teaching in that community, and has no meaningful economic ties to any other community. Under these circumstances, the association of her employment income with the location of her employment is strong. In addition, it does not appear from these 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.²⁸ This happy result almost certainly would be

27 *Container Corp. v. Franchise Tax Bd.*, 463 US 159, at 192; 103 S. Ct. 2933, at 2954 (1983). See Reuven S. Avi-Yonah, “Slicing the Shadow: A Proposal for Updating U.S. International Taxation” (1993) vol. 58, no. 11 *Tax Notes* 1511-15.

28 That assignment of the right to tax may 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 may also claim the right to tax.

achieved in a tax system using source rules or in a tax system using some type of formulary apportionment.²⁹

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.³⁰ On these 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.³¹

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 may 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 may find itself subject to tax in more than one country. Or it may 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.

29 Combined 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.

30 The example is drawn in part from *Spermacet Whaling & Shipping Co. S/A*, 30 TC 618 (1958); aff'd, 281 F.2d 646 (6th Cir. 1960).

31 Internal Revenue Code of 1986, as amended, section 863(d)(1) (herein referred to as "the Code") (specifying that income derived from a "space or ocean activity" has its source in the country where the person deriving the income is located). This rule, adopted in 1986, changes the result reached in *Spermacet Whaling & Shipping Co. S/A*, supra note 30.

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 on the basis of 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.³² Some countries make extensive use of formulas for allocating the cost of goods sold to particular gross receipts 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 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 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. These 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 such a world, it is argued, the economic source of income is the place where the capital is located.³³ Obviously, the world we live in is not a world of perfect competition. Indeed, without much exaggeration, one might define the MNE as a legal structure for obtaining economic rents on a global scale, particularly marketing rents and rents from intangible property.

32 Code section 863(b)(2).

33 See Charles E. McLure Jr., “Replacing Separate Entity Accounting and the Arm’s Length Principle with Formulary Apportionment” (2002) vol. 56, no. 12 *Bulletin for International Fiscal Documentation* 586-99, at 593.

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,³⁴ 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 MNE, however, is intangible property, and such property, by definition, has no geographical location. Some rule might be adopted to assign a location to such property—to the place of use, for example,³⁵ or to the place where the ownership rights to the intangible property are assigned by law. But any such assignment rule is a legal rule, not an economic principle, although economic considerations may 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.³⁶ Analysts may properly decide, after applying the criteria set forth in the section entitled “The Theoretical Underpinning for Combined Reporting,” 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.

In the real world of imperfect competition, multinational enterprises have flourished through their ability to exploit what are commonly called economic rents. Those rents may be present on the production side or on the marketing side. They generally are not visible or tangible. They may 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. In this respect, economic

34 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.

35 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, *supra* note 16, at section 3/A.1.3.

36 See, for example, William Vickrey, “The Corporate Income Tax in the U.S. Tax System” (1996) vol. 73, no. 5 *Tax Notes* 597-604, 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.”

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. Such a residual asset obviously has no definite geographical location.

In some cases, an economic rent may arise from ownership rights to real property. In such cases, the economic rent may be associated with the geographical location of the real property. For example, assume 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.³⁷ 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.³⁸

Most MNEs 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.

37 See McLure, *supra* note 33, at 593 (discussing what he characterizes as “location-specific economic rents”). See also McLure and Weiner, *supra* note 14, at 259. The authors of the latter article recount a case in which an American 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: *ibid.*, at note 27. In general, a diversion between the results under combined reporting and the arm’s-length/source-rule methodology is not suspect and certainly is not discrediting to combined reporting. To attempt 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 may 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 US foreign tax credit, 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 US fisc 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.

38 See the section entitled “The Theoretical Underpinning for Combined Reporting,” above, for a list of factors that should be taken into account in assigning an item of income to a particular geographical 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.

In the oil industry, for example, the income of the MNE 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.³⁹ 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.⁴⁰

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 on the basis of a 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 may 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 an MNE 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 may be called “source” rules or may be given some other name, such as income apportionment rules or income assignment rules. As noted earlier, 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.

Comparison with Arm’s-Length/Source-Rule Method

As explained in part 1, above, the combined reporting method requires a common enterprise to determine its worldwide taxable income. The members of the

39 Oil 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.

40 For 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 this volume.

common enterprise are then taxable 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 its 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 their own 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 depends on a wide variety of factors.⁴¹

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.

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.

41 See Michael J. McIntyre, "Contrasting Methodologies: A Systematic Presentation of the Differences Between an Arm's-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System," in *Proceedings of the Eighty-Seventh Annual Conference on Taxation* (Columbus, OH: National Tax Association, 1994), 226-35.

- 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.
- 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 guidelines⁴² 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.
- 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 and foreign source gross income. This calculation, plus the calculation in step 4, is required in order 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.
- 4) *Allocation of deductions.* As the final step in determining its domestic 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.

- 1) *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

42 Organisation for Economic Development and Co-operation, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf) (herein referred to as "the OECD transfer-pricing guidelines").

the taxing jurisdiction. The starting point in determining the amount of such income is the books of account of the PE. The rules applicable to a foreign corporation that is not entitled to treaty benefits will depend on the domestic laws of the taxing jurisdiction. Some countries utilize the permanent establishment concept unilaterally. Other countries may employ various source rules to determine the taxable income of a foreign corporation.

- 2) *Adjustments to step 2.* 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.
- 3) *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, may not be the same as the rules applicable to domestic persons. In some cases, a foreign corporation may be allowed to exclude from domestic taxable income certain book income of the branch that does not have a domestic source.
- 4) *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 may differ in some respects from the rules used to attribute deductions to the domestic source income of domestic corporations. For example, a country may have different interest allocation and apportionment rules for foreign and domestic corporations.⁴³

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 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 meet.

43 For example, the US interest allocation and apportionment rules applicable to US-based multinationals, found in Code reg. section 1.861-8 et seq., apportion interest deductions pro rata to the taxpayer's assets, whereas the interest rules applicable to foreign-based multinationals, found in Code reg. section 1.882-5, use a modified tracing method. For a detailed discussion of those rules, see McIntyre, *supra* note 16, at section 3/B.2.

Source rules are sometimes simple and sometimes quite complex. Some are difficult to manipulate, whereas others invite manipulation. The US 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 Andersen 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.⁴⁴

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. In addition, 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 anti-avoidance rules to limit abuses arising under the arm's-length/source-rule methodology. One important set of anti-avoidance rules is the controlled foreign corporation (CFC) rules. The details of those rules differ from country to country. In general, however, the rules are designed to tax certain 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.⁴⁵ A worldwide combined reporting method does not use any of these rules, except, perhaps, incidentally, so it has little need for CFC rules.

Combined reporting also has no need for foreign tax credit 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

44 For a detailed discussion of the tax aspects of the Enron imbroglio, see United States, Joint Committee on Taxation, *Report Of Investigation Of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations*, JCS-3-03 (Washington, DC: Joint Committee on Taxation, February 2003) (available at <http://www.access.gpo.gov/congress/joint/jcs-3-03/>).

45 For a detailed, albeit dated, discussion of the various types of CFC regimes, see Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986); for a recent overview, see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2d ed. (The Hague: Kluwer Law International, 2002), chapter 5.C.

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.⁴⁶

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.

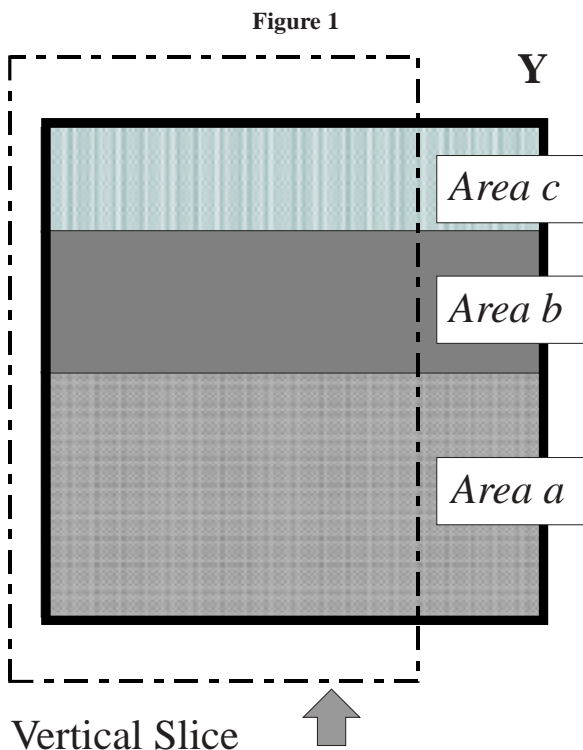
In contrast, an arm's-length/source-rule system treats the income of a common enterprise as derived by its constituent parts. That is, the branches and affiliates that make up the enterprise are treated as the exclusive owner of a part of the total income of the enterprise. That income is then comminuted into various categories for the purpose of applying source rules. For example, it may 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.

Figure 1 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, labelled Y, represents the total net income of U. "Net income" in this context is taxable income computed without reference to income taxes paid.

In figure 1, *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.

⁴⁶ The major design features of a combined reporting system for nation-states and the potential simplification benefits of that system are set forth in Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," in *Proceedings of the Eighty-Fourth Annual Conference on Taxation* (Columbus, OH: National Tax Association-Tax Institute of America, 1991), 118-24.



- *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.
- *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 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. Figure 1 shows a portion of *area a*, *area b*, and *area c* within that vertical slice. The point being made 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.

Figure 1 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 D Co and F Co, two related corporations. D Co is a resident of country D. It manufactures the widgets in country D and sells them to F Co. F Co is a resident of country F. F Co 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 ($\$500 \times 1/2 \times 1/2 = \125)—would be apportioned to country D as the place where one-half of the widgets were sold. The remaining one-quarter of the combined profits would be apportioned to country F, which was the place of sale for one-half of the widgets. After intra-state apportionment, country D would tax D Co on profits of \$375 ($\$250 + \125) and would tax F Co on profits of \$125.

Note that the amount of income taxable by country D in the above example is independent of the prices that D Co charged when it sold widgets to F Co. 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 D Co decreased the price it charged F Co 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 in figure 1 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 may also affect the source of its income. In addition, 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 D Co and F Co in the above example change their organizational structure by having D Co merge into F Co. 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 F Co is merged into D Co. In contrast, the amount taxable in an arm's-length/source-rule system depends heavily on the form of organization. Under the initial arrangement—D Co doing the manufacturing and F Co 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 F Co is merged into D Co, however, country D would tax all of the income in *area Y* under its residence jurisdiction. If D Co is merged into F Co, 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, F Co, that would be taxed by country D would depend on the branch accounting rules and on certain source rules, which may or may not be the same as those applicable if the merger had not occurred.

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 such opportunities. First, the income subject to apportionment in a combined reporting system is the income of the common enterprise. A multinational group may attempt to include or exclude certain activities from a common enterprise so as 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 American states would 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 American states have a significant number of conflicts with taxpayers over the contours of a common enterprise, due in part to poor drafting of the state tax codes.⁴⁷ If the taxpayer has more than one line of business and there are no substantial synergies between the businesses, then 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 in accordance with reasonably well-understood criteria. A determination of the contours of a common enterprise, once made, is typically binding for future years.⁴⁸

47 For references to recent cases interpreting the contours of a unitary business, see Richard D. Pomp and Oliver Oldman, *State & Local Taxation*, 4th ed. (Hartford, CT: Pomp, 2001), 11-41.

48 Conflicts do arise between taxpayers and states over the classification of income as business or non-business income. The US Supreme Court has interpreted the US Constitution as imposing significant limitations on the power of the states to tax non-business income of a taxpayer on an apportionment basis. Most states, following the UDITPA, have defined non-

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 D Co and F Co would be included in the combined report. If D Co established a foreign affiliate to create intangible property for the common enterprise or to hold title to such 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, vertical divisions (for example, aircraft business and banking business) of an enterprise are permitted in appropriate cases, but horizontal divisions (marketing, manufacturing, research, 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 may attempt to include or exclude, inappropriately, various items of their property, payroll, and revenue from the apportionment factors. These 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 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 4, below.

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 utilize that control to minimize their worldwide taxes. The multinational firms annually spend billions of dollars in legal, accounting, and consulting 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

business income more broadly than required under the US Constitution. For an argument for defining non-business income as narrowly as possible, see Michael J. McIntyre, "Constitutional Limitations on State Power To Combat Tax Arbitrage: An Evaluation of the Hunt-Wesson Case" (2000) vol. 18, no. 1 *State Tax Notes* 51-64; Walter Hellerstein, "The Business/Non-Business Income Distinction and the Case for Its Abolishment" (2001) vol. 21, no. 10 *State Tax Notes* 725-39.

frequently depends, for example, on the taxpayer's organizational structure. The transfer-pricing rules often give decisive weight to organizational structure and to intra-group contract arrangements that have little relevance outside the corporate group.

- The model embodied in the transfer-pricing rules of how income is earned by an MNE is faulty. 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.⁴⁹
- The transfer-pricing rules are not really rules of law that provide definite answers to legal questions but instead 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 ex post through the negotiations of the parties, with only the seller's minimum price and the buyer's maximum price actually set ex ante by market forces.⁵⁰
- 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.⁵¹
- 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 for well-staffed tax departments.

49 See McIntyre, *supra* note 16, at section 3/D.1.2. See also R.M. Bird and D.J.S. Brean, "The Interjurisdictional Allocation of Income and the Unitary Taxation Debate" (1986) vol. 34, no. 6 *Canadian Tax Journal* 1377-1416; Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length" (1986) vol. 30, no. 7 *Tax Notes* 625-81, at 654-69.

50 See McIntyre, *supra* note 16, at section 3/D.1.1.

51 The term "entity isolation" was coined by Paull Mines when he was serving as general counsel to the Multistate Tax Commission. See Paull Mines, "Conversing with Professor Hellerstein: Electronic Commerce and Nexus Propel Sales and Use Tax Reform" (1997) vol. 52, no. 4 *Tax Law Review* 581-623. See also Michael J. McIntyre, "Taxing Electronic Commerce Fairly and Efficiently" (1997) vol. 52, no. 4 *Tax Law Review* 625-54, at 626 and 636-53.

As an illustration of some of the common tax-planning opportunities available in an arm's-length/source-rule system, consider D Co and F Co 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.⁵² 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 D Co and F Co on the basis of the prices charged by independent companies making comparable sales of comparable products.

To apply the CUP method, some additional facts must be provided. Assume that D Co manufactured 10 widgets at a unit cost of \$10 and sold the widgets to F Co at the arm's-length price. F Co sold the widgets to unrelated customers at a unit price of \$70 and had selling costs per unit of \$10. On these facts, the profit per widget for the combined enterprise would be \$50 ($\$70 - \$10 - \10) and the total profits would be \$500 ($\50×10 widgets). The allocation of profit between D Co and F Co would depend 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 D Co should charge F Co that price per widget. As a result, D Co would earn profits of \$250 ($(\$35 - \$10) \times 10$ widgets), and F Co would earn profits of \$250 ($(\$70 - \$35 - \$10) \times 10$ widgets).

This result is reasonably favourable to country D. It would have jurisdiction to tax the \$250 of manufacturing income on a residence basis and, presumably, on a source basis as well. In addition, it might have jurisdiction on a source basis to tax F Co 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. This harmony in the results is due to the fact that under both systems, the sales activities and the manufacturing activities are treated as equally profitable.⁵³

52 For a straightforward discussion of the various pricing rules approved by the OECD, see Arnold and McIntyre, *supra* note 45, at chapter 4.

53 In 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.

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 D Co to compute the arm's-length price on its sale of widgets to F Co 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. All of the remaining profits, including the entrepreneurial profits, from the common enterprise would be attributed to F Co, the sales affiliate.

Assume, for example, that D Co produces evidence tending to show that unrelated manufacturers earn a profit percentage equal to 20 percent of their costs. In that event, D Co should have profits of \$20 ($\$100 \text{ costs} \times 0.20$) on its sales of 10 widgets to F Co under the cost-plus method. To earn that profit, it would need to charge F Co \$12 ($\$10 \text{ cost} + \$20/10 \text{ profit}$) 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 F Co, 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 F Co 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 D Co to F Co and changing its character from manufacturing income to sales income may not produce a favourable 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 D Co and F Co 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 D Co and F Co from using blatantly inconsistent methods in country D and country F with respect to 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 all involved a common enterprise with only two members, each of which was organized in a country that may 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 D Co and

F Co arrange for the establishment of H Co 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 H Co to own the rights to proprietary intangible property used by D Co to produce widgets. H Co is also made the owner of trademarks and other intangible property used by F Co in selling widgets. The common enterprise of D Co, F Co, and H Co is now positioned to use the arm's-length/source-rule system to shift to H Co the manufacturing and sales income that was taxable to D Co and F Co in the above example.

Assume, for example, that D Co is using the CUP method to set the arm's-length price on sales to F Co. Under that method, the arm's-length price per widget is \$35. Prior to the transfer of the intangible property to H Co, D Co was earning a profit of \$25 on each widget sale to F Co. Under the arm's-length/source-rule system, however, D Co must pay a royalty to H Co for the use of H Co's property. Assuming a royalty charge of \$20 per widget sale, D Co's profits are reduced to \$5 per widget. If H Co imposes a similar change on F Co for the use of the marketing intangibles, F Co's income similarly will be reduced from \$25 per widget to \$5. H Co will have income from the payments from D Co and F Co 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 defence would be for each country to impose a withholding tax on the payments made to H Co. 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,⁵⁴ 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 systems of nation-states and certain anomalies in the way two

54 Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003).

particular tax systems interrelate. In many cases, their tax-avoidance plans are themselves 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 tiny 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 these sets of rules. Moreover, the reforms needed for the arm's-length/source-rule system to operate effectively are at best uncertain.

Some Practical Design Issues

Defining a Common Enterprise

The American states are prohibited under US constitutional law from taxing the income of a corporation unless the income has "some definite link, some minimum connection"⁵⁵ 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 purposes of 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 may 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, may simultaneously conduct more than one common enterprise. In some cases, only one of these enterprises would have activities in the taxing state. In such a 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 relating to that enterprise. A corporation might conduct two enterprises, each of which was conducted in the state. In this case,

55 *Miller Bros. Co. v. Maryland*, 347 US 340, at 344-45; 74 S. Ct. 535, at 539 (1954).

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 P Co manufactures widgets for use in the aerospace industry and that S Co, its subsidiary, manufactures widgets for the automotive industry. If P Co's enterprise is described very specifically as manufacturing widgets for the aerospace industry, then the activities of S Co might not appear to be related to that enterprise. Moving to a slightly higher level of generality, P Co's unitary enterprise might be described as manufacturing widgets. Under that definition, S Co's activities and P Co's activities would more likely be considered to be part of a common enterprise. Even more generally, P Co's enterprise might be described as manufacturing. In that event, the activities of all of P Co's manufacturing subsidiaries might be part of a common enterprise. On the highest level of generality, P Co 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 P Co might be part of a common enterprise.⁵⁶

The American 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.⁵⁷ A fairly broad definition, however, is desirable and is permitted under controlling US 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 factors⁵⁸ 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 non-trivial way to each other's profitability;
- sharing or exchanging value is occurring 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 non-trivial business objectives;

56 Pomp and Oldman, *supra* note 47, at 10-21.

57 *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 US 768; 112 S. Ct. 2251 (1992).

58 This list of factors, with some minor changes, is taken from McIntyre, Mines, and Pomp, *supra* note 3, at 721-22.

- 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, certain presumptions should be established to help the tax department and taxpayers determine the existence and scope of a common enterprise. The following recommended presumptions are drawn from the experience of the American states with combined reporting.⁵⁹

- 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; and
- 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 analogue 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 on transfers of tangible and intangible property from one controlled corporation to another.⁶⁰ Assume, for example, that A Co designs and manufactures golf shoes and golf clubs and sells both products to B Co, a related company, which markets the products in various countries. To apply a profit-split method, A Co and B Co must determine whether they are engaged in one business (golf equipment) or two businesses (golf shoes and golf clubs).

59 This list of presumptions, with some minor changes, is taken from McIntyre, Mines, and Pomp, *ibid.*, at 723-24.

60 See Code reg. section 1.482-6(a) (1994). Under this regulation, the common enterprise, for purposes of applying the profit-split method, is "the most narrowly identifiable business activity of the controlled taxpayers for which data are available that includes the controlled transactions (relevant business activity)."

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.⁶¹

Property Factor

As discussed in part 1, above, 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. In addition, 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 knowhow, 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.⁶²

A taxpayer may 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 American 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.⁶³

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. In an attempt 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.

61 For the California special rules, see, for example, 18 California Code of Regulations sections 25137 to 25137-11 and 25101 (providing special apportionment procedures for bus transportation, freight forwarding companies, mining, printers, professional sports, oil and gas industry, stockbrokers, telecommunications companies, timber, and vessels such as tug boats and barges).

62 For the implementation of this rule, see Code reg. section 1.863-3(c)(1)(i)(C) (1998). The rule is described in appropriate detail in McIntyre, *supra* note 16, at section 3/A.2.3.3. The regulatory rule adopted in 1998 was proposed in an earlier edition of that treatise.

63 The US rule is to exclude leased property except in abuse cases: Code reg. section 1.863-3(c)(1)(iv), example 3 (1998).

Conversely, a taxpayer may 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. 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 American 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.

The 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.

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 American 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.

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 of the American 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 certain 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.

Problems arise under the revenue factor because some types of revenue, such as software royalties, are received net of expenses whereas other types of revenue,

such as 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 American states do not make such 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 itself 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.⁶⁴

The American states generally do not attempt to make the types of adjustments to the revenue factor suggested above, although many states do 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 states, is to give the tax authorities the discretion to calculate certain 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.

64 For an analogous solution to the problem of having gross and net income in the denominator of the apportionment fraction, see Code reg. sections 1.861-17(c)(2) and (3) (requiring a gross-up of licensing fees when apportioning research and development deductions under the sales method).

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 may be apportioned through the operation of the apportionment formula to a taxing jurisdiction that cannot tax the income. In the common parlance of the American states, such 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.

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.

The American 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.

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.⁶⁵ The states generally do not use a throwback rule to relocate the property or payroll components of the apportionment formula. In addition, 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.⁶⁶

For an example of the use of a throwback rule to relocate sales revenue, assume that P Co, operating out of state A, makes a mail-order sale into state B.

65 See UDITPA, section 16(b) (available at http://www.law.upenn.edu/bll/ulc/fnact99/1920_69/udiftp57.pdf) (defining the place of sale as the place of shipment if the taxpayer is not taxable in the state of the purchaser).

66 California uses a “double throwback” rule to tax income from a sale when the origin state and the destination state do not have the power to tax the income and the sale has nexus with California. It applies primarily to sales involving the drop shipment of goods—that is, the goods sold are shipped directly from a state where the taxpayer is not subject to tax to a customer located in a state where the taxpayer is not subject to tax. See, for example, 18 California Code of Regulations section 25135(a)(7). Some other states have also adopted this rule.

State B does not have jurisdiction to tax the income from that sale. P Co 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, P Co 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, it is analogous to residence jurisdiction in an arm’s-length/source-rule system. As used by the American 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.

An American state may not be able to tax income derived from sales made within its borders for one or more of the following three reasons.

- Taxation may be barred under the due process clause of the US 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 may also be barred from taxing a remote seller on sales made within its borders under the commerce clause of the US Constitution. In the *Quill* case,⁶⁷ the US 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.⁶⁸
- Federal statutory law⁶⁹ may 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

67 *Quill Corp. v. North Dakota*, 504 US 298 (1992).

68 For an analysis of *Quill* in the context of an income tax on remote computer vendors selling into a state, see Richard D. Pomp and Michael J. McIntyre, “State Taxation of Mail-Order Sales of Computers After Quill: An Evaluation of MTC Bulletin 95-1” (1996) vol. 11, no. 2 *State Tax Notes* 177-84.

69 Pub. L. 86-272, *supra* note 17.

as a temporary measure, is criticized in highly derogatory terms by many commentators.⁷⁰ 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 may 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 may 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

70 See, for example, Robert L. Roland, “Public Law 86-272: Regulation or Raid” (1960) vol. 46, no. 6 *Virginia Law Review* 1172-89, at 1172, citing Robert L. Roland, “State Taxation of Interstate Income: A State Tax Administrator’s Viewpoint” (1959) vol. 12, no. 1 *The Tax Executive* 35-39, at 35 (characterizing it as “a piece of hasty, hysteria legislation”); Michael T. Fatale, “Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272” (2002) vol. 21, no. 4 *Virginia Tax Review* 435-506, at 498: “The Act provides very little, if any, federal benefit in terms of protecting interstate commerce, but at the same time, imposes an enormous cost upon the states.”

71 See Pomp and Oldman, *supra* note 47, at 10-19.

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.

Throwout Rules

Throwout rules are rarely used by the American 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 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

For an example of the use of a throwout rule to relocate sales revenue, assume that P Co 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, and state C does not. State A, a combined reporting state, imposes an income tax on the enterprise conducted by P Co. In computing its tax liability in state A, P Co must calculate the revenue fraction in the apportionment formula. Calculated without regard to the throwout rule, the denominator of the fraction would be \$300 ($\100×3) and the numerator would be \$100. Under the throwout rule, the revenue from sales in state C is removed from the denominator of the apportionment fraction. In calculating the revenue fraction for state A, the numerator remains the same (\$100), but the denominator is reduced to \$200 ($\$300 - \100). As a result, the revenue fraction is increased from $\frac{1}{3}$ to $\frac{1}{2}$.

Choosing Between the Throwback and Throwout Rules

Both the throwback rule and the throwout rule result in all income being apportioned to a tax jurisdiction 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, it is the denominator that 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

72 *Ibid.*, at 10-14.

73 MTC reg. section IV.18(c) (see *supra* note 13). California follows the MTC regulation. See 18 California Code of Regulations section 25137(c)(1)(C) (providing that unassignable income from intangibles shall be excluded from the denominator of the revenue factor).

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 in the case of 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.

Water's-Edge Limitation

California is the most important supporter among the American states of worldwide combined reporting. MNEs have objected fiercely to that method of taxation. A number of foreign-based MNEs brought pressure on California to modify or abandon that method. Similar pressure came from the US Treasury Department,⁷⁵ acting at the behest of US-based multinationals.

In 1986, California succumbed to the pressure and adopted legislation that allowed a corporate group under some conditions to avoid including certain 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

74 In the US context, a major reason for the need for a throwback rule is Pub. L. no. 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 Pub. L. no. 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 US Supreme Court. See *McLeod v. Dilworth Co.*, 322 US 327; 64 S. Ct. 1023 (1944).

75 The US Treasury Department convened a working group on formulary apportionment that recommended that the states not include foreign corporations in their combined report. See United States, Worldwide Unitary Taxation Working Group, *The Final Report of the Worldwide Unitary Taxation Working Group: Chairman's Report and Supplemental Views* (Washington, DC: Government Printing Office, 1984) (reprinted as appendix I in Charles E. McLure Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* (Arlington, VA: Tax Analysts, 1986), 235-326).

76 Cal. Stat. 660 (1986).

income according to a water's-edge combined report. The water's-edge election was liberalized in 1993.⁷⁷ Subject to certain 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.

A water's-edge election has no necessary effect on the treatment of the foreign-source income of domestic corporations that are 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 also limited their taxation of foreign source income.⁷⁹ Such a 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 those activities are conducted through a foreign corporation but the income is included in the combined report if the activities 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

77 Cal. Stat. 881 (1993). For a discussion of the 1993 legislation and the combination of pressures that led to its enactment, see Eric J. Coffill, "A Kinder, Gentler 'Water's Edge' Election: California Wards off Threats of U.K. Retaliation as Part of Comprehensive Business Incentive Tax Package" (1993) vol. 61, no. 4 *Tax Notes* 477-87 (also published in (1993) vol. 7, no. 17 *Tax Notes International* 1049-60); Jerome R. Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment" (1993) vol. 60, no. 10 *Tax Notes* 1131-45, at 1139 (referring to the water's-edge legislation as "a 'shotgun' marriage arrangement" because of the federal and other pressures brought to bear on California).

78 California Revenue and Taxation Code sections 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).

79 See, for example, Ariz. Rev. Stat. section 43-1122(7) (1998) (exempting foreign dividends).

80 Various commentators have suggested the use of combined reporting within NAFTA, the European Union, and elsewhere. For a proposal to apply that method within NAFTA, see Robert S. McIntyre and Michael J. McIntyre, "Using NAFTA To Introduce Formulary Apportionment" (1993) vol. 6, no. 14 *Tax Notes International* 851-56 (reprinting testimony

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 purposes of 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.

before the US Senate Committee on Governmental Affairs, March 25, 1993); Paul R. McDaniel, "Formulary Taxation in the North American Free Trade Zone" (1994) vol. 49, no. 4 *Tax Law Review* 691-744. For a similar proposal for the European Union, see Mike McIntyre, "Harmonizing Direct Taxes in the EEC" (1990) vol. 2, no. 2 *Tax Notes International* 131-32; Alicia Munnell, "Taxation of Capital Income in a Global Economy: An Overview" (September-October 1992) *New England Economic Review* 33-51. See also Charles E. McLure Jr., "Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience" (1989) vol. 29, no. 8 *European Taxation* 243-50, at 250 (concluding that "as Europe becomes more closely integrated . . . it will become increasingly inappropriate to continue to rely on separate accounting in all cases to determine the income properly attributable to a particular European country"). The European Union has itself begun the process of considering some type of combined reporting. See European Commission, *Company Taxation in the Internal Market*, Commission Staff Working Paper COM (2001) 582 final (Luxembourg: Office for Official Publications of the European Communities, 2002), and Malcolm Gammie, "Arm's Length or Formulary Apportionment? A European Union Perspective," in this volume. For a proposal for the use of combined reporting in developing countries, see Oliver Oldman and Jennifer J.S. Brooks, "The Unitary Method and the Less Developed Countries: Preliminary Thoughts" (1987) vol. 1, no. 1 *Revue de droit des affaires internationales* 45-61. For its proposed use by countries located in the South Pacific, see Richard J. Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)" (1991) vol. 45, no. 3 *Bulletin for International Fiscal Documentation* 99-111; and (" . . . Part II") (1991) vol. 45, no. 4 *Bulletin for International Fiscal Documentation* 151-63.

81 California provides a useful summary of its water's-edge rules, including copies of required forms, in California Franchise Tax Board, *California Forms & Instructions, 100W: 2002 Corporation Tax Booklet, Water's-Edge Filers* (Sacramento, CA: Franchise Tax Board, 2002) (available at http://www.ftb.ca.gov/forms/02_forms/02_100wbk.pdf).

- 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 twenty percent or more of its business activities, as measured by 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 certain other payments made to a foreign member of the common enterprise that is excluded from the water's-edge group. That is, a strict earnings-stripping rule would apply.
- Royalties, rents, interest, and certain 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 the American states because of constitutional limitations on the taxation of non-business 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-

82 California Revenue and Taxation 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), and 59-7-401(2)(a). Under the California system, the 20 percent rule does not apply to foreign banks.

edge group would be required to obligate itself to provide the tax department, 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 favour 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 anti-avoidance 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.

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 American 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 American states are assisted in administering their corporate income taxes by the presence of the national tax. In addition, the US Supreme Court and the US Congress put some internal pressures, albeit weak ones, on the states to promote uniformity. Still, the successful use of combined reporting by some American 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.

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 an MNE, to intra-company ownership rights and contractual arrangements that have almost no legal or economic significance?
- Why should the form of organization of an MNE be given substantial weight in determining which countries should tax the income derived by that enterprise?
- Why should a system that encourages MNEs to deflect income to tax havens be preferred over a system that gives no tax benefit for such action?
- Why should a system that effectively allows MNEs to elect whether to pay taxes be preferred over one that imposes taxes in accordance with 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 these 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 American 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 that is 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.

- 1) 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.
- 2) 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, such as 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 an MNE would be resident in a country where substantial management activities occurred.⁸⁵ The residence of a subsidiary corporation should depend almost exclusively on the residence of the corporations that control it, directly or indirectly.⁸⁶
- 3) 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

83 For a recent proposal for ending deferral in the United States, see Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income" (1999) vol. 52, no. 2 *SMU Law Review* 455-529.

84 For a recent defence of the CFC regime used by the United States, see United States, Office of Tax Policy, Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* (Washington, DC: Office of Tax Policy, Department of the Treasury, December 2000) (available at <http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf>).

85 See Reuven S. Avi-Yonah, "For Haven's Sake: Reflections on Inversion Transactions" (2002) vol. 27, no. 2 *Tax Notes International* 225-31, at 228-230 (proposing, at 229, 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").

86 See Michael J. McIntyre, "Determining the Residence of Members of a Corporate Group" (2003) vol. 51, no. 4 *Canadian Tax Journal* 1567-73.

used systematically in all appropriate cases. In addition, 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 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 multi-billion 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 the 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. Third, it rests on a stronger theoretical foundation. As indicated above, a study of combined reporting offers insights that can be applied to improve substantially the current system. But why should countries settle for better when best is within their grasp?