Apportioning Income of Multinational Enterprises Among the States Where the Income is Derived

REVENUE AND TRANSPORTATION INTERIM COMMITTEE
62ND MONTANA LEGISLATURE
JULY 19, 2012

MICHAEL J. MCINTYRE
PROFESSOR OF LAW
WAYNE STATE UNIVERSITY, DETROIT, MICHIGAN

Montana's Apportionment System

EVALUATING HOW MONTANA TAXES MULTINATIONAL BUSINESS

1. Discussion of the theory of combined reporting with formulary apportionment and a comparison with the alternative, the arm's length method.

2. Application of the theory to Montana's system for taxing multinational enterprises on cross-border income — worldwide combined reporting with a Water's Edge election.

3. Some suggestions for refinements and reform of the current Montana system.

Combine and Apportion

MONTANA'S SYSTEM FOR TAXING CROSS-BORDER INCOME

- *Worldwide Combined Reporting* — all members of the unitary group required to combined their income into a single report and pay tax in Montana on Montana's share of that total income.
- Montana's share determined by a *three-factor formula* (Sales, Payroll, and Property).
- *Water's Edge Election* available that allows some members of the unitary business to avoid having their income and apportionment factors included in the combined report.

Features of Combined Reporting

COMBINED REPORTING RULE OF JUST OVER HALF U.S. STATES

- All members of a "consolidated group" (defined broadly) engaged in a common enterprise ("unitary business") are required to file a combined report.
- The income taxable in any state is a portion of the total taxable income of the consolidated group, as determined by the *apportionment formula*.
- All income is apportioned to states able to tax the income (eliminates "nowhere income").

The Goals of Combined Reporting

A Plan for Substance over Form

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

Contrast to Arm's Length System

Attributing Income Among Tax Jurisdictions

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

A Helpful Analogy

Dividing Up Claims to Lake Water

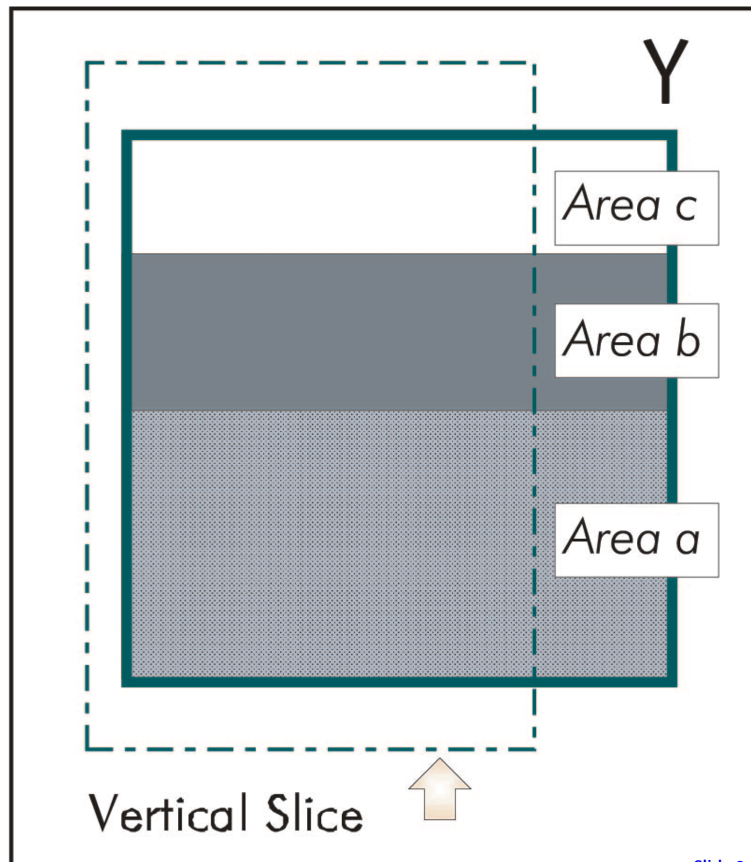
- *Facts*: Countries A and B have a lake on their common border. They want to share net increases in the lake water but not deplete the lake.
- *Arm's Length Approach*: Determine how much new water each state contributed to the lake (by rainfall, underground springs, streams, etc.).
- *Combined Reporting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

Vertical Slice Example

Contrasting Methodologies

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

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



Choice of Formulas

Based on Payroll, Property and sales (Receipts) : UDITPA

- U.S. states traditionally used a three-factor formula
  - **Payroll** (total amount paid as compensation for services)
  - **Property** (value of *tangible property* used in the production of goods or services)
  - **Sales** (sales proceeds and other receipts)
- Although *intangible property* can be a major contributor to the production of income, it generally has no set geographical location and is best omitted from the apportionment formula.

Theory of the Formula

Payroll, Property, and Sales Are Mere Proxies

- The point of the formula is to divided the net (taxable) income of an enterprise according to some political goal.
- The UDITPA 3-factor formula was proposed in 1977 and has been adopted by Montana as a means of promoting uniformity.
- *Discretion to Tax Department.* The tax department should have the authority to modify the results reached under the formula to prevent distortion or an unreasonable result.

Choice of Formulas (1)

Apportionment to Production State

- *Payroll and Property* can serve as proxies for location of production when production occurs in more than one state.
  - **Payroll** — total amount paid (e.g., to employees or independent contractors) to produce goods and services.
  - **Property** — value of *tangible property* used in the production of goods or services. Intangible property, which has no set geographical location, is ignored (generally).

Choice of Formulas (2)

Apportionment to Market State

- **Sales** — sales proceeds and certain other receipts. Again, the point is to find a proxy for the contribution of the market state, so sales not relevant for that purpose (e.g., "sales" of bonds or other financial instruments) should be ignored.
- P.L. 86-272 protects a corporation from state taxation if its only business activities within the state consist of the solicitation of orders for tangible goods. Many states have adopted anti-avoidance rules to prevent abuse.

Features of Combined Reporting

It is Not Just about Formulas

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

Arm's Length Int'l Tax Rules

FOUR SETS OF RULES

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

Relative Simplicity of CR/F

ALL APPORTIONMENT SYSTEMS HAVE SOME COMPLEXITY

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

Cost of Compliance under CR/F

Compare to the millions for an AL/S audit

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

Worldwide Combined Reporting

The Original Montana System, and Best in Theory

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

Unitary Business Concept

DETAILS SET BY CASES INTERPRETING U.S. CONSTITUTION

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

Limiting the Combined Group

THE SO-CALLED WATER'S EDGE SYSTEM

- Since 1987, Montana, following California's lead, allows a business enterprise to elect to limit the members of the combined group.
  - Certain domestic and foreign corporations engaged in a unitary business are excluded if they do not have substantial property and/or payroll within the U.S. (excluded companies)
  - Anti-Avoidance rules are adopted to limit abuses.

Excluded Companies

Companies Allowed to Make a "Water's Edge" Election

- In general, members of a controlled group can be excluded from the combined report unless they have substantial property and/or payroll in the U.S.
  - All foreign companies are excluded unless they are controlled foreign corporations (over 50% voting stock) and over 20% of the average of their payroll and property in located within the U.S.
  - Domestic companies are excluded if they do not meet the 20% test.
- For excluded members, their income and apportionment factors are excluded.

My Reform Suggestions

Limiting Excluded Companies to Prevent Abuse

- Domestic Companies — some options
  - Include ALL domestic corporations (best rule);
  - Revise 20% rule as follows (2d best rule):
    - Domestic corporations are included unless
      - 20% or less of the average of their payroll and property factors are located within the U.S. AND
      - 20% or less of their sales factor is located within the U.S.
  - Revise 20% rule to be average of all three apportionment factors, with discretion to tax department (3rd best).
- Foreign Companies — Revise 20% rule as above (2d best).

Special Inclusion Rules

Members of a unitary business not excluded

- A domestic company if the denominators of both its payroll and property factors are zero.
- A foreign corporation if it is "engaged in business" or "doing business" in this state.
- A corporation incorporated in a tax haven (list of tax havens included in Montana statute, reviewed periodically).

My Reform Suggestions

Defining a Tax Haven/Tax Shelter/Low-Tax Regime

- *General Definition*. A tax shelter jurisdiction is a jurisdiction that provides for tax measures resulting in low (under 15%) or nominal income taxes and has at least one of the following characteristics:
  - does not provide information to requesting foreign governments on a regular basis about the deposits and other financial transactions of the residents or nationals of the requesting governments; OR
  - grants tax advantages to foreign companies even without those companies having substantial business activity or a substantial economic presence in the jurisdiction.
- The present Montana tax haven list should be augmented by the addition of Singapore, Switzerland, Hong Kong, Ireland, and the Netherlands, with Austria, Botswana, Brunei Darsussalam, and Lebanon under study and Luxembourg retained. Also, the list should be updated to take account of the changes in the Netherlands Antilles.

Continued Relevance of Arm's Length

ARM'S LENGTH METHOD APPLIES IN SOME CASES

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

Advantages of Combined Reporting

AT LEAST IT IS A SYSTEM THAT CAN WORK

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

Arm's Length No Answer

Problems with Water's Edge not solved by Arm's Length

- A Water's Edge election is a fish out of water — it is fundamentally inconsistent with the basic theory of combined reporting with formulary apportionment.
- As long as the election is available (repeal would be desirable from a policy perspective and is permitted by *Container* and *Barclays Bank*), the goal should be to minimize transactions that need to be treated under arm's length.
- Thus, Montana's tax haven rule is good, anti-income stripping rules are good (e.g., limits on royalty deductions, interest deductions, etc. on payments to related excluded persons — See MTC Model Statute).

Product Comparison

OECD's Arm's Length Method with Source Rules (AL/S) vs.
Combined Reporting with Formulary Apportionment (CR/F)

No.	Features	AL/S	CR/F
1.	Facilitates shifting of hundreds of billions of dollars annually to tax haven companies, avoiding tax in the countries where the income was earned	Yes	No
2.	Substitutes taxation by negotiation for the rule of law	Yes	No
3.	Promotes the development of a secret tax law (e.g., secret APAs, secret arbitrations, secret competent authority agreements)	Yes	No
4.	Often requires the "discovery" of comparable transactions that do not exist	Yes	No
5.	Treats branches and affiliates the same, letting substance prevail over form	No	Yes
6.	Imposes astronomical costs on taxpayers and tax departments	Yes	No
7.	Treats paper transactions that are internal to a multinational enterprise as having substance by a false analogy to real transactions between unrelated persons (e.g., internal "loans", internal "insurance" and other "risk-shifting" arrangements)	Yes	No
8.	Requires complex and easily manipulated source rules, branch accounting rules, and residency rules	Yes	No
9.	Shifts control of the tax rules from the sovereign state to the taxpayer or to international organizations (e.g., OECD) outside the control of state governments and most national governments	Yes	No
10.	Is not perfect but works reasonably well	No	Yes

Discussion and Questions