Theory and Practice of Combined Reporting with Formulary Apportionment

Prof. Michael J. McIntyre
Wayne State University Law School

Presented at:
Multistate Tax Commission
2009 Fall Uniformity Meeting
December 2, 2009

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.
- *Mechanism*: Apportion (by formula) the total income of the enterprise (unitary business) based on a political division of the tax base, with no pretense of determining the unknowable (where the income actually was earned).

Features of Combined Reporting?

Formulary By Separate Company is Wrong

- All members of a "consolidated group" (defined broadly) 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 — the portion determined by the apportionment formula.
- If a member of the consolidated group is not taxable in a state, the income otherwise allocated to that state is reallocated to the origin state or is allocated pro rata to all states.

A Helpful Analogy

Dividing Up Claims to Lake Water

- *Facts*: Country 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.
- *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 under veil of ignorance.

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 and then to attribute a share of that income to particular taxing jurisdictions using (often arbitrary) source rules.
- A combined reporting system skips that first step. It apportions the aggregate taxable income of an enterprise among the taxing jurisdictions in which it derives income.

Features of Combined Reporting

IT IS NOT JUST ABOUT FORMULAS

- The entire corporate family (with important exceptions) is treated as a unit — substance over form.
- Nexus to tax is based on proxies for where certain important economic activity occurs (e.g., place of sale and place of production).
- Internal Accounting Has No Tax Effect.
- Residence of a corporation is Ignored.
- Transfer Prices (generally) are Ignored.

Arm's Length Int'l Tax Rules

FOUR SETS OF RULES

- *Transfer Pricing*. Complex, easily manipulated, failing as to income from intangibles, ignores special "monopoly" profits of MNEs.
- *Residence Rules*. MNEs control the residence of each affiliate separately.
- *Source*. Source is often artificial — e.g., income from intangibles may be sourced based on "location" of legal ownership.
- *Accounting Rules*. Flexible, few real standards, no real penalties for abuse.

Vertical Slice Example

CONTRACTING METHODOLOGIES

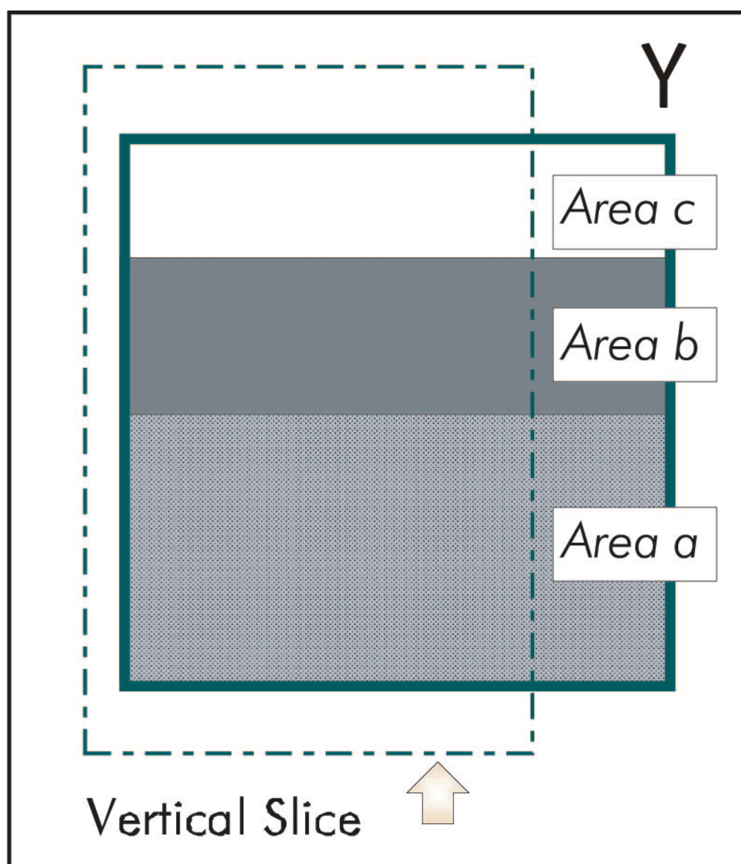
- *Facts*: A MNE has 3 companies, ACo, BCo, and CCo. ACo produced goods in Country A and sells the output to BCo and CCo. BCo sells the goods in Country A and CCo sells the goods in foreign jurisdictions.
- *Issues*: Where is the income taxable? Does it matter whether the companies are foreign or domestic?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

Y = income

c = foreign sales (CCo)

b = domestic sales (BCo)

a = domestic production (ACo)



Consolidated vs. Combined

No Real Substantive Difference

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

Theory of the Formula

PAYROLL, PROPERTY, AND SALES ARE MERE PROXIES

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

Choice of Formulas (1)

APPORTIONMENT TO PRODUCTION STATE

- Payroll and Property can serve as proxies for location of production when production occurs in more than one state.
  - **Payroll** — total amount paid (to employees or independent contractors) to produce goods and services. Exclude payments to sales people.
  - **Property** — value of tangible property used in the production of goods or services. Inventory property should NOT be included.
- What is the proper treatment of intangibles?

Choice of Formulas (2)

APPORTIONMENT TO MARKET STATE

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

Worldwide Combined Reporting

THE BEST IN THEORY

- The combined group is defined as all related persons (under a control test) engaged in the common enterprise, wherever incorporated.
- The entire income of the group (pre-apportionment income) is determined, ignoring internal transactions (call it "Y")
- That amount is apportioned to states by formula.

Limiting the Combined Group

The So-called Water's Edge System

- All domestic corporations (and other legal entities ???) engaged in the common enterprise (unitary business) are included in the combined group.
- Certain foreign corporations engaged in the unitary business are excluded if they do not have substantial activities with the United States (excluded companies)
- Anti-Avoidance rules are needed to prevent abuse.

MTC's Water's-Edge Election

Included companies of unitary business

1. U.S. companies, including D.C. and U.S. possessions
2. Foreign companies meeting 20%-factors-in-U.S. test
3. Income of any DISC or FSC
4. Foreign company to extent of U.S. source income (ignoring treaties)
5. Subpart F income of CFCs;
6. Foreign corporations that earn more than 20 percent of their income from amounts deductible by the unitary members, to the extent of that income.
7. Any member that is doing business in a tax haven (using 1998 OECD definition).

Unitary Business Concept

DETAILS SET BY CASES INTERPRETING US CONSTITUTION

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

Excluded Companies

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

- In general, foreign companies having only a small amount of business activity in the United States can be an excluded company.
  - E.g., the foreign company must have less than 20% of its activities (apportionment factors) in the US to be excluded.
- Holding companies and other entities used for tax-avoidance should not be excluded.
- Both apportionment factors and income should be excluded.

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.
  - Transactions between members of the combined group and excluded companies.
  - Transactions with unrelated persons.
  - Transactions with companies taxable on an allocation method (e.g., nonbusiness income).