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**Resolution 99-12**  
**Federal Use of Formula Apportionment Based Methods**  
**of International Income Division**

**WHEREAS**, Internal Revenue Service statistics released each year continue to provide significant evidence of serious under-reporting of income by U.S. subsidiaries of foreign-based multinational corporations especially, with transfer pricing a likely explanation for such under-reporting; and

**WHEREAS**, a 1999 study by Professors John Zdanowicz and Simon Pak of Florida International University based on a sophisticated computer analysis of merchandise trade data suggests that improper transfer pricing could have cost the federal government as much as \$35.6 billion in 1998; and

**WHEREAS**, under-reporting of federal U.S. source income translates directly into a revenue loss for state governments whose corporate income taxes are linked to federal income definitions; and

**WHEREAS**, in their complexity, the revised regulations under Section 482 of the Internal Revenue Code are a graphic demonstration that the arms-length transfer pricing standard is virtually, if not totally, inadministrable in the modern international economy with the enormous number of international transactions occurring daily; and

**WHEREAS**, the arms-length standard has long been criticized as theoretically flawed for failing to capture intangible flows of value that lead to the creation of multinational corporations rather than arms-length dealings between independent entities in the marketplace; and

**WHEREAS**, this recognition of economic synergies within corporations led the states decades ago to reject specific geographic accounting and instead to adopt the approach of apportioning the total income of an integrated economic enterprise among the jurisdictions in which it operates by use of factors reflecting the in-state activities of such an enterprise; and

**WHEREAS**, formula apportionment has proven for the states to be a workable method of reasonably attributing income to such jurisdictions that eliminates the potential for manipulating transfer prices to shift income among jurisdictions; and

**WHEREAS**, the fundamental fairness and constitutionality of international formula apportionment methods used by the states has recently been reaffirmed by the U.S. Supreme Court in the *Barclays Bank* and *Colgate-Palmolive* cases; and

**WHEREAS**, even as it rhetorically embraces the arms-length pricing system and seeks to shore it up through ever-more-complex regulations, the federal government acknowledges its failings by acknowledging that it has concluded Advanced [transfer] Pricing Agreements based on formula apportionment methods; and

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**WHEREAS**, the United States Senate, in response to the leadership initiative of Senator Byron Dorgan of North Dakota, has passed a sense of the Senate resolution in support of greater use of formula apportionment methods by the federal government to prevent revenue losses from transfer pricing abuse; and

**WHEREAS**, MTC staff have had discussions with the staff of the U.S. Treasury Department that indicate an open-mindedness toward and interest in formula apportionment as an alternative framework for international income division; and

**WHEREAS**, there is growing evidence of international conflict in the application of the arms-length transfer pricing principle that demonstrates that the arms-length system is no less susceptible to the creation of the multiple taxation that is alleged to be the fatal flaw of formula-based income division methods;

**THEREFORE, BE IT RESOLVED**, that the Multistate Tax Commission shall continue to reach out to interested tax officials and tax practitioners, including those from foreign nations, to create an open-minded dialogue concerning the potential benefits and shortcomings of formula apportionment as a basic element of a system for dividing income internationally; and

**BE IT FURTHER RESOLVED**, that the Multistate Tax Commission commends Senator Byron Dorgan for his efforts to draw attention to the transfer pricing problem and to educate his colleagues concerning the states' formula apportionment solution; and

**BE IT FINALLY RESOLVED**, that the Multistate Tax Commission urges the federal government to adopt formula based methods as the primary means of dividing income internationally.

Originally adopted the 29<sup>th</sup> day of July 1994, by the Multistate Tax Commission.  
Reaffirmed the 30<sup>th</sup> day of July 1999.

Attest: \_\_\_\_\_  
Dan R. Bucks  
Executive Director