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Issues in the Design of Formulary Apportionment in the Context of NAFTA

Richard Pomp
University of Connecticut School of Law

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COMMENTARY

Issues in the Design of Formulary Apportionment in the Context of NAFTA

RICHARD D. POMP*

I. Introduction

Professor McDaniel's article[1] reflects the breadth of intellectual inquiry characteristic of his scholarship. He provides an invaluable service by stimulating serious discussion of "formulary apportionment/combined reporting"[2] in the context of the North American Free Trade Agreement.[3] This issue is a worthy one and his work will be the starting point for any serious discussion in the future.

My commentary is directed to his proposal as it relates to formulary apportionment. I gladly embrace the opportunity because that part of his article is especially relevant, even independent of NAFTA. The

* Alva P. Loiselle Professor of Law, University of Connecticut Law School. I am indebted to my good friend Mike McIntyre for sharing with me the kinds of insights that only someone conversant with both the federal and state tax systems could have.

[1] Paul R. McDaniel, Formulary Taxation in the North American Free Trade Zone, 49 Tax L. Rev. 691 (1995).

[2] I use the term formulary apportionment/combined reporting as a reminder that both features are essential components of any serious tax regime along the lines proposed by Professor McDaniel. By combined reporting, I mean that the preapportionment tax base will not be limited to only that of a corporation having factors in the NAFTA region, but also will include the income of related corporations, regardless of whether they also have NAFTA factors. To illustrate, assume a U.S. corporation owns a non-NAFTA corporation (that is, a corporation incorporated in a country other than Canada, the United States or Mexico). Suppose the U.S. corporation has NAFTA factors so that it apportions income to some (or all) of the NAFTA countries. If the U.S. corporation were to file a combined report, the income and factors of the non-NAFTA corporation would be combined with those of the U.S. corporation. Intercorporate transactions between the two also would be eliminated, similar to the treatment of intercorporate transactions in a federal consolidated return. Essentially, in a combined report, a non-NAFTA corporation would be treated as if it were a branch of the U.S. parent. Without a combined report, form rather than substance would control a corporation's tax liability because a corporation would be treated differently depending on whether it chose to incorporate a branch.

[3] North American Free Trade Agreement, Dec. 8-17, 1992, 32 I.L.M. 289, 32 I.L.M. 605 [hereinafter NAFTA].

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tax community is well aware of the defects in the federal arm's length/source rule regime.[4] Some commentators have suggested that a modified version of the type of formulary apportionment/combined reporting regimes used by the states[5] could serve as a replacement for what they view as the fatally flawed federal approach.[6] Indeed, when Professor McIntyre testified before Congress and suggested the use of formulary apportionment/combined reporting in the NAFTA region,[7] he seized on a politically opportune moment to advance the case for replacing the federal system. Most new ideas have a minimum gestation period, and I am delighted that Professor McIntyre's proposal and Professor McDaniel's article start the period running.

Professor McIntyre notes how the states, which have had long experience with formulary apportionment, are natural allies of Professor McDaniel's proposal and could be looked to for political support.[8] The other group of allies, although probably not as powerful politically, are the third world countries. For years, academics have discussed formulary apportionment/combined reporting with third world leaders as a possible replacement for the arm's length/source rule approach that nearly all developing countries find nigh impossible to ad-

[4] In using the term "arm's length/source rule," I am following the practice of Professor Michael J. McIntyre. He was the first commentator to consistently use this term to describe the federal rules. E.g., 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, 87th Conf. on Tax'n, Nat'l Tax Ass'n 226 (Frederick Stocker ed., 1995). He purposely chose this terminology to emphasize the key role source rules play in the federal system. Defenders of the arm's length/source rule system claim that it is less arbitrary than formulary apportionment/combined reporting. Nearly all of the criticism of the federal rules in the international context has focused on the transfer pricing aspect of separate accounting, but the arm's length approach obviously incorporates source rules, which are inherently arbitrary.

[5] While all states use some form of formulary apportionment, not all provide for combined reporting.

[6] Jerome R. Hellerstein, Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment, 60 Tax Notes 1131 (Aug. 23, 1993). Viewing formulary apportionment/combined reporting as a substitute for separate accounting/source rules is not a new idea. The League of Nations Treaty of 1933, for example, provided for the use of formulary apportionment if separate accounting did not work satisfactorily. Commercial Agreement, Apr. 24, 1933, 139 L.T.S. 129.

[7] The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers Before the Senate Comm. on Governmental Affairs, 103d Cong., 1st Sess. 123 (1993) (statement of Professor Michael J. McIntyre); see also Robert S. McIntyre & Michael J. McIntyre, Using NAFTA to Introduce Formulary Apportionment, 6 Tax Notes Int'l 851 (Apr. 5, 1993).

[8] Michael J. McIntyre, Commentary, The Design of Tax Rules for the North American Free Trade Alliance, 49 Tax L. Rev. 769, 793 (1994) [hereinafter Commentary]. California has been an especially strong defender of the virtues of formulary apportionment/combined reporting.

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minister.[9] I am hopeful that if solutions to some of the technical problems discussed in Professor McDaniel's article can be found, the third world might join the states in rallying behind his proposal. At the least, if some of the details could be fleshed out, other countries might adopt formulary apportionment/combined reporting for use in their own regional trade alliances.

As a counterweight to this support, most multinational enterprises are likely to oppose Professor McDaniel's proposal, in part out of the fear that formulary apportionment/combined reporting might spread to other countries, but especially to the third world. I often have suspected that much of the opposition by Japanese corporations to California's use of formulary apportionment and worldwide combined reporting ("WWCR") was not so much because they cared about the California tax per se. After all, while they were vigorously lobbying against WWCR, the yen appreciated relative to the dollar, and WWCR actually helped them reduce their California tax by apportioning more income outside that state. Quite possibly, their real concern was that the California system would be replicated throughout the Pacific Rim.

Whether or not I am right about the Japanese motives in California, it is safe to predict that the multinationals will attempt to stifle any incipient movement toward formulary apportionment/combined reporting.[10] Ironically, California recently won a major Supreme Court case upholding against constitutional challenge the application of WWCR to the Barclays multinational banking enterprise.[11] Yet, by

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[9] One variation of this theme involves the use of formulary apportionment/combined reporting by a third world country as an alternative minimum tax to the tax calculated under a separate accounting/source rule approach.

[10] The U.S. federal system already contains aspects of formulary apportionment. See McDaniel, note 1, at 703-04. As Professor McDaniel notes, because of these features, taxpayers should be familiar with formulary apportionment and may not view "shifting to formulary apportionment within the NAFTA zone . . . as revolutionary as might be thought." Id. at [619]. Professor McDaniel also notes that formulary apportionment is used by the Service in certain advance pricing agreements ("APA"s). Id.; see note 11. The political problem, as I see it, is not that taxpayers are unfamiliar with formulary apportionment, but that they are all too familiar with it. After all, most corporations doing business in the United States that file federal tax returns probably already file state tax returns, and thus have first hand experience with formulary apportionment/combined reporting. Because California is such a key economic market, most large multinational corporations were conversant with that state's long debate over WWCR and many were active participants. The very advantages that commentators see as flowing from formulary apportionment—eliminating the need to police transfer pricing and emasculating the benefits of tax havens—are likely to be seen as disadvantages by taxpayers. See notes 15, 16 and 49.

[11] Barclays Bank v. Franchise Tax Bd., 114 S. Ct. 2268 (1994). Although Barclays challenged the California tax, it apparently does not oppose formulary apportionment under all circumstances. While challenging California's use of WWCR, Barclays negotiated an APA with the Service that used principles of formulary apportionment. Gerald C. Shea, APAs May Effectively Address Income and Expense Allocation Problems Faced by Global

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the time the Supreme Court had given its imprimatur to WWCR, the California legislature had succumbed to political pressures and retreated to a water's edge system.[12]

Because of the expected opposition to any attempt to advance the use of formulary apportionment/combined reporting in the context of NAFTA, it is critical that great care be given to the details of Professor McDaniel's proposal. The ambitious breadth of his article required by necessity that he paint with a broad brush. Nevertheless, he has identified the types of problems that will arise from a shift to a formulary system. He has suggested some tentative approaches, rejected others and properly remained agnostic on still others. All the issues he raises are complex, and each one could be the subject of future research. But, of course, the devil is in the details; it is to these details that I now turn.

Section II identifies two constraints that I feel unnecessarily hamper Professor McDaniel's approach. Section III discusses technical issues that arise in any system of formulary apportionment/combined reporting, whereas Section IV focuses on those problems that especially need to be thought through afresh in the context of NAFTA.

My commentary draws heavily on the experience of the states, which is only natural because they are the taxing jurisdictions with the most formulary apportionment/combined reporting experience. Relating this experience to NAFTA helps to identify virtues and drawbacks in various responses to the problems Professor McDaniel perceptively identifies.

II. Unnecessary Constraints

Preliminarily, I think Professor McDaniel has bridled himself with two unnecessary constraints: (1) the adoption of a water's edge limitation and (2) the incorporation of a unitary business requirement. Freed of these two constraints, it will be easier to resolve some of the technical issues that inevitably are confronted when two fundamentally different systems—formulary apportionment/combined reporting and arm's length/source rules—interface.

Trading Businesses, 4 Tax Notes Int'l 1022 (May 18, 1992); John Turro, IRS Grants Two APAs in Derivative Products Areas, 4 Tax Notes Int'l 959 (May 11, 1992); see also Robert E. Ackerman, Sandy Cohen, Jennifer Deville, D. Clark Norton, Kathryn H. O'Brien, Cindra Rehman, Monique Van Herksen & Steven C. Wrapp, The Advanced Pricing Agreement (APA) Program: A Model Alternative Dispute Resolution Process, Daily Tax Rep. (BNA), Jan. 19, 1994, at L-4 (Case Ex. 2). Case Example 2 is widely believed to be the APA entered into with Barclays.

[12] In the California context, water's edge refers to the exclusion of most foreign corporations from a combined report. Professor McDaniel uses the term in a different sense, which leads to unnecessary complications. See discussion in Section II.A.

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A. *The Water's Edge Constraint*

The first constraint is Professor McDaniel's willingness to limit his proposal to what he describes as the "water's edge." By this, he means that formulary apportionment would apply only to income sourced within the NAFTA countries and that the apportionment formula would include only NAFTA factors.[13] One consequence of this definition is that Professor McDaniel first would use federal source rules and arm's length principles to determine the income of a corporation from Canadian, U.S. or Mexican sources.[14] Only that income would enter into the preapportionment tax base. This approach undercuts one of the major benefits of formulary apportionment—eliminating the need to police transfer prices.[15]

Consider, for example, Professor McDaniel's treatment of a corporation having both a NAFTA branch and a non-NAFTA branch. He would apply the arm's length methodology and source rules to calculate the taxable income of the NAFTA branch.[16] Once the amount of income sourced in the NAFTA region is determined, the principles of formulary apportionment would assign that income to Canada, the United States and Mexico.[17]

If I understand Professor McDaniel's approach correctly, he has complicated matters unnecessarily. There is no need in the above situation to combine formulary apportionment with arm's length/source rules. Consistent with the principles of formulary apportionment, the amount of taxable income attributable to each of the NAFTA coun-

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[13] McDaniel, note 1, at 727.

[14] Another consequence is that non-NAFTA corporations would not be included in a combined report. See note 38.

[15] As long as formulary apportionment/combined reporting is limited to the NAFTA countries, the transfer pricing problem remains for corporations not subject to the proposed regime.

[16] McDaniel, note 1, at 728. In the case of a non-NAFTA corporation with a NAFTA branch, Professor McDaniel would determine the branch's income using "the arm's length principle or the formulary rules applicable to branches. Of course, once the income attributable to a NAFTA country were determined, [formulary apportionment] would govern the allocation of that income among the NAFTA countries." Id.; see also note 54. Presumably, Professor McDaniel also would use "the formulary rules applicable to branches" to determine the income of a NAFTA branch of a NAFTA corporation. The reference to formulary rules applicable to branches is probably a reference to § 1.863-3T(b)(2) of the Regulations and to the formulas used for allocating deductions. See Reg. §§ 1.861-8(a); 1.861-8(e)(3),(4)-(8); 1.882-5; McDaniel, note 1, at 703-04.

[17] It may not be obvious, but under Professor McDaniel's approach, the formula for assigning NAFTA branch income to the NAFTA countries has to be different from the formula he would use for apportioning income both within and without the NAFTA region. The formula used to assign the income of a NAFTA branch to the NAFTA countries could not incorporate any non-NAFTA factors. Otherwise, the very income that Professor McDaniel has determined to be attributable to the NAFTA region would be reapportioned outside the region.

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tries should be calculated by applying the relevant formula[18] to a corporation's worldwide tax base.[19] Hence, there is no need to determine the income of a branch of a corporation as a precondition to applying formulary apportionment.[20]

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18 See Section III.B.

19 Those familiar with state taxation will recognize that the approach in the text mirrors California's calculation of its share of a multinational enterprise's worldwide income under the state's previous WWCR regime. See Barclays Bank v. Franchise Tax Bd., 114 S. Ct. 2268 (1994); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983).

20 Professor McDaniel defends his water's edge approach on two grounds. His first justification is that it may be required by existing tax treaties. McDaniel, note 1, at 727. He does not elaborate on this argument.

In evaluating this argument, distinguishing two situations may be useful. First, consider a NAFTA corporation with both NAFTA and non-NAFTA branches. Presumably, in this case, no treaty issue is implicated because only the taxation of a NAFTA corporation by a NAFTA country is involved. The formulary apportionment rules would be provided in a trilateral tax treaty that would supersede the existing bilateral tax treaties among the NAFTA countries.

Second, consider a non-NAFTA corporation with both NAFTA and non-NAFTA branches. The issue is whether the use of formulary apportionment to determine the income of a NAFTA branch of a non-NAFTA corporation would violate an existing treaty between the NAFTA countries and the corporation's country of residence. I cannot comment on the interpretation of the Canadian or Mexican treaties on this point, but certainly there is little firm guidance in the U.S. literature regarding the proper taxation of branches of foreign corporations under U.S. treaties. In discussing the taxation of the U.S.-based operations of a non-NAFTA corporation, Professor McDaniel states that the income of such operations would continue to be determined under either the arm's length method or the formulary rules applicable to branches. Id. at 728. The model treaty of the Organization of Economic Cooperation and Development (OECD) also provides for the use of apportionment principles under specified conditions in determining the income of a permanent establishment, although many U.S. treaties do not contain a similar provision. OECD Model Income Tax Convention, July 23, 1992, art. 7, Tax Treaties (CCH) ¶ 191 [hereinafter OECD Model Treaty].

No reported case exists challenging as a treaty violation the use of apportionment techniques, whether based on § 1.863-3T(b)(2) of the Regulations or otherwise, to determine the income of the U.S. branch of a foreign corporation. To the extent that current practice is to use formulary-rules, as Professor McDaniel suggests, the substitution of a different formula, that is, the NAFTA apportionment formula, should not give rise to a legitimate challenge under a treaty. If, on the other hand, the use of a formula under existing treaties is uncommon, some opposition among our treaty partners can be expected, but such opposition would occur in any event. The only difference is that such resistance might now be based on the more respectable grounds of objecting to an asserted treaty violation.

Professor McDaniel's second justification for a water's edge approach is founded on the "reactions by some European companies and their governments to worldwide unitary measures of some states in the United States, ... notably California ... ." McDaniel, note 1, at 727. This same reaction was unsuccessfully cited by the taxpayer in Barclays Bank v. Franchise Tax Bd., 114 S. Ct. 2268, 2283-84 (1994), in an attempt to establish that California's tax violated the foreign commerce clause. Because many of the hoped-for gains from formulary apportionment/combined reporting would be undercut by Professor McDaniel's water's edge approach, I would be unwilling to concede the issue without very compelling reasons. I would hope that any future versions of his proposal would abandon this water's edge constraint unless it appeared to be an absolutely essential concession.

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In other words, the federal concept of source is irrelevant in a formulary apportionment/combined reporting system. For this reason, that part of Professor McDaniel's article that asserts that foreign source dividends must be removed from the preapportionment tax base under a water's edge approach[21] is also an unnecessary constraint. If such dividends constitute part of the enterprise's unitary business,[22] they should be included in the preapportionment tax base, regardless of source. The concept of source simply has no role to play in a formulary system.[23]

B. *The Unitary Business Constraint*

Another constraint that unnecessarily shapes Professor McDaniel's proposal is that of a unitary business. He never articulates why a unitary business rule is either necessary or appropriate or how he would define a unitary business.[24] Presumably, he is piggybacking onto state income tax doctrine. In the state context, the Supreme Court has stated that the "linchpin of apportionability in the field of state income taxation is the unitary business principle,"[25] and Professor McDaniel implicitly has made the same assumption about apportionability in the context of a trilateral NAFTA tax treaty.

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21 McDaniel, note 1, at 727; see Section III.B.

22 Whether a unitary business principle is required as part of a NAFTA tax treaty is discussed in Section II.B.

23 I would prefer that discussions about formulary apportionment avoid use of the word "source" entirely because of the federal baggage that accompanies it. If source is to be used at all, I would limit it to describing the amount of income assigned to a taxing jurisdiction after the application of formulary apportionment.

24 A common definition of unitary business is "[i]f the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary . . . ." Edison Cal. Stores, Inc. v. McColgan, 183 P.2d 16, 21 (Cal. 1947). A more particular statement of the test is that a business is unitary if these circumstances are present: "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use of its centralized executive force and general system of operation." Butler Bros. v. McColgan, 111 P.2d 334, 341 (Cal. 1941). This approach by the California courts is broader than that of other states. See, e.g., Texas Co. v. Cooper, 107 So.2d 676 (La. 1958). For a general treatment, see 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation 8-76 to 8-197 (2d ed. 1993). The Supreme Court stated that the "prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods . . . . [A] relevant question in the unitary business inquiry is whether 'contributions to income [ ] resulted from functional integration, centralization of management, and economies of scale.'" Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178-79 (1983) (citations omitted). "[T]he out-of-state activities of the purported 'unitary business' [must] be related in some concrete way to the in-state activities. . . ." Id. at 166. "A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on a theme . . . ." Id. at 167.

25 Mobil Oil Corp. v. Vermont, 445 U.S. 425, 439 (1980).

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To illustrate the context of the Court's statement, consider a corporation that conducts activities both within and without the taxing state. Clearly, a state can tax income generated by activities occurring within its boundaries; the issue is how to make that determination. Initially, the states used separate accounting, but the defects in that approach hastened the development of formulary apportionment. For a taxing state to include all of a corporation's income in the preapportionment tax base, some relationship must exist between those activities conducted within the taxing state and those activities conducted without the state. Otherwise, the taxing state would have no right to include in the tax base any income generated by the out-of-state activities. That relationship, which is required by the Due Process Clause of the Fourteenth Amendment, is satisfied if the activities within and the activities without the state are integrated, interdependent or synergistic. This relationship is encapsulated by the phrase "unitary business."[26]

For example, consider a corporation that manufactures widgets in *State A*, warehouses them in *State B* and sells them through an office in *State C* to customers in *State D*. Because of the integrated, interdependent or synergistic relationship among the activities in the various states, the corporation would be viewed as conducting a unitary business. Accordingly, each state, in determining its share of the corporation's income, would include the corporation's entire income in its preapportionment tax base. Then each state would apply its apportionment formula to determine its share of the preapportionment tax base.

In contrast, suppose part of the income of a corporation has nothing to do with the activities conducted in the taxing state. For example, assume a corporation conducts a dry cleaning operation in *States A* and *B* and a parking lot operation in *States C* and *D*. The corporation could be considered as conducting two different and independent unitary businesses.[27] *States A* and *B* would apply formulary apportionment to assign the income of the dry cleaning operation between themselves, and *States C* and *D* would apply formulary apportionment to assign the income of the parking lot operation between themselves.[28] *States A* and *B* would not include the income from the parking lot operation in the corporation's preapportionment tax base, and

[26] The unitary business principle grew out of the "unit rule" of the late 19th century, which was used for apportioning the property tax of railroads, telegraph and express companies. Under the unit rule, the value of the entire enterprise was first determined and then apportioned to a taxing jurisdiction through the use of a formula. Allied-Signal v. New Jersey, 504 U.S. 768, 778-79 (1992).

[27] For the opposite view, see text accompanying notes 36 and 37.

[28] Presumably, some method akin to separate accounting would be used to determine the income of the dry cleaning business and the income of the parking lot operation.

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the activities attributable to that operation would not enter into the factors of the formula. Similarly, *States C* and *D* would not include the income from the dry cleaning operation in the corporation's preapportionment tax base, and the activities attributable to that operation would not enter into the factors of the formula.

In the state context, the concept of a unitary business is needed to satisfy the Due Process Clause of the Fourteenth Amendment. (In the federal context, the counterpart is the Due Process Clause of the Fifth Amendment.) The reason that *States A* and *B* constitutionally cannot tax the parking lot operation is that insufficient contacts exist between the activities of that operation and either of the two states to satisfy the Due Process Clause. To say that no part of a unitary business is conducted in either *State A* or *State B* is another way of stating that there are insufficient due process contacts between the corporation's activities and either *State A* or *State B*. This constitutional lack of taxing jurisdiction is captured by stating that the parking lot is not part of the unitary business (dry cleaning) conducted in *State A* or *B*. Put differently, the corporation would be described as conducting two independent and separate unitary businesses.

Many of the complexities that the states encounter in applying formulary apportionment arise from the unitary business concept. This complexity might escalate if, to impose their taxes, the three NAFTA countries had to agree on what parts of an enterprise's activities constitute a unitary business.[29] If the concept is unnecessary in the context of a NAFTA tax treaty, this definitional problem is avoided, along with a panoply of other technical design problems.

The issue reduces to whether or not through a trilateral treaty, the NAFTA countries could apply formulary apportionment to all the income of a NAFTA corporation regardless of whether a unitary business exists. For example, if a non-U.S. NAFTA corporation conducted a parking lot operation within the United States and a dry cleaning business elsewhere, could all of its income enter into its preapportionment tax base, part of which would be then apportioned to and taxed by the United States?[30]

[29] See McDaniel, note 1, at 712.

[30] Under federal law, the United States taxes U.S. corporations on their worldwide income without any reliance on the unitary business concept. This assertion of taxing jurisdiction has gone unchallenged. Presumably, the act of incorporating in the United States satisfies the Due Process Clause of the Fifth Amendment. The United States taxes foreign corporations on their income sourced in the United States. IRC §§ 881, 882. Characterizing the income as sourced within the country supplies the necessary due process contacts. Because the United States can tax a U.S. corporation on all of its worldwide income, no constitutional problem should arise if that same amount of income enters into the preapportionment tax base in a formulary apportionment system. Accordingly, the due process

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This issue has two dimensions. First, would the Court, while paying lip service to the Due Process Clause of the Fifth Amendment, accept a definition of a unitary business that would encompass all of the corporation's profit seeking activities? If that approach is outside any acceptable definition of a unitary business,[31] could the Senate, in ratifying a NAFTA tax treaty, actually substitute its interpretation of the Due Process Clause for that of the Court?

In the context of the Fourteenth Amendment, there are serious doubts as to whether Congress, as a general proposition, can legislate due process matters.[32] But if economic issues are involved, Congress might have more power.[33] In any event, a NAFTA tax treaty would implicate the Fifth Amendment, not the Fourteenth. Although both amendments use the same due process language, the Courts have not held that they must be interpreted identically.[34] In addition, the con-

issue raised in the text is limited to the U.S. taxation of a Canadian or Mexican corporation on an apportioned share of all of its worldwide income.

[31] In *Container Corp.*, the Court adopted a new standard for reviewing the definition of a unitary business: "whether the state court applied the correct standards to the case; and if it did, whether its judgment was within the realm of permissible judgment." Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 176 (1983).

[32] See ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 350 n.14 (O'Connor, J., dissenting) ("Congress generally cannot waive a ruling of this Court decided under the Due Process Clause"), reh'g denied, 459 U.S. 961 (1982). The *ASARCO* majority responded to Justice O'Connor's dissent by noting that the power of Congress to legislate "is not presented in the case, and we imply no view as to it." Id. at 328 n.23. Chief Justice Burger concurred in the majority opinion "in reliance on the Court's express statement that the Court's holdings do not preclude future congressional action in this area." Id. at 331. More recently, the Court stated that Congress does not "have the power to authorize violations of the Due Process Clause." Quill Corp. v. North Dakota, 504 U.S. 298, 305 (1992). This statement is dictum, however, because the issue of congressional power was not before the Court in *Quill*.

For a broader view of Congress's power to legislate under the Due Process Clause of the Fourteenth Amendment, see William Cohen, Congressional Power to Validate Unconstitutional State Laws: A Forgotten Solution to an Old Enigma, 35 Stan. L. Rev. 387 (1983).

[33] Prior to *Quill*, two leading commentators concluded that if the Due Process Clause prohibits the states from requiring out-of-state mail order houses to collect their use taxes on goods delivered to the purchaser within the state, the Court likely would sustain congressional legislation providing for a contrary result. 2 Hellerstein & Hellerstein, note 24, at 19-30 to 19-32. Since their analysis, the Court has held that no due process protection necessarily exists in the situation to which they referred. *Quill*, 504 U.S. at 301-02.

[34] No case has presented the issue discussed in the text, which involves the special responsibility of the United States with respect to foreign affairs. Analogies exist, however, with respect to other situations, which support the general proposition that the Court will apply different standards in evaluating constitutional challenges to federal legislation than it will in evaluating analogous challenges to state legislation in light of certain sui generis federal responsibilities. For example, in evaluating the federal government's power to regulate the admission of aliens, the Court has applied a less stringent due process standard under the Fifth Amendment than what would have been applied under the Fourteenth Amendment. U.S. ex rel. Knauff v. Shaughnessy, 338 U.S. 537 (1950). Similarly, in applying an equal protection analysis to the federal government's regulation of foreign affairs and alienage, the Court also has applied a less strict standard than what would have been

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stitutional question would arise in the context of the Senate's exercising its plenary power of treaty making.

There is no relevant learning on the standard that should apply in evaluating the constitutionality of a NAFTA tax treaty that included the entire income of a Canadian or Mexican corporation in the preapportionment tax base.[35] The constitutional issue would be avoided, however, if the Court were to endorse a broad view of a unitary business. The case for such a view would start by noting that the problem of defining a unitary business involves determining the proper level of generality with which to describe the activities of the taxpayer. This problem is common in legal analysis,[36] although the parallel with defining a unitary business has gone unrecognized.

A corporation's unitary business can be defined in various ways from the most specific to the most general. To illustrate, consider a corporation that manufactures widgets for use in the aerospace industry. On the least general level, the corporation could be described as conducting a unitary business of manufacturing widgets for the aerospace industry. On a slightly more general level, the unitary business could be described as manufacturing widgets. More generally, the unitary business could be described as a manufacturer. On the most general level, the corporation could be described as in the business of allocating its resources to maximize its internal rate of return.

Under the last definition, all of a corporation's activities and all of its income would constitute a unitary business. Suppose, therefore, that in passing a NAFTA tax treaty, the Senate made clear findings of fact that it considered all corporations to be conducting their activities in order to maximize their internal rate of return, hardly an unrealistic view. That legislative finding, made in the context of a NAFTA tax treaty under the Senate's plenary power to negotiate treaties, might make it difficult for the Supreme Court to substitute its own notions of a unitary business.[37]

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applied under the Fourteenth Amendment. Hampton v. Mow Sun Wong, 426 U.S. 88 (1976). I am grateful to my good friend and colleague, Professor Richard S. Kay, for this particular insight.

[35] No constitutional problem arises in the case of a U.S. corporation. See note 30. I will leave it to Canadian and Mexican commentators to raise any potential constitutional problems under their systems.

[36] For example, the level of generality issue permeates equal protection analysis in which the question is how broadly to define the relevant classes. See Kirk D. McQuiddy, Note, Taxing Out-of-State Corporations After *Western & Southern:* An Equal Protection Analysis, 34 Stan. L. Rev. 877, 891-93 (1982). See also Bruce Ackerman, Levels of Generality in Constitutional Interpretation: Liberating Abstraction, 59 U. Chi. L. Rev. 317 (1992); Laurence H. Tribe & Michael C. Dorf, Levels of Generality in the Definition of Rights, 57 Chi. L. Rev. 1057 (1990).

[37] See note 31 for the standard of review in state cases. In interpreting the Fourteenth Amendment, the Court has rejected expansive definitions of a unitary business, including

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III. Issues Inherent in any Formulary System

A. *Combined Reports and the Treatment of Related Corporations*

An issue linked to the definition of a unitary business involves the treatment of related corporations. Unless form is to be elevated over substance, no tax difference should result between a corporation that operates through a branch and one that incorporates that branch and operates it as a subsidiary. To disregard differences in the way a corporate family is organized, a mandatory consolidated report should be imposed on related corporations. This approach is known in the state context as a combined report.[38]

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ones consistent with that offered in the text. See, e.g., Allied Signal v. New Jersey, 504 U.S. 768 (1992); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, reh'g denied, 459 U.S. 961 (1982); F.W. Woolworth Co. v. Tax'n & Rev. Dep't of New Mexico, 458 U.S. 354, reh'g denied, 459 U.S. 961 (1982). The states, however, have never couched their arguments in the context of the familiar legal problem of the level of generality discussed in the text. Moreover, none of the states in these cases could present legislative findings as to the nature of a unitary business. The willingness of the Court to restrain a broad assertion of state taxing power under the Fourteenth Amendment does not necessarily mean that it would restrain a similarly broad assertion of federal taxing power under the Fifth Amendment in the context of a treaty.

At two points in his article, Professor McDaniel seems to abandon the unitary business principle. For example, he would include in the tax base of the payee any investment income it received from a nonunitary NAFTA corporation if the payor deducted the payment (for example, interest, rents, royalties). McDaniel, note 1, at 720. If, however, the unitary business requirement is constitutionally imposed, the income cannot be included in the preapportionment tax base of the payee just because the payor deducted the payment. Rather, for the income to be taxed by the payee, there must be a unitary business relationship between either the payor and the payee (which Professor McDaniel's example assumes is not part of the same unitary business as the payee) or between the income (or the asset generating the income) and the unitary business of the payee. See *Allied Signal*, 504 U.S. at 771; Richard D. Pomp & Rebecca S. Rudnick, Federal Tax Concepts as a Guide for State Apportionment of Dividends: Life After *ASARCO*, 18 Tax Notes 411, 419 (Nov. 8, 1982).

Similarly, Professor McDaniel states that "[a]ll types of passive investment income received from a non-NAFTA enterprise could be included in the apportionable income of the NAFTA unitary enterprise." McDaniel, note 1, at 720. Again, the fact that the payor is a non-NAFTA corporation does not override the unitary business requirement. (For reasons having nothing to do with the unitary business requirement, Professor McDaniel backs off from his statement that all types of passive investment income received from a non-NAFTA enterprise could be included in the preapportionment tax base. Id. at 727 (qualifying this position with respect to dividends)).

In determining whether a state could tax a capital gain, the Court in *Allied Signal*, 504 U.S. at 779-80, described the test as whether the "capital transaction serve[s] an operational rather than an investment function." This test presumably would be satisfied if the income were effectively connected with the payee's unitary business, or were considered to be an integral part of the unitary business's everyday operations under the approach of *Corn Products*, 350 U.S. 46 (1955). Compare Pomp & Rudnick, supra, at 418-19 with McDaniel, note 1, at [630].

[38] See note 2. Some states distinguish between consolidated returns and combined reports. Although there is no uniformity of terminology among the states, a consolidated return generally includes only those related corporations that are directly taxable by the

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To illustrate the workings of a combined report, suppose a NAFTA corporation owns a non-NAFTA subsidiary. Only the NAFTA parent does business in the NAFTA region and only the parent has NAFTA factors. In computing its preapportionment tax base under a combined report, the parent would consolidate its income with that of its subsidiary and eliminate their intercorporate transactions. In addition, in applying the apportionment formula, the parent would consolidate the factors of the subsidiary with its own factors. Accordingly, the preapportionment tax base and the apportionment percentage (and thus the income assigned to the NAFTA countries) would remain unchanged if a corporation incorporated its branch and operated it as a subsidiary or if a corporation liquidated its subsidiary and operated it as a branch.

Under the Due Process Clause of the Fourteenth Amendment, a state can impose a combined report on related corporations only if they constitute a unitary business.[39] If, however, a unitary business doctrine has no role to play in a NAFTA tax treaty, that requirement can be dispensed with as a precondition to imposing a combined report.

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state, that is, those corporations that have nexus with the state. See, e.g., Mass. Gen. Laws, ch. 63, § 32B (West 1988). By contrast, a combined report determines the income of a corporation subject to the taxing jurisdiction of the state by treating related corporations that are part of the unitary business as if they were branches rather than separate entities. It is irrelevant in computing the preapportionment income whether such related corporations are taxable by the state. See, e.g., Cal. Rev. & Tax Code § 25102 (West 1992). Some states allow corporations that filed consolidated federal returns to file on a similar basis, regardless of whether the corporations are part of a unitary business and regardless of whether all the corporations have nexus with the state. See, e.g., Fla. Tax & Fin. Code § 220.131 (West 1989).

Professor McDaniel apparently would limit a combined report to only NAFTA corporations. He does not explicitly state this, but it is implicit in his self-imposed water's edge constraint and in some of his other examples and discussion. Professor McDaniel is forced to exclude non-NAFTA corporations from a combined report because if such corporations were to be merged into the parent and operated as branches, he would exclude their non-NAFTA income from the preapportionment tax base. See McDaniel, note 1, at 727. To be consistent, he must exclude the same income from the preapportionment tax base, whether earned through a branch or through a subsidiary (or other related corporation). For situations where his discussion implicitly assumes that non-NAFTA corporations are excluded from a combined report, see id. at 727, 738.

No need exists, however, to exclude a non-NAFTA corporation from a combined report. Including non-NAFTA corporations in a combined report is not tantamount to taxing such corporations—their inclusion is only to determine better the income of the NAFTA corporation.

[39] Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). Consider, for example, the parking lot/dry cleaning illustration above involving *States A* and *B*. Recall that *States A* and *B* could not tax the income from the parking lot operation because it was not part of the dry cleaning business. If the parking lot operations were incorporated, a combined report could not be imposed on the parent and its subsidiary because they would not be part of a unitary business.

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Even if a unitary business is not a precondition, one issue that needs resolution is the threshold percentage of stock ownership that would trigger the combined report. Some states use an 80% test,[40] similar to the federal rules on electing consolidated return treatment.[41] Others use a "more than 50%" test.[42]

An 80% test has little to commend itself, other than mirroring the federal threshold for electing consolidated return treatment. A corporation wishing to avoid a combined report could avoid the 80% test easily without sacrificing much of economic substance. The real policy decision is the choice between a 50% test and a more than 50% test.

No state uses a 50% test.[43] But a more than 50% test has a major disadvantage. As the federal experience with a more than 50% own-

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[40] Tenn. Code Ann. § 67-4-812(c)(2)(1994).

[41] IRC § 1504.

[42] Cal. Rev. & Tax. Code § 25105 (West 1992).

[43]

> The [more than 50%] ownership requirement contemplates an element of controlling ownership over all parts of the business; the lack of controlling ownership standing alone requires separate treatment regardless of how closely the business activities are otherwise integrated .... A mutual dependence and contribution may exist between two enterprises, for example, where one enterprise supplies the raw materials for fabrication by a second enterprise. However, it would be improper to treat the two enterprises as unitary unless one owns and controls the other. In the absence of such controlling ownership, intercompany charges properly may be reflected by separate accounting. Generally speaking, controlling ownership can only be established by common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock.

Appeal of Revere Copper & Brass, 1977 Cal. Tax LEXIS 38, at *10 (Cal. St. Bd. of Equal. July 26, 1977).

In defending the more than 50% test, the court seems concerned with transfer pricing issues. According to the court, without the element of control, intercompany charges properly will reflect the income of the separate entities. But the transfer pricing problem is only one reason a combined report is preferable to separate accounting. As the Supreme Court emphasized in *Container Corp.*, a combined report captures the flow of values among units of a corporate enterprise. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178-79 (1983). Separate accounting is defective in measuring the contributions to income that result from functional integration, centralization of management and economies of scale. Nothing stops a 50% shareholder from sharing in these contributions merely because it may not control the corporation. Realistically, of course, whether a 50% shareholder can exercise control is in part a function of how diffused the ownership is in the remaining shares of the corporation and the degree of cooperation among the other shareholders.

In the context of the Due Process Clause of the Fourteenth Amendment, the Supreme Court has stressed that before a unitary business can exist between the payors of dividends and the payees in the same line of business, actual control must be exercised; the potential to control is not sufficient. ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 322-23, reh'g denied, 459 U.S. 961 (1982); F.W. Woolworth Co. v. New Mexico Tax'n & Rev. Dep't, 458 U.S. 354, 366-70, reh'g denied, 459 U.S. 961 (1981). A unitary business relationship between the payors and the payees is sufficient, but not necessary, for the dividends to be taxed by the states having nexus with the payees. For the dividends to be taxed, the shares that generate the dividends must serve an operational function in the hands of a

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ership requirement in Subpart F demonstrates,[44] taxpayers wishing to avoid a combined report will be tempted to maintain de facto control while reducing their stock ownership to 50% (or less).[45] The Subpart F experience suggests the merits of a 50% test, which has the additional advantage of including legitimate joint ventures in a combined report.[46]

The ability to form 50-50 joint ventures in tax haven countries also argues forcefully for a 50% stock ownership test. Professor McDaniel would deal with tax havens by denying deductions for amounts paid to any corporation organized in a haven that was related to any corporation that was part of the unitary business.[47] As he recognizes, this

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payee rather than an investment function. See note 37. Consider, for example, excess working capital that is invested by a corporation in shares of a mutual fund. Any dividends distributed with respect to such shares could be taxed by states having nexus with the corporation, notwithstanding that neither the mutual fund nor the corporations owned by the fund stand in a unitary relationship with the payee. The ownership of the shares serves an operational rather than an investment function. Id.

[44] IRC § 957(a).

[45] See Michael J. McIntyre, 2 The International Income Tax Rules of the United States 6-15 to 6-19 (1994).

[46] A 50-50 joint venture could be viewed as a partnership. Each shareholder would include in its preapportionment tax base 50% of the joint venture corporation's income and 50% of its factors, provided there were no special allocations.

Professor McDaniel states, without any discussion, that "the unitary business should be determined on an economic basis, not on a percentage of ownership basis (although high percentage ownership would create a presumption of a unitary enterprise)." McDaniel, note 1, at 712 n. 93. As the text suggests, I would not use a unitary concept unless required by constitutional considerations. Moreover, an economic analysis of a unitary business depends on the level of generality adopted. See notes 36, 37 and accompanying text. Because Professor McDaniel does not discuss the constitutional dimension of the problem, presumably he has other reasons for requiring the existence of a unitary business. In any event, I do not understand why any presumption of unitariness should be raised simply because a parent owns a subsidiary. For example, a conglomerate easily might have a holding company that owns 100% of its subsidiaries, each of which is in a different unitary business from that conducted by the others. Unless Professor McDaniel is willing to adopt a very broad definition of a unitary business along the lines suggested in the text accompanying notes 36-37, an approach that essentially views all businesses a being in the unitary business of maximizing their internal rate of return—a view that he would presumably reject—the conglomerate example shows that stock ownership is not the key to determining a question of unitariness.

Professor McDaniel is on safer ground when he suggests:

> a significant level of transactions between supposedly separate unitary businesses should be strong evidence (or create a presumption) that there is only a single unitary business. The taxpayer would have a heavy burden of proof to overcome this evidence (or presumption) and thus be able (or required) to use arm's length reporting for interenterprise transactions.

Id. at 713-14. Through the use of these types of presumptions, Professor McDaniel hopes to avoid the otherwise difficult problem of defining a unitary business and to avoid the need of enforcing arm's length pricing among an enterprise's different unitary businesses. These are valid and significant objectives, which makes it puzzling why he rejects the easiest approach—a stock ownership test.

[47] Id. at 733.

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would require the NAFTA countries to agree on a list of tax haven countries, which may not be achievable. A combined report, however, automatically deals with tax haven corporations in a more complete manner. Intercorporate transactions among corporations included in a combined report have no effect. Consequently, much of the income shifting opportunities facilitated by the use of a tax haven corporation would be undone. Moreover, to the extent that few activities of substance would take place in the haven country, the apportionment formula also would be unaffected.[48] Because neither the preapportionment tax base nor the apportionment formula would be affected, a combined report would undercut the goals of using a tax haven.[49]

Notwithstanding all of its virtues, a combined report does not necessarily eliminate the need to police transfer prices. Consider, for example, a Canadian parent, its Japanese subsidiary and a U.S. subsidiary of the Japanese subsidiary all doing business in the NAFTA region. The orthodox interpretation of the U.S.-Japanese tax treaty[50] is that it requires an arm's length approach in determining the income of the Japanese corporation.[51] (Presumably, the Canadian-Japanese treaty[52] would be interpreted similarly.) The Canadian parent would calculate its preapportionment tax base using a combined report that would include both its Japanese subsidiary and its U.S. grandchild,[53] and the U.S. corporation would calculate its preapportionment tax base using a combined report that included both its Japanese parent and its Canadian grandparent.[54] The Japanese corporation would determine its

[48] Michael J. McIntyre, Design of a National Formulary Apportionment Tax System, 84th Conf. on Tax'n, Nat'l Tax Ass'n 118, 121 (Frederick D. Stocker ed., 1992) [hereinafter Design].

[49] California's old WWCR system eliminated the tax advantages flowing from the use of tax havens. Perhaps it is not a coincidence that the corporation challenging California's use of WWCR was Barclays Bank, with offices in some of the best-known tax havens of the world—Bahamas, Barbados, Bermuda, Cayman Islands, Channel Islands, Gibraltar, Hong Kong, Isle of Man, Naura, Netherlands Antilles, New Hebrides, Singapore, Turks and Caicos and Virgin Islands. See Barclays Bank v. Franchise Tax Bd., 114 S. Ct. 2268 (1994); Barclays International, A World of Banking—List of Offices 4-5 (1977). Professor McDaniel recognizes that a combined report would virtually eliminate the problem of tax havens but seems to rank it third on his list of possible solutions. McDaniel, note 1, at [643].

[50] Income Tax Convention, Mar. 8, 1971, U.S.-Jap., Tax Treaties (CCH) ¶ 5,203.

[51] See generally Louis M. Kauder, The Unspecific Federal Tax Policy of Arm's Length: A Comment on the Continuing Vitality of Formulary Apportionment at the Federal Level, 60 Tax Notes 1147 (Aug. 23, 1993).

[52] Income Tax Convention, Nov. 14, 1987, Can.-Jap., Can. Tax Rep. (CCH) ¶ 34,391.

[53] The Canadian parent would have no trouble gaining access to information about the income and factors of its Japanese subsidiary and its U.S. grandchild because of its control over these entities. See note 54.

[54] Unlike the situation involving the Canadian parent, see note 53 and accompanying text, the U.S. corporation would not have access as a matter of right to the income and

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income based on the transfer prices of transactions with the Canadian and U.S. corporations. This example illustrates one of the interfacing problems that are inherent in simultaneously administering a formulary apportionment/combined reporting system for some taxpayers and an arm's length/source rule system for others.

B. *Designing the Apportionment Formula*

Serious thought must be given to designing the formula (or formulas) for apportioning the tax base. The traditional three factor formula (sales, property and payroll) evolved in the context of manufacturing and mercantile activities and has worked satisfactorily when limited to that sector of the economy. The state experience suggests, however, that the traditional formula does not work well for other types of activities. The states have developed specialized formulas for banking, publishing, mutual funds, communications, pipelines, transportation, natural resources and so forth.[55] Some of these formulas are intended to deal with industry-specific features, but others reflect "beggar thy neighbor" policies intended to favor particular activities, industries or taxpayers.

Specialized formulas, no matter how meritorious, come with a price: A corporation's activities need to be characterized to determine the

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factors of its Japanese parent or its Canadian grandparent. Exactly such a problem existed under California's old WWCR system and was one of the grounds asserted by Barclays in its unsuccessful challenge. *Barclays*, 114 S. Ct. 2268. The information access problem might be easier at the federal level, however, than at the state level. The exchange of information article in most tax treaties might provide access by the governments to the needed data. See, e.g., OECD Treaty, note 20, Tax Treaties (CCH) ¶ 191.

In many situations, the combined report filed by the Canadian corporation would be identical to the combined report filed by U.S. corporation. Therefore, the return filed by the parent would provide all the needed information. As an illustration of where the combined reports would not be identical, assume that the Canadian corporation acquired the Japanese subsidiary on July 1 and that the Japanese subsidiary acquired the U.S. subsidiary on October 1. The activities reflected on the combined report filed by the Canadian corporation would reflect the activities of the Japanese corporation as of July 1 and the activities of the U.S. corporation as of October 1. The combined report filed by the U.S. corporation would reflect the activities of both the Canadian corporation and the Japanese corporation as of October 1.

In the scenario in the text, Professor McDaniel apparently would not have the U.S. corporation file a combined report. McDaniel, note 1, at 738-39. Apparently, his self-imposed water's edge constraint requires that non-NAFTA corporations be excluded from a combined report. See Section II.A. Accordingly, he would use arm's length principles to determine the income of the U.S. corporation and then apply formulary apportionment to assign a share of that income to the NAFTA countries. See notes 15, 16 and 57.

[55] New York Tax Law § 210(3)(a)(2)(B) (newspaper receipts); § 210(3)(a)(2)(C) (closed circuit and cable television transmissions) (McKinney 1986).

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applicable formula.[56] In addition, the more categories, the greater the likelihood that arm's length prices will need to be administered for transactions among those parts of an enterprise subject to different formulas.[57] As usual in taxation, this issue presents the common conflict between precision and administrability.[58]

Economic theory is unhelpful in designing apportionment formulas. None of the existing formulas that the states use is grounded on economic principles or on economic models, nor were they intended to be. Rather, the formulas are a political compromise that assign income in a manner acceptable to both the states of production and the market states and also acceptable to the taxpayers involved.

The lack of economic theory does not mean that no principles are available to inform the development of formulas. The principles that I would endorse are the principles that Professor McIntyre has developed for designing source rules in the federal system: administrative simplicity, neutrality, economic nexus, inclination to tax and sovereign control of tax.[59] While all of these principles bear on designing a formula, the inclination-to-tax principle has special significance in the context of jurisdictional threshold rules.

[56] These characterization problems raise issues similar to those raised by the definition of a unitary business. Abandonment of the unitary business requirement, see Section II.B., should be accompanied by a decision to have as few formulas as possible.

[57] McDaniel, note 1, at 711; see McIntyre, Design, note 48, at 120-21. For example, suppose that financial activities were subject to a formula different from that used for manufacturing. Assume a corporation has both manufacturing and financing divisions. Presumably, arm's length type principles would be used to determine the preapportionment income of the two divisions.

[58] If all NAFTA countries had fairly similar tax rules and rates, (Professor McDaniel assumes that rates would fall within a narrow range, McDaniel, note 1, at 708, with low jurisdictional thresholds, see Section III.C. and accompanying text, and if most corporations doing business in the region had large NAFTA factors, the design problems would be minimized. Under these conditions, a corporation would not have a serious financial stake in the formula. All of its income would likely be apportioned and taxed by one of the three NAFTA countries at a similar rate. Of course, the three NAFTA countries would care greatly about the formula's revenue effects, but at least taxpayers would not lobby over the details of the formula because they would pay the same amount in any event.

Professor McDaniel suggests that the starting point in designing a formula is one "that in some broad sense, replicates the revenues derived by each country from its existing corporate tax." McDaniel, note 1, at 709. Even assuming that a formula could achieve this goal, some corporations would pay more and others would pay less than they do currently. Some transitional measures might be in order that would impose a special tax on the "winners" under formulary apportionment, the revenues of which might be used to subsidize the "losers." Otherwise, losers, who nearly always seem to be more politically active than winners, might threaten the viability of his proposal.

[59] McIntyre, Design, note 48, at 3-65 to 3-70.

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C. *Jurisdictional Threshold Rules*

A relationship, not always fully appreciated, exists between the development of an apportionment formula and the jurisdictional threshold rules. The relationship is captured by what Professor McIntyre refers to as the "inclination to tax": the formula should apportion income to countries that are inclined to tax it.[60]

Despite the radicalness of Professor McDaniel's general thesis of using formulary apportionment within the NAFTA region, he is less bold when discussing jurisdictional threshold issues and endorses the conventional permanent establishment approach.[61] If receipts are one of the factors in an apportionment formula, the consequence of a permanent establishment threshold rule is that income may be assigned to countries unable to tax it.[62]

As an alternative, Professor McDaniel might consider a threshold standard based on market penetration, as evidenced by gross receipts above a predetermined amount. In other words, a NAFTA corporation would be taxable in a NAFTA country if its gross receipts there[63] exceeded a certain threshold amount. For example, why should a corporation that constructs a turnkey plant in five months for $10 million

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> To the extent feasible, income with an economic nexus in more than one country should be sourced in a country that is inclined to subject the income to taxation. By designing source rules to conform to the inclination-to-tax guideline, policy makers would reduce the risk of undertaxation, thereby promoting fairness and economic efficiency. They would also make possible a generally lower rate of tax on other sources of income.
>
> ....
>
> ... [T]he assignment of source to the country of import is incompatible with the permanent establishment requirement of tax treaties because importers routinely avoid having a permanent establishment ....

Id. at 3-68 to 3-69.

61 Professor McDaniel favors a permanent establishment standard for the pragmatic reason that a relatively uniform definition of permanent establishment already exists. McDaniel, note 1, at 707-08.

Professor McDaniel states that the "creation of a subsidiary in one country that is a part of the unitary business of its parent corporation located in one of the other countries would give rise to the right of the subsidiary's country to share in the tax base of the enterprise." McDaniel, note 1, at 707. But it is difficult to see how that country would obtain any jurisdiction to tax because a subsidiary does not automatically constitute a permanent establishment.

62 This same defect greatly undermines Professor Avi-Yonah's proposal for a one factor apportionment formula based on sales. See Reuven S. Avi-Yonah, Slicing the Shadow: A Proposal for Updating U.S. International Taxation, 58 Tax Notes 1511 (Mar. 15, 1993). I am grateful to Professor McIntyre for this particular insight.

63 Obviously, rules would be needed to define what is meant by a sale within a NAFTA country. The common state apportionment formulas contain a sales factor and typically define a sale as occurring within a state if the goods are shipped to points in that state. New York Tax Law § 210(3)(a)(2)(A) (McKinney 1986 & Supp. 1995).

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not be taxable merely because it did not have a permanent establishment under existing treaty definitions?[64]

The state experience underscores the importance of the above comments. State income tax jurisdiction has been constrained by a federal statute.[65] In general, that statute prevents a state from levying an income tax on a foreign corporation[66] whose only activity in the state is the solicitation of orders for tangible personal property that will be approved outside the state and filled from outside the state.[67] The federal statute increases the likelihood that a corporation may apportion income to a state that does not have the power to tax. To deal with this situation, the Uniform Division of Income for Tax Purposes Act (UDITPA)[68] and the Multistate Tax Compact[69] incorporate a so-called throwback rule: "sales of tangible personal property are in this state [and thus included in the numerator of the receipts factor] if: . . . the property is shipped from an office, store, warehouse, factory, or

[64] The possibility that a corporation might have a receipts factor in a country in which it does not have a permanent establishment can be minimized through the use of throwout or throwback rules, but the problem should be addressed frontally through an economically meaningful jurisdictional standard such as market penetration. For a discussion of throwout and throwback rules, see Richard D. Pomp, Reforming a State Income Tax, 51 Alb. L. Rev. 375, 704-07 (1987); see also note 70.

[65] 15 U.S.C. § 381 (1994) (setting minimum standards for imposition of state net income tax).

[66] In this context, a foreign corporation is one incorporated outside the taxing state.

[67]

> No State, or political subdivision thereof, shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

15 U.S.C. § 381(a) (1994).

[68] UDITPA was formulated by the National Conference of Commissioners on Uniform State Laws in 1957. UDITPA, 7A U.L.A. 336 (1985). A majority of the states that levy a tax on or measured by income have adopted UDITPA in whole or in part. UDITPA specifies an equally weighted, three factor formula, UDITPA, § 9.4; today it is common for states to double weight the sales factor. See, e.g., Cal. Rev. & Tax Code Ann. § 25128 (West Supp. 1994); 1993 Cal. Stats., ch. 946, § 1; New York Tax Law § 210(3)(a)(4) (McKinney 1986 & Supp. 1995).

[69] Multistate Tax Compact, reprinted in 2 Multistate Corporate Income Tax Guide (CCH) ¶ 8450 (1985).

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other place of storage in this State and . . . the taxpayer is not taxable in the State of the purchaser."[70]

The state experience also points out a fundamental difference between formulary apportionment and the residence-based federal system. In the federal system, income often escapes source taxation because a corporation does not have a permanent establishment. Sometimes this result will simply mean that the country of residence will increase its share of the tax base because there will be no source tax that will be creditable against the residence country tax. In a formulary system, by contrast, the stakes can be much higher. If income is apportioned to a jurisdiction that lacks the power to tax, it escapes taxation by all jurisdictions. Accordingly, the higher the threshold rules, the greater the need for anti-avoidance techniques. The state experience suggests the merit in having low threshold rules, such as the gross receipts approach mentioned above.

III. Special Problems Arising from Switching to Formulary Apportionment in the Context of NAFTA

A. *Rule Shopping and Tax Administration Shopping*

Professor McDaniel is correct that his proposal would eliminate treaty shopping among the NAFTA countries.[71] My fear, however, is that, unless the three countries adopted identical tax systems, rule shopping would replace treaty shopping. Consider, for example, that currently Mexico does not have the equivalent of § 367. Suppose a U.S. corporation wanted to avoid the impact of § 367. Presumably, it could make a tax-free transfer of the target assets to a Mexican corporation,[72] which could then transfer the assets tax-free offshore. One way to stop this type of tax avoidance would be to require Mexico, as part of any NAFTA tax treaty, to adopt provisions equivalent to § 367. More generally, all three countries would have to adopt essen-

[70] UDITPA, § 16; Multistate Tax Compact, note 69, art. IV, § 16, at ¶ 8,470. An alternative approach is a so-called "throwout" rule. Under a throwout rule, if a corporation is not subject to income tax in the destination state, the receipts from such sales are excluded from both the numerator and the denominator of the receipts factor.

State apportionment formulas typically use receipts, property and payroll. When income is apportioned to a state that lacks the power to tax, normally, it is because of the receipts factor, but similar types of problems can arise in the case of the property and payroll factors. See Pomp, note 64, at 705-06; cf. Phillips Petroleum Co. v. Commissioner, 101 T.C. 78 (1993), where the court adopted a throwout rule for property in interpreting § 1.863-3(b)(2) (Ex. 2(iv)) of the Regulations.

[71] McDaniel, note 1, at 713.

[72] See id.

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tially identical tax laws; otherwise, problems similar to the above would surface in other contexts.[73]

Although identical rules would preclude rule shopping, a corporation might also shop for the least vigorous tax enforcement. If, for example, Mexico were viewed as having the least competent tax administration, a transaction could be structured so that it would be reported on a return filed only in Mexico.[74] To be sure, the disallowance of tax-free transfers among NAFTA corporations would mitigate this type of problem but that approach would be inconsistent with viewing the three countries as part of one integrated economic union. The ultimate solution is equally competent tax administrations, which underscores the significance of a trilateral NAFTA tax agency, staffed with personnel from all three countries.[75]

Another illustration of the necessity of uniform rules and uniform tax administration involves the U.S. treatment of a controlled foreign corporation (CFC). Suppose a U.S. parent has a Mexican CFC, which has a non-NAFTA CFC. Under subpart F, the U.S. parent might be taxed on the income of the Mexican CFC or the non-NAFTA CFC.[76] But suppose the parent were merged tax-free into its Mexican subsidiary, resulting in a Mexican corporation with a non-NAFTA CFC. Because Mexico does not have CFC rules comparable to the U.S. rules, this scenario would allow the U.S. parent to achieve a tax savings because the preapportionment tax base would now exclude the income of the CFC.[77]

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[73] Professor McIntyre's example of how the adoption of a Canadian GST sent shoppers scurrying to malls on the U.S. side of the border is another reminder of the need to harmonize tax systems in a free trade area. McIntyre, Commentary, note 8, at 783-84. From the perspective of a Canadian shopper, the United States looked like a tax haven (no federal sales tax and relatively low state sales taxes). With low transaction costs (that is, a short ride to the border), the Canadian consumer, like other forms of movable capital, sought out the higher return available from the United States.

[74] One way to achieve this result is to have the transaction executed by a corporation having factors only in Mexico.

[75] See McDaniel, note 1, at 725.

[76] See IRC § 951(a).

[77] The problem in the text would be solved if the Mexican corporation were to file a combined report with its non-NAFTA subsidiary. Professor McDaniel's water's edge constraint, however, would prevent the inclusion of a non-NAFTA corporation in the combined report.

Problems similar to those referred to in the text can arise in the state context. For example, states such as Delaware that have favorable rules on the taxation of intangible income, Del. Code Ann. tit. 30, § 1902(b)(8) (1984 & Supp. 1994), are the domestic counterpart of foreign tax havens and are often used in tax avoidance situations. See, e.g., Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (S.C. 1993).

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B. *The Treatment of Dividends*

One of the stickier design issues involves the treatment of dividends. There are a number of issues involving dividends, some presenting fewer problems than others.

The easiest case involves dividends paid by a corporation that was included in a combined report with the payee. The dividend should be excluded from the payee's preapportionment tax base. Consistent with the theory of a combined report, there should be no tax consequences triggered by the movement of earnings among corporations included in the combined report.[78]

Another possibility is that the dividend is paid to a NAFTA corporation by another NAFTA corporation that is not part of the combined report.[79] Professor McDaniel would exempt the dividend because the profits out of which the dividend is paid already have been included in the NAFTA tax base of the payor.[80] Consequently, he would treat this situation the same as if the dividend were paid by a corporation that was included in the payee's combined report.[81]

Why these two situations should be treated the same is unclear. In the first situation, where both the payor and payee are NAFTA corporations, the combined report would have the effect of treating all members of the unitary business as if they were branches or divisions of the same taxpayer. In that situation, a dividend from a subsidiary included in the payee's combined report is viewed properly as the shifting of money within the same enterprise. The dividend would have no taxable consequence for the same reason that a shifting of funds from one division of a corporation to another generally has no tax effect. In the second situation, however, the payor and the payee do not file a combined report and are not viewed properly as part of the same enterprise. If the dividend is to be exempt, it must be for reasons that Professor McDaniel does not articulate.

Consider, for example, a Mexican subsidiary of a U.S. corporation. Assume that the parent and its subsidiary do not conduct a unitary business under Professor McDaniel's approach so that no combined report would be filed. To take a slightly unrealistic but informative example, suppose the Mexican subsidiary apportioned 1% of its income to Mexico under the applicable apportionment formula, and

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[78] For a fuller explanation, see note 2.

[79] The payor might not be part of the combined report because it is not part of the unitary business conducted by the payee (if such a requirement were a prerequisite to the filing of a combined report, see Section II.B.), or the payor might not have the minimum ownership interest in the payee required to file a combined report. See note 43 and accompanying text.

[80] McDaniel, note 1, at 720.

[81] Id. at 706, 712, 720 and 727.

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none to the United States. Assume the Mexican subsidiary paid a \$100 dividend to its U.S. parent, which apportioned all of its income to the United States because, under the applicable formula, it had only U.S. factors. Why should the apportionment of 1% of the subsidiary's income to Mexico exempt the dividend from being apportioned 100% to the United States?

I could understand a rule that exempted that part of the dividend that was assumed to be paid out of profits already taxed by the United States.[82] I also could understand a rule that exempted that part of the dividend that was assumed to be paid out of profits already taxed by Mexico, although the U.S. foreign tax credit already addresses the double taxation issue. But I do not see the logic in a 100% exemption.[83]

In any event, assuming, as Professor McDaniel does, that the dividend would be fully exempt, transitional rules and tracing rules would be needed. Continuing the preceding example, assume the Mexican subsidiary has profits that accrued prior to the start of the new NAFTA formulary regime. Should these profits be exempt because they already would have been taxed by a NAFTA country? If not, a tracing rule would be needed to decide the order in which profits from the pre- and postformulary regimes are considered to be paid as dividends. Tracing rules also would be needed because not all dividends paid after the start of the new rules necessarily would be paid out of profits taxed by one of the NAFTA countries.[84]

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82 For example, assume, contrary to the example in the text, that the Mexican payor had apportioned some of its income to the United States because it had U.S. factors and satisfied the U.S. jurisdictional threshold. Under this assumption, the United States already has taxed the Mexican corporation on part of the profits that are now distributed to the U.S. parent and it could logically choose to exempt such part.

83 If a unitary business principle is a precondition to taxability, then the dividends might be exempt because either the income itself or the business of the payor did not stand in a unitary business relationship with the payee. If no such principle is required, the dividends automatically would enter into the preapportionment tax base of the payee. One example in which dividends might constitute the unitary business income of the payee regardless of the activities of the payor, involves working capital. Suppose a corporation parks its working capital in an equity mutual fund. The dividends paid by the mutual fund would be viewed as part of the working capital of the corporation and would be included in the preapportionment tax base along with the corporation's other unitary business income. See note 43.

84 For example, assume that the Mexican subsidiary referred to in the text apportioned one-half of its income to NAFTA countries. Any dividend paid by the Mexican subsidiary to its U.S. parent would not be paid entirely out of profits that would have been taxed by the NAFTA countries. Tracing rules would need to be developed to specify what part of the dividend should be exempt because it was viewed as being paid from NAFTA-taxed income and what part should enter into the preapportionment tax base of the payee because the profits out of which the dividend was paid were viewed as never having borne any NAFTA tax.

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Professor McDaniel is able to ignore these situations because he would exclude dividends paid by non-NAFTA subsidiaries from the preapportionment tax base.[85] He does so, inter alia, because their inclusion would violate his notion of a water's edge system.[86] His prior defense of a water's edge approach[87] is less applicable here. I do not understand how the exclusion of the dividend is required by existing tax treaties because currently foreign source dividends are already taxable. In addition, unlike the foreign response to California's worldwide combined reporting, the taxation of foreign source dividends by the United States has not aroused any opposition and is accepted international practice. More fundamentally, federal concepts of source have no role to play in a formulary apportionment regime.[88]

IV. Conclusion

Professor McDaniel's article is an intellectual tour de force. He and I agree on the major contours of the move toward a system of formulary apportionment/combined reporting in the NAFTA region. True, we might quibble over some details. My own preference, for example, would be to abandon the water's edge and unitary business constraints that Professor McDaniel embraces. Moreover, I would adopt generous combined reporting rules. In addition, I would minimize the number of apportionment formulas and incorporate low level jurisdictional rules.

The difference in our views may reflect the weight that I place on the experience of the states and the implications of that experience for NAFTA. I have drawn on the learning of the states regarding the more fundamental and structural issues inherent in formulary appor-

[85] McDaniel, note 1, at 727. This exclusion is apparently a gloss on his general assertion that "all types of passive investment income received from a non-NAFTA enterprise could be included in the apportionable income of the NAFTA unitary enterprise." Id. at 720.

[86] Id. Professor McDaniel also notes that including the dividends in the preapportionment tax base of a NAFTA-based parent would create locational distortions and distortions in repatriation decisions because non-NAFTA corporations would not include such dividends in their tax base. McDaniel, note 1, at 727. The more general point—and probably more significant point—is that a formulary apportionment regime for NAFTA corporations that would coexist with a separate accounting/source rule regime for all other corporations would have the potential to induce locational distortions. Intuitively, I do not have a feel for the magnitude or severity of this more general problem. Presumably, deciding to proceed with formulary apportionment is tantamount to deciding that locational risks are outweighed by other advantages. Of course, one could proceed with formulary apportionment but decide that the treatment of dividends causes a special set of risks. Professor McDaniel, however, has not made that argument. Moreover, the foreign tax credit, which still would be available even under formulary apportionment, see McDaniel, note 1, at 713, 720, would mitigate the problem.

[87] See notes 13-23 and accompanying text.

[88] See Section II.A.

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tionment. The insights garnered from over 50 years of state experimentation cannot be easily dismissed. In a sense, the states provide us with a window into the future. To paraphrase the philosopher Santayana, those who do not know the mistakes of the states are condemned to repeat them.[89] Rarely when federal tax legislation is proposed is there any relevant experience from comparable jurisdictions to study. That fortunately is not the case with formulary apportionment.

[89] "Those who cannot remember the past are condemned to repeat it." George Santayana, 1 The Life of Reason 284 (2d ed. 1922). Professor McDaniel relies less on the state experience than I do because "[m]any of [their] problems can be resolved or avoided in a system developed by national government agreement." McDaniel, note 1, at 705. If he means that a trilateral tax treaty can impose a solution on problems the states live with, I would agree. But certainly the state experience identifies the problems requiring a solution. Indeed, a comparison of the apportionment formulas used by most states to deal with manufacturing activities, see, e.g., New York Tax Law § 210(3)(a)(2) (McKinney 1986 & Supp. 1995); 72 Pa. Stat. Ann. § 7401(2)(a)(1)(A) (1994), with their federal counterpart in § 1.863-3T(b)(2) of the Regulations illustrates well the level of sophistication that the states have achieved. For example, the issues first addressed in Phillips Petroleum v. Commissioner, 101 T.C. 78 (1993), discussed in note 70, have long been resolved by most states.

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