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What Can the OECD Learn From the States?

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A few months before the widespread devastation unleashed by the coronavirus pandemic, nearly 140 countries agreed to formulate a plan for modernizing the income taxation of multinational corporations. The director of the OECD's Centre for Tax Policy and Administration acknowledged that the date "may look a bit insane," but the alternative is the risk of trade wars based on tax disputes. Today — in the middle of a global economic depression — that risk looks downright tame. The real risk is that the implosion of economies throughout the world will lead countries to recede to the basest and darkest of human emotions.

Insane or not, the end of 2020 is no longer aspirational but has now become a critical deadline. The pandemic has made taxing jurisdictions around the world desperate for money if their institutions are to survive. The OECD needs to recognize that the states developed a better mousetrap in dealing with cross-jurisdictional corporations. It is time their experiences should be recognized as a model to be emulated.

A. Historical Perspective[4]

Necessity is the mother of invention, and at the beginning of the 20th century the states were forced to develop a better alternative to federal transfer pricing and sourcing rules. Long before the dramatic rise of the multinationals after World War II, which started to expose the weaknesses in the federal rules and in the bilateral income tax treaties, the states had to respond to the challenge of taxing interstate corporations.

To deal with this, after a few inadequate starts, formulary apportionment emerged as the consensus approach in the early 20th century, building on the taxation of interstate railroads. Some states, under the intellectual leadership of California, started combining domestic related entities by the mid 1930s, which eliminated the need to police transfer prices and the shifting of profits to domestic tax havens (such as Nevada in the case of California). The apportionment formula would determine how much of the tax base a state could tax, substituting for the primitive federal sourcing rules.

The IRS was essentially indifferent to purely domestic interstate corporations, which typically filed consolidated returns. Consequently, interstate corporations posed no tax problem at the federal level, unlike the challenges they presented at the state level.

To be sure, there were a small number of U.S. corporations with foreign activities as early as the mid-19th century, such as the Singer Manufacturing Co. — incorporated in 1851 and often cited as the first U.S.-based multinational — selling sewing machines first in Europe and later in India, Australia, South Africa, and New Zealand. By the end of the 19th century, Singer was joined by other multinationals of the time, including Westinghouse, General Electric, Eastman Kodak, and Standard Oil.

B. The Rise and Fall of Mandatory Worldwide Combined Reporting

These multinationals presented special problems for both the IRS and the states, especially after World War II. The IRS used the federal transfer pricing and source rules, in the context of international tax treaties, and many states often piggybacked on this, accepting the resulting federal allocation of income as their starting point.[5] But some states that were combining domestic corporations went further, and extended this technique to include foreign entities, a method known as worldwide combined reporting.

[4] *See* Richard D. Pomp, *State and Local Taxation*, 9th ed. 2019, pp. 10-1 through 10-8; 10-40 through 10-79.

[5] One early exception was New York. *See Bass, Ratcliff & Gretton Limited v. State Tax Commission*, 266 U.S. 271 (1924).

The major advantages are obvious. Tax havens are combined, bringing their income back into the tax base. The need for the global intangible low-taxed income (GILTI) regime and similar approaches is eliminated. Tax minimization games built around income shifting are undercut, if not fully stopped. The manipulation of tax treaties is eliminated.

Although a tax treaty with the United Kingdom unsuccessfully tried to halt mandatory worldwide combined reporting, political pressure from the Reagan administration bullied California and those in its fold to stop using this approach. The lesson for the OECD (and the EU) is that this retrenchment was political in nature and not because of administrative obstacles (although critics would allege otherwise).

C. Production vs. Market[6]

Much of the European debate is over how to assign the tax base between the production country and the market country. The states have fought this battle at least since 1957 when the Uniform Law Commission brought us the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA sets forth an evenly weighted three-factor formula, using property, payroll, and sales. In the case of tangible personal property, sales are attributed to the state in which the goods are delivered or shipped. That formula thus incorporates two production or origin factors (property and payroll) and one market factor (sales).

For all other sales, most notably services, UDITPA assigns the receipts using what is known as the costs of performance approach. In this case, there is an all-or-nothing approach: The one state in which the greatest costs of income-producing activities occurs receives all the receipts. (Some states reject this all-or-nothing approach and utilize a proportional methodology.)

Of special interest to the OECD (and the EU) is the dissatisfaction with the production bias inherent in the costs of performance approach. Instead, states have been replacing that approach by using a market-based approach to the sales factor (and some go even further, apportioning income using only sales). The MTC, probably the greatest depository of intellectual firepower in the field, has spent two years drafting exhaustive rules designing different approaches to market-based sourcing depending on the type of transaction involved.

The OECD should design its own formula, factors, and their respective weighting, but the MTC has done the heavy intellectual lifting. And the MTC has special formulas for special industries.

D. Nexus

With the fairly recent U.S. Supreme Court case *South Dakota v. Wayfair Inc.*,[7] the physical presence rule imposed under the commerce clause was rejected in sales tax cases, similar to the movement to eliminate the PE rule that is at the heart of existing bilateral income tax treaties. The experience of the states post-*Wayfair* is another source that can be drawn upon. Moreover, long before *Wayfair*, the states were imposing economic nexus rules in their income taxes. The MTC developed "factor presence" rules for nexus, which incorporated economic nexus approaches. Free of any commerce clause constraint, the OECD can also draw on this experience in designing its nexus rules.

E. Adopting Mandatory Worldwide Combined Reporting

Without a commerce clause to deal with, the OECD has more latitude than the American states to adopt a worldwide combined approach. (All the U.S. litigation over the definition of a unitary business, a precondition under the commerce clause to combination, would be irrelevant.) Once again, the MTC and the states have relevant experience to draw on. Mandatory worldwide combined reporting, with a well-designed apportionment formula, is a better alternative to the OECD's agenda. It deals better with tax havens, transfer pricing, defining specific types of businesses, such as digital or "consumer-facing," profit shifting, and the allocation of overhead. It

[6] *See* Richard D. Pomp, Report of the Hearing Officer, Multistate Tax Compact Article IV, [UDITPA], Proposed Amendments (2013).

[7] 138 S. Ct. 2080 (2018).

nicely addresses the digital economy and undercuts many tax minimization strategies.

F. The Combined Tax Base

One area in which the state experience will not be useful, however, is the nature of the tax base to be combined. Neither UDITPA nor the MTC addresses this critical issue. International accounting standards and the Common Consolidated Corporate Tax Base could fill the void as a starting point. I have enough friends who are financial accountants and who, like tax lawyers, can make anything so complicated that the temptation is to throw up our collective hands in frustration. Experienced draftspersons know, however, that "the perfect is the enemy of the good." Persons working in good faith and with an urgent sense of mission can arrive at something good enough to be workable.

Helen Hecht's contribution in this installment summarizes the OECD's ambitious 11 "work streams." The states have much to offer in resolving the issues addressed by these work streams. It is unnecessary for the OECD (or the EU) to reinvent the wheel when the states already own the original patent.

G. Administering a Worldwide Combined Reporting

Many countries will be unable to administer a worldwide combined reporting regime without help. My preference would be for a nongovernmental organization that has the capability, expertise, and sophisticated personnel who can climb the needed learning curve, to take on this burden on behalf of *all* countries. The OECD, the U.N., the IMF, or the World Bank would be logical candidates. Resistance can be expected, of course, to this new global tax and the resulting international bureaucracy, with conspiracy fanatics being unleashed and warning of "black helicopters" and "world domination." But the real fear is not this lunacy, but rather the dystopian world we will be moving toward if there is not sufficient revenue to rebuild economies and bolster democratic institutions by the end of 2020.