

## Adopt Formulary Apportionment And Combined Reporting

By Joe Huddleston

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I urge Chair Volcker and members of the task force to seriously consider formulary apportionment, along with combined reporting, as a new method for multinational firms to determine the share of their net income subject to tax in the United States. As the world economy becomes increasingly integrated, the federal sourcing method that attempts to separately identify a geographic source of particular items of income becomes increasingly impractical. The federal system requires a resident multinational firm to separately account for income and expenses attributable to specific activities in the United States using geographic accounting and extremely complex transfer pricing rules. The formulary apportionment system is simpler and more practical because it treats the production of world income as more of a multinational endeavor with contributions from all taxing jurisdictions. Under formulary apportionment, there is no need for detailed separate geographic accounting or transfer pricing agreements. The complex rules for deferrals and U.S. taxation of foreign-source income could be eliminated, or at least greatly simplified.

Combined formulary apportionment would allocate a portion of a multinational firm's worldwide net income based on a formula that roughly reflects the relative amount of economic activity located in the United States (that is, based on property, payroll, and sales in the United States) as a percentage of those activities in all jurisdictions. Of course, there is no one true answer to the question of how much income a multinational firm earns from its activities in the United States. Both separate

accounting and formulary apportionment produce reasonable estimates, but formulary apportionment makes that estimate with less complexity and less opportunity for tax avoidance.<sup>1</sup> Thus, combined formulary apportionment provides a more accurate reflection of the tax base that would permit a combination of increasing tax revenues and a reduction in marginal tax rates. Reducing marginal tax rates enhances economic efficiency while also reducing the incentive to improperly shift income to lower-tax countries.

Under the current system, some firms engaged in international trade can improperly shift income from the United States to lower-tax jurisdictions through the use of transfer pricing and by assigning their valuable patents and trademarks to affiliates in tax havens and deferring their tax liabilities. Combined reporting, by requiring the components of a single multinational enterprise (corporate parents and subsidiaries) to add their income together, prevents a variety of tax avoidance schemes that many multinational corporations have devised to artificially move net income out of the jurisdictions where they are earned and into jurisdictions where they will be taxed at lower rates — or not at all.

A federal formulary apportionment system is also a practical approach to taxation of world income that would allow for increased efficiencies in tax administration through greater coordination of federal and state corporate tax systems. Most states base their corporate income tax base on the federal definition of net income, with adjustments. Nearly half of those states also use combined reporting, and many of the combined reporting states allow combination on a worldwide basis.<sup>2</sup>

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<sup>1</sup>See, e.g., Michael J. McIntyre, "The Use of Combined Reporting by Nation States," *Tax Notes Int'l*, Sept. 6, 2004, p. 917; Charles E. McLure Jr. and Joann M. Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income," in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford Univ. Press (2000)); Reuven S. Avi-Yonah and Kimberly A. Clausing, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," Discussion Paper 2007-06 (Washington: The Hamilton Project, June 2007).

<sup>2</sup>See, e.g., Cal. Rev. & Tax Code section 25110; Ma GL ch 63, section 32B(c)(3); W. Va. Code section 11-24-13f. See also *Barclay's Bank PLC v. Franchise Tax Board of California*, 512 U.S. 298 (1993) (worldwide combined reporting not unduly burdensome).

Of course, the U.S. federal tax system is interwoven and balanced to some extent with the tax systems of other nations. A change to the U.S. system could prompt changes in other nations' systems. There is an opportunity to consider this specific change now, as the European Union is also considering formulary apportionment.<sup>3</sup> Together, these two large segments of the world economy could provide international leadership in creating a more practical system of sourcing income. ■

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<sup>3</sup>See Ana Agúndez-García, "The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options," European Commission, Taxation and Customs Union, Working Paper 9 (2006).