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Addressing BEPS: Lessons From the U.S. States

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In this report, the authors write about state corporate income tax systems, focusing on the different states' approaches to tax multistate income. They also discuss what international governments can learn from the states' experiences to make changes in their tax provisions to address base erosion.

I. Overview

National governments around the globe are increasingly focusing on "stateless income," "nowhere income," or "double non-taxed income" earned by multinational enterprises that is subject to little or no taxation in any country. International organizations, including the OECD through its initiative to reduce base erosion and profit shifting, are evaluating options for addressing this issue.[1]

Although BEPS is emerging as a new international tax issue, it has been the focus of attention for many years in the most unlikely of international places: U.S. state income taxation. For decades, the U.S. states have been dealing with nowhere income and BEPS. Their experience — as integrated, open-border economies with geographically mobile capital and labor plus governments competing to attract jobs and investments — may provide some helpful lessons for the global tax policy debate. Although there are important differences between U.S. states and national governments in terms of legal structures, constraints on business tax systems, and the mobility of factors, there are also many similarities regarding the tax policy issues surrounding taxation of multistate and multinational businesses.

With the strong growth of international trade in goods and services, the increasing importance of intangible assets in the production of income, and the expanding use of complex business structures used in international operations, nations are paying more attention to the challenges in determining how income should be distributed across countries where MNEs operate.

Countries and U.S. states are trying to answer the same question: Where is the location of a taxpayer's economic activities that create the income that governments are attempting to tax? For example, if royalty income from leasing intangible property is to be taxed at its source, how do you determine in what state or country the activity is located that produces the income? Is the source country where the sales incorporating the intangible occur (the "market" location), where the intangible was developed, or a split between the two locations?

Under the international tax system, countries are increasingly concerned that taxable income reported for tax purposes is becoming disconnected from the location of economic activities that are presumed to generate the income.[2] The system was constructed with a focus on preventing double taxation of the same income; today's focus is shifting to preventing "double nontaxation," a phrase used in the OECD plan discussion of BEPS, or ensuring "single taxation." As noted, U.S. states have also been addressing the same issues of potential overtaxation and undertaxation for more than 100 years.

The tax policy emphasis for both U.S. states and nations is on strengthening the link between the distribution of taxable income and the economic activities within a geographic area. As the OECD plan points out, the primary factor contributing to international base erosion is the "artificial" separation of taxable income from the location of

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[1]The G-20 finance ministers asked the OECD to develop a plan to address the BEPS issue. The resulting 15-point action plan is presented in OECD, "Action Plan on Base Erosion and Profit Shifting" (the OECD plan) (July 2013). The OECD plan is discussed in some detail in the EY International Tax Alert, "OECD Issues Action Plan on Base Erosion and Profit Shifting (BEPS)" (July 21, 2013). As this article went to press, the OECD released the first of its recommendations to address BEPs.

[2]This concern is advanced in OECD, "Addressing Base Erosion and Profit Shifting" (Jan. 2013), Chapter 2.

the economic activities that create the income. The OECD plan is evaluating tax policy changes that will more closely align the geographic distribution of economic activities and taxable income.

Although U.S. states and nations have taken fundamentally different approaches to determining the geographic distribution of taxable income for multistate and multinational taxpayers, the problems of base erosion and profit shifting are common to both systems. This paper discusses the U.S. states' experience that may provide insights relevant to the global debate over reducing corporate income tax base erosion and determining the country-by-country assignment of taxable income.

The following are discussed in this paper:

- Determining the geographic location of economic activity that generates corporate taxable income — where to source income — is very difficult. The increasing role of services and intangibles in generating income makes linking income and the location of real economic activity even more challenging. No simple, theoretically preferred approach to answering this question exists. Any mechanism, including both formulary apportionment and separate accounting with arm's-length transfer pricing, has its strengths and weaknesses.
- U.S. states have reached a consensus on the general approach to dividing income of multistate taxpayers among the states. Over time, states have moved away from separate accounting to assign corporate taxable income to the use of a system of formulary apportionment of taxable income.
- States' apportionment systems are not the solution to all the challenges of corporate income taxation. The increasing importance of intangibles and services in the generation of corporate taxable income provides the same challenges to apportionment systems as the international taxation approach using separate accounting with arm's-length transfer pricing to determine the geographic source of income. Both systems must deal with the difficult issue of how to recognize and measure the contribution of intangibles in determining the geographic distribution of income.
- States' attempts to adopt uniform corporate income tax provisions have been ephemeral. State efforts to produce more uniform corporate tax systems, including a uniform apportionment formula, have met with limited success. Factors undermining uniformity include different state economic conditions and variations in the importance given to different tax policy objectives across the 50 states.

  Key conflicting objectives include protecting the corporate income tax base to raise sufficient corporate income tax revenue and providing economic incentives — including corporate income tax reductions — for businesses to locate and expand in a state. In response to the latter, states have adopted features that lower taxes on companies with a significant economic presence in a state at the expense of out-of-state businesses with relatively less physical presence in the state but substantial in-state sales. In other words, states have legislated significant reductions in the tax base.
- States have not reached a consensus on the most effective way to address potential base erosion because of the development of complex business structures of multistate and multinational businesses. For example, states are divided into two camps on how to treat related entities in determining taxable income. One camp is the combined reporting states; the other is separate filing states.[3]

  In combined reporting states, the "taxpayer" is defined as a group of affiliated corporations under the assumption that it is not possible to assign income to a specific company operating within a group of affiliated companies. Combined reporting is viewed by some states as an effective way to prevent corporate income tax base erosion through the transfer of intangible property among affiliates.

  The other group of states uses separate accounting that treats each affiliated corporation as a separate taxpayer in determining the taxable income base. Those states have developed targeted adjustments to the corporate taxable income base designed to address base erosion. Those adjustments include the disallowance of deductions for payments to related parties.
- The U.S. states' corporate income tax experience suggests that any new consensus on global taxation, if it can be reached, will not be a simple or static system because of the growing complexities of cross-border economic transactions and the different, and possibly conflicting, policy objectives of individual countries.

  The alternative may in fact be a hybrid, more complex corporate income tax system mixing approaches to assigning and taxing different corporate income sources among countries. Also, like the U.S. state system, if a consensus can be reached on a new or modified global tax system, it will be subject to continuous pressure over time to be altered as individual country economic conditions, forms of doing business, and national policy objectives change.

The next section provides a brief overview of the evolution of the U.S. state corporate income tax system, with a focus on the different approaches used to divide taxable multistate income among the states and to deal with base erosion. The following sections discuss possible insights and

[3]For a comprehensive discussion of the options that states have used to address corporate income tax base erosion, see the Pennsylvania Independent Fiscal Office report, "Corporate Tax Base Erosion: Analysis of Policy Options" (Mar. 4, 2013).

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lessons learned from the U.S. states' experience for the discussion of changes in international tax provisions to deal with base erosion.

II. Evolution of U.S. States' Approach to Taxing Multijurisdictional Income

The state corporate income tax system has evolved over the last 100 years, shaped importantly by unique national constitutional constraints and broad states' rights to experiment with alternative approaches to taxing corporate income. In the process, states have adapted their corporate tax systems to changing business structures and increased geographic mobility of business activities. The way the state system has evolved provides insights that may be relevant to the BEPS discussion.

Determining how to divide income of multistate taxpayers among the states has been a key issue driving the evolution of state corporate income taxes. Early state corporate income taxes used separate accounting to divide taxable income among the states where a taxpayer operated.[4] That approach treated a taxpayer's operations in a single state as a stand-alone economic activity separate from the taxpayer's operations in other states.

With the growth of multistate firms with significant economic activity in different states, U.S. states began switching to a formulary approach for determining what portion of the income from a multistate taxpayer is subject to tax.[5] Under this alternative system, widely used by the 1930s, each state's share of a taxpayer's income is determined by the state's share of the taxpayer's measureable "factors" that can be assigned to a geographic location. Those factors were chosen as indirect measures of economic activities that were assumed to generate taxable income.

As formula apportionment developed, states differentiated between business income from a regular trade or business and nonbusiness income.[6] The use of economic factors to distribute business income geographically was viewed as less appropriate in determining the distribution of nonbusiness income, such as investment income. States generally assign (or allocate) this type of income to a company's domicile or the specific location where the income was generated. The remaining income is considered to be operating or business income that is apportioned among the states. This distinction results in a hybrid system that assigns business income to multiple source states and nonbusiness income to a single state.

States' early formulas differed widely in terms of the included factors and the weights given to each factor. The traditional formula included payroll, property, and sales factors. The inclusion of the sales factor in the early apportionment formulas added another hybrid feature and more complexity to the apportionment system. The payroll and property factors were considered to be measures of the source of economic activities generating taxable income. In contrast, the sales factor was considered to be a measure of the activities regarding the market for goods and services. The three-factor formula assigned economic activities (and the related taxable income) to "market" states or "production" states. The inclusion of the sales factor was perceived as a necessary compromise to gain a consensus among the states for a more uniform apportionment system.

Although formula apportionment provided a practical method for states to determine the geographic location of taxable income for a specific multistate firm, states became concerned about possible corporate income tax base erosion as multistate firms shifted from operating as divisions of a single company to a more complex structure operating as affiliated, separate legal entities. Beginning in the 1930s, following the lead of California, selected states began to shift to a new system, combined reporting of corporate taxable income. This approach views a group of affiliated companies as a single taxpayer for purposes of determining taxable income. The group's income is summed and then apportioned to individual states using the state's apportionment formula.[7]

Numerous states viewed combined reporting as a method of reducing tax planning opportunities to reassign taxable income among affiliates in different states. In other words, those states assert that combined reporting provided a stronger link between the assignment of taxable income and the

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[4] *See* Jerome R. Hellerstein and Walter Hellerstein, *State Taxation,* Volume I, Chapter 8, for a detailed discussion of the approaches that states have used over time to determine the interstate division of taxable income.

[5] U.S. Supreme Court cases have specified the constitutional constraints that states must follow in apportioning multistate income. Those constraints include the requirement that the income and apportionment factors to be used in apportioning multistate taxable income be limited to taxpayer activities in other states that are related to the taxpayer's in-state activities (referred to as a unitary business). The constitutional concept of a unitary business was first developed in the context of state property taxation of railroad property before the advent of the corporate income tax.

[6] The distinction between apportioning business income and allocating nonbusiness income is provided for in the Uniform Division of Income for Tax Purposes Act, which was voluntarily adopted by numerous states.

[7] The concept of combining incomes of multiple taxpayers has also been introduced into the OECD guidelines to arm's-length transfer pricing calculations. The residual profit-split method, for example, starts with an estimate of the combined profits of both entities involved in a controlled transaction. After subtracting each affiliate's profits regarding their non-unique activities, the remainder (residual profits) is attributed to the separate affiliates based on measures (allocation keys) of each affiliate's activities contributing to the residual profits. While the second step division does not use an apportionment formula analogous to state apportionment formulas, the residual profit-split method does include a limited income combination concept found in state combined reporting systems.

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location of measurable, economic activity producing the income. Combined reporting proponents argued that it reduces the possibility of assigning taxable income of a group of firms to a state with minimal real economic activity.

Other states take the position that combined reporting is not a preferred approach to separate company filing in determining corporations' taxable income. A major concern raised by this group of states is that the apportionment of combined income effectively results in the same level of average profitability for the group of related companies being assigned to each dollar of factors in every state. Given the diversity of operations across the affiliated groups and the large variance in economic conditions among the states, combined reporting critics argue that the assignment of income does not accurately reflect the taxable income generated by the actual economic activities in a specific state. In other words, while combined reporting may reduce base erosion from shifting of income unrelated to real economic activity, it may create a different form of distortion or disconnect between the geographic division of taxable income and the actual profitability of in-state economic activities.

Over the last decade, the separate filing states have adopted provisions short of combined reporting to reduce perceived corporate income tax base erosion, including:

- the disallowance of deductions (addbacks) for intangible expenses (such as royalties and licensing fees) and interest paid to affiliated companies;
- the disregard of transactions without a business purpose between affiliates;
- adjustments to transfer prices;
- the addition of income earned by related parties located in low- or no-tax "tax haven" countries and states; and
- the assertion of economic nexus for affiliates without physical presence in the state.

In some cases, combined reporting states have also adopted those additional adjustments that target base erosion.

It is important that the U.S. states have not been able to reach a consensus on the most effective approach to taxing affiliated corporations to address corporate income tax base erosion. Roughly half of the states use combined reporting of the income of related corporations, while the remaining states continue to use the separate filing system that treats each corporation as a separate taxpayer.[8]

The most recent trend in U.S. states' corporate income tax systems is the shift to apportionment formulas that heavily weight the sales factor, including at least 18 that use (or are phasing in) formulas that include only the sales factor. States are adopting single-sales-factor apportionment primarily as an economic development policy that reduces taxes on corporations with relatively high ratios of in-state payroll and property. Also, those states are sourcing sales of intangibles and services to the state where they are used, rather than to the state where the services are produced.

By not including payroll and property — the key determinants of economic value added — in the apportionment formula, single-sales-factor apportionment is weakening the link between the geographic assignment of multistate income and the distribution of real economic activity creating the income. This growing disconnect is not because of base erosion from tax planning by taxpayers, but from legislative decisions regarding changes in the statutory apportionment provisions.

With the adoption of single-sales-factor and market-based sourcing of sales, states are simultaneously adopting an economic presence nexus standard to determine if corporations are subject to tax. Thirty-three states assert (statutorily, administratively, or judicially) that an economic presence, not a physical presence, is sufficient to subject a business to state corporate income taxes. This change is designed to impose income taxes on firms selling into a state that may not have a physical presence in the state. The recent changes are shifting the state corporate income tax from a production state approach to a market state approach in assigning multistate taxable income.

This brief overview is designed to highlight the evolution of the U.S. states' system for taxing the income of multijurisdictional corporations. Lessons relevant to the BEPS debate may have more to do with the "dynamics" of the development of state corporate income taxes than the structure that states use to determine the geographic distribution of corporate taxable income. States' experience in adjusting to the same business structure, technology, and market developments affecting countries may provide important insights for the BEPS discussion.

III. Similarities in U.S. State and Global Corporate Income Tax Systems

The following sections discuss additional insights from the state experience in more detail. Also, the appendix includes a side-by-side comparison of the terminology for key corporate income tax concepts used to describe the U.S. state and international tax features regarding the taxation of multijurisdictional corporate income. That crosswalk may be helpful in identifying the lessons from the U.S. states' experience that may be relevant to the international tax discussion.

Although the mechanisms for allocating income may differ, U.S. states and national governments face common challenges in taxing the income of multistate or multinational companies. The challenges stem from numerous similarities, including:

[8]For a more detailed discussion of lessons learned from the U.S. states' experience with income combination and apportionment of corporate income taxes, see Chapter 6 in EY's "Study on the Economic and Budgetary Impact of the Introduction of a Common Consolidated Corporate Tax Base in the European Union" (2011), prepared for the Irish Department of Finance.

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- A growing share of economic activity is accounted for by corporations operating in multiple jurisdictions. Among the U.S. states, increased multistate business activities preceded the more recent rapid increase in multinational business activities.
- Both U.S. states and countries are open-border economies with increasing trade, capital, and labor flowing across borders of taxing jurisdictions. The sales of services and intangibles are a rapidly growing share of the expanding trade for both states and countries. The geographic assignment of taxable income from those activities has proven to be much more challenging than the assignment of income from the sale of tangible property.
- Capital investments are becoming as mobile among countries as they have been among U.S. states. Intangible property investments are increasingly important relative to tangible property investments.[9] Intangible property — and the income it creates — is the most mobile form of capital.
- The tax policies of both states and countries may be constrained by a higher level of "government." U.S. states are constrained by the Constitution, as determined by the U.S. Supreme Court, and by laws enacted by Congress under that constitutional authority. Also, state organizations such as the Multistate Tax Commission advocate for uniformity in state corporate income taxes.

  Similarly, many European countries' tax policies are constrained by EU directives and their interpretation by the Court of Justice of the European Union. International organizations — including the European Union, the OECD, and the IMF — are becoming more involved in discussions regarding increased coordination of national tax systems that apply to multinational companies.
- Both U.S. states and countries strongly defend their sovereignty and their right to determine the specific tax system for their respective jurisdictions. However, the resulting differences in tax systems can lead to either double taxation or less than 100 percent taxation of multistate and multinational income. Most analysts agree that tax rates should be determined by each country, but more uniformity in tax bases is important for avoiding both base erosion and double taxation.[10]

[9]*See* OECD, "Supporting Investment in Knowledge Capital, Growth and Innovation" (2013), at 22. The study estimates that investments in knowledge-based capital (computerized information, innovative property, and economic competencies) exceed tangible capital investments in the United States and other advanced countries.

[10]In addition to the BEPS project, a more uniform corporate income tax base has been proposed in the form of a common consolidated corporate tax base in the European Union.

IV. The Challenge of Assigning Income to Different Jurisdictions

Both U.S. states and countries face similar challenges in determining the geographic location of economic activities that generate taxable corporate income, challenges that are exacerbated by the increasing role of intangibles in generating income. Over time, the U.S. state and global tax systems have developed quite different mechanisms for determining how multinational and multistate taxable income should be assigned to different jurisdictions.

A. Comparing and Contrasting U.S. State and Global Corporate Tax Systems

Nations tax MNEs under domestic corporate income tax rules and tax treaties incorporating generally agreed-on standards. The international system strikes a balance between two potentially conflicting perspectives on the rights of countries to tax the income of MNEs. The first perspective recognizes the right of a country to tax the income of its residents wherever earned in the world (the residence principle). The second perspective recognizes the right of a country to tax income earned within the country (the source principle). The calculation of taxable income earned at source in a specific country is generally based on the principle of separate accounting for the activities of different legal entities operating within the country. Arm's-length transfer pricing rules are used to determine the geographic attribution of taxable income for transactions between related parties, including branches and affiliated companies.

International agreements, including bilateral tax treaties, have established mechanisms to minimize double or multiple taxation of the same income. Generally, the country of residence provides a credit for taxes paid at source to other countries. Also, the tax treaties generally provide different mechanisms for taxing active business income and passive income.

U.S. states take an alternative approach to determining the geographic distribution of a taxpayer's income: using apportionment formulas to determine each state's share of a taxpayer's U.S.-wide (and in limited cases, worldwide) business income. The factors in the formula are proxies that measure a state's share of the taxpayer's U.S. economic activities.

In theory, if each state used the same tax base, used the same apportionment formula, and had taxable nexus in each state where it had factors, 100 percent of a taxpayer's U.S.-wide income would be distributed among the states where the taxpayer is operating. In practice, however, states have widely differing formulas that instead result in potential taxation of more or less than 100 percent of the taxpayer's U.S.-wide income. Because the income subject to tax is divided among the states using an apportionment formula, unlike the separate accounting international tax regime, the

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state system does not provide credits for taxes paid in other states to reduce possible double taxation.[11]

The U.S. Constitution's commerce and due process clauses have been key in determining a state's reach in taxing corporations that operate in multiple states. As pointed out by Hellerstein, Congress has not imposed "horizontal" conformity on state corporate income tax systems, such as a uniform apportionment formula.[12] However, the MTC, which has 18 member states and additional participating states designed to coordinate state efforts to implement uniform tax laws, developed a model tax compact that incorporates the Uniform Division of Income for Tax Purposes Act. UDITPA includes a uniform, equally weighted, three-factor apportionment formula and a definition of business income. Although the MTC has been successful in some of its initiatives, the state corporate income tax system is far from uniform.[13]

In the global tax setting, countries have developed bilateral treaties and general multicountry (supranational) agreements that determine which companies are subject to a country's corporate income tax and how income should be sourced. The OECD and the European Commission appear to be playing roles similar to the MTC in addressing cross-border income tax issues. For example, the OECD is pursuing the BEPS initiative to strengthen the international tax regime, while the EU has proposed a common consolidated corporate tax base that would apportion multinational income of affiliated firms to EU countries based on shares of total EU factors (employment, wages, property, and sales) located in each country. That is similar to the approach the U.S. states have used for decades to divide U.S.-wide income among the states.

Both the U.S. state and most country corporate income tax systems generally tax income at its source (within the country producing the income). However, the state apportionment formula (outlined in UDITPA) introduced the further complication of a hybrid system of determining the source of economic activity by introducing destination sales into the apportionment formula. For sales of tangible personal property, the sales factor is measured by relative sales to the market or destination state, whereas the payroll and property tax factors — if they are used — are origin or source concepts. The inclusion of destination sales in the apportionment formula attributes a portion of business income to the market state, not just the source state. In contrast, for all other sales, including services, UDITPA assigns sales geographically on an all-or-nothing cost-of-performance basis, a source concept, not a destination (market) concept.

Bilateral tax treaties between countries have also created hybrid international tax systems that deviate from the principle of attributing income to the source country. That occurs when the treaties assign passive income (royalties and interest, for example) to the residence country (by providing exemptions from the withholding tax), not the source country where the business activity occurs. The end result in both the U.S. state and international tax regimes is that the source location (state or country) is sharing income with other jurisdictions, either market states or countries.[14]

U.S. states maintain that their corporate income tax systems with apportionment provide a practical method for assigning multistate corporate income among the states. State apportionment formulas include economic measures or factors to determine where economic activity occurs. (It should be noted that the property factor in state apportionment formulas generally only includes real and tangible property, not intangible property, because of the difficulties in determining the value and geographic location of intangibles.) In theory, the state approach taxes income only once (that is, in the state where the economic activity is located), if all states used the same apportionment formula. However, because states have exerted their right to adopt apportionment formulas of their own design, in practice apportionment differs across states. Nonuniformity results in the possibility of under- or overtaxation of a corporation's U.S.-wide income.[15]

States do not provide credits for corporate income taxes paid in other jurisdictions. The assumption is that the apportionment formula assigns taxable income to the geographic location (state) of the economic activity that produced the income as measured by the factors. In theory, the factors are assigned to a specific state so each dollar of taxable income is subject to tax in only one state. But as already noted, the lack of uniformity in apportionment formulas in practice does not guarantee that result.

Under the U.S. federal corporate income tax, U.S. multinationals are taxed on worldwide income with a deferral

[11]Also, state corporate income taxes do not allow a deduction for income taxes paid to other jurisdictions.

[12]Testimony by Walter Hellerstein, "Federal-State Tax Coordination: What Congress Should or Should Not Do," at 11 (Apr. 25, 2012). Federal court decisions have been targeted at limiting the reach of state corporate income taxes, not requiring uniformity.

[13]The MTC's Multistate Tax Compact was advanced as an alternative to federal legislation to impose a uniform apportionment formula on state corporate income taxes.

[14]This comparison assumes that — from an economic perspective — the payroll and property factors in the apportionment formula measure where value added occurs, a source concept. Advocates of including destination sales in the apportionment formula argue that the market is also a "source" of economic value and, therefore, all three factors are necessary to identify where net income is produced and should be taxable. In the extreme, a single-sales-factor apportionment formula ignores payroll and property as proxies for the geographic source of income.

[15]State corporate tax systems may also be described as water's-edge systems because taxable income is generally limited to income from economic activities located in the United States. While there are a few states that include worldwide income in the tax base, they provide a water's-edge election. Most states allow companies to make the case for an alternative apportionment where it more accurately reflects where income is earned.

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system until income is repatriated by foreign subsidiaries to the U.S. parent corporations. Because the same foreign income is normally taxed in another country under the taxation of income at source principle, the United States provides a credit for taxes paid to other countries on foreign-source income.[16]

Most countries use territorial corporate income tax systems that generally limit the tax to income only generated by economic activities within the country. That is achieved by using arm's-length separate accounting principles and procedures to determine in-country income. Separate accounting is similar to the approach used to determine a state's corporate income tax base in numerous states in the first half of the 20th century before the adoption of formulary apportionment.

Although the BEPS project is not considering alternatives to the separate accounting, arm's-length transfer pricing system, some public finance economists and tax authorities are giving more consideration to the concept of income apportionment in the international tax setting.[17] Examples include an EU proposal to combine and apportion income among countries based on factors of production and sales, not to mention proposals by academics to apply an apportionment formula to split related-company profits among residence and source countries.[18]

Mirroring the state diversity in apportionment formulas, selected international tax proposals call for mechanisms to split profits among countries where affiliated businesses are using different factors, including a single sales factor based on destination or market sales. That is similar to the version of the state corporate income tax apportionment formula that has supplanted the original UDITPA three-factor apportionment as the predominant U.S. state formula.

It should be noted that the introduction of the market-based sales factor in U.S. states, as well as the introduction of market sales into a profit-split calculation, adds a consumption tax concept (market "sales") to the determination of the geographic assignment of corporate taxable income. The mixing of corporate income and consumption tax concepts can be expected in the BEPS discussion. If it occurs, it will likely complicate the process of reaching a consensus on an improved system to address BEPS.

In the BEPS process, the market perspective is likely to arise in the context of a discussion of the role of "market intangibles" in the determination of income sourcing. The tax policy question is whether income from intangibles should be sourced to the market country or the country where the intangible is developed. In the state corporate income tax setting, the balance between market and production states is addressed through the choice of weights in the apportionment formula. In the BEPS discussion, that balance will be addressed within the framework of arm's-length transfer pricing. The important state lesson is that it is very likely that a new international consensus will require establishing the same type of balance among different countries competing for a portion of a corporation's taxable income.

Although the BEPS action plan is not intended to reallocate the corporate income tax base among countries, if the BEPS project does "provide countries with domestic and international instruments that will better align rights to tax with economic activity," it may result in a redistribution of taxes among countries, in addition to a possible increase in the level of worldwide taxable income if base erosion is reduced.[19] It is reasonable to expect that any changes in the consensus system of international taxation will, in fact, result in a different allocation of taxes across countries.[20] Another state lesson is that corporate income tax policy changes are more challenging when redistribution of tax liabilities (among states and across industries) is combined simultaneously with changes in the level of taxes.

B. Uniformity and Stability in Multistate Corporate Taxes

Over 50 years ago, representatives of a group of U.S. states agreed to a uniform, equally weighted, three-factor formula (including payroll, real and tangible property, and sales) for apportioning a taxpayer's taxable income among states.[21] The formula provided a compromise solution to the challenge of balancing the interests of producing and market

[16]Foreign corporations also pay the U.S. corporate income tax if their income is effectively connected to the conduct of a trade or business in the United States. Selected income sourced to the United States, but not effectively connected, is subject to a 30 percent federal withholding tax. State corporate income tax systems do not have a tax corresponding to the withholding tax.

[17]The OECD action plan explicitly rejects the consideration of a system of combined reporting with apportionment as a substitute for separate company accounting with arm's-length transfer pricing. The report notes: "There is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward." OECD plan, at 14. It should be noted, however, that action 13, dealing with transfer pricing documentation, is proposing the adoption of a country-by-country data reporting template that is likely to include measures of a taxpayer's level of economic activities, such as revenue, number of employees, and tangible assets. While the intended use of the economic activity data is to undertake audit risk assessments, there is some concern among MNEs and some countries — including the United States — that this information could also be used in developing a formulary apportionment alternative to separate accounting.

[18]*See* discussion in Martin A. Sullivan, "Economic Analysis: How to Prevent the Great Escape of Residual Profits," *Tax Notes*, Oct. 7, 2013, p. 13.

[19]OECD plan, at 11.

[20]EY estimated the country-by-country corporate income tax impacts of a mandatory system requiring consolidation of income of affiliated companies with apportionment. While the net change in corporate income tax collections among the EU member states was only 0.2 percent, tax changes varied from a 6 percent increase in France to an 8 percent decrease in Denmark. *Supra* note 8, at Chapter 4.

[21]The agreement was UDITPA, developed by the Uniform Law Commission in 1957.

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states in assigning multistate income. In the 1950s, economists and others initially argued for using only payroll and property in the apportionment formula, giving the producing or source state the sole claim on income. The rationale was that value added by capital and labor was the source of income. Following strong opposition from market states where products were delivered, the destination sales factor was added to payroll and property in the apportionment formula. As suggested, the BEPS project may face a similar challenge in balancing the interests of countries that may disagree on how to source multinational corporations' income.

The introduction of the sales factor into state apportionment formulas added two new concepts to the corporate income tax system: origin (the state from which sales are shipped) and destination (state to which sales are shipped). Those concepts were borrowed from U.S. state and local retail sales tax systems. In contrast, the international corporate income tax system has traditionally been described using the concepts of residence taxation and source taxation. The state origin and international source concepts are similar. The destination concept is, however, fundamental to the operation of the VAT.

While states' adoption of three-factor apportionment was accepted as a practical way to balance the interests of producing and market states, the formula has not turned out to be a stable compromise. Driven primarily by interstate tax competition and their economic development objectives, states are inexorably moving toward single-sales-factor apportionment that assigns economic activity *solely* on market sales. In 1986, 80 percent of state corporate income tax systems used UDITPA's original equally weighted, three-factor formula with origin sourcing of the sales factor. Twenty years later, only 20 percent used the UDITPA formula and, as of 2013, the percentage dropped even further to 16 percent. In 2013, 37 percent of the states used only a single sales factor with destination sourcing of sales for all or a significant percentage of corporate income taxpayers.[22]

Given the widening gap between the UDITPA apportionment provisions for assigning income to individual states and what states are actually using, the MTC is evaluating proposed changes to the Multistate Tax Compact's apportionment provisions.[23] In a significant departure from the existing UDITPA apportionment provisions, the MTC is evaluating proposals to update the apportionment system, including a recommended 50 percent weight on the sales factor and changes to the method of assigning sales geographically (sourcing of sales). Under UDITPA, sales of services and intangibles are generally sourced to the state where the greatest costs to perform services or develop intangibles occur. The proposed change would source the sales of services and intangibles to the market state where the services are delivered or the intangibles are "used." That would result in sourcing all sales — including tangible property, services, and intangibles — under the same destination-based sourcing rule.

The proposed apportionment changes are an attempt to align the sales factor with the increasing importance of cross-border sales of services and intangibles among the U.S. states. That fundamental change shifts the assignment of the sales of services and intangibles from the location where the activities regarding the services are performed (an origin concept) to the location where they are delivered or used (destination concept). The proposed change in UDITPA recognizes that 16 states have already adopted some form of market-based sourcing for revenue derived from the sale of services or intangibles.

C. Assigning Income From Intangibles

From the perspective of both U.S. state and international corporate income taxation, the geographic assignment of income generated by intangibles is the most challenging tax policy issue regarding the corporate income taxation of cross-border economic activity. The basic tax policy question is: Where does the economic activity occur that generates income from intangible property?

The international consensus generally assigns the income from marketing intangibles, such as trademarks, to the market country. The rationale is that the intangible is "used" when the products regarding the intangible are sold. The country of use determines the source of that income. That perspective is quite familiar to those who study U.S. state corporate income tax systems. As states move toward a single-destination sales factor, they are creating state corporate income tax systems that assign almost all business income — not just income from the sale of tangible property — to the market state. In other words, the location of destination sales is determining the location of corporate income. The rationale for adopting that approach is that it is perceived as creating a more competitive corporate income tax system that removes the tax disincentive from expanding labor and capital in a state for a company that exports its output to other states. States adopting that approach understand that they may be reducing total corporate income tax collections as the price for providing that investment incentive.

Among some countries participating in the BEPS discussion, including developing nations, there is a perception that the tax rules regarding the definition of a permanent establishment may have to be updated to reflect the growing

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[22]For changes in the U.S. state apportionment formulas over time, see Kimberly Clausen, "Lessons for International Tax Reform From the U.S. State Experience Under Formulary Apportionment" (2014), at 9. States generally allow companies the opportunity to request an alternative apportionment formula to better reflect the taxpayer's business activities in a state (UDITPA, section 18).

[23]*See* Richard Pomp, "Report of the Hearing Officer: Multistate Tax Compact Article IV (UDITPA) Proposed Amendments" (Oct. 25, 2013), for a detailed discussion of the MTC's proposed changes in UDITPA's apportionment formula.

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importance of intangibles in cross-border transactions.[24] The BEPS action plan (action 6) discusses the situation of corporations selling into a country through local agents rather than distributor subsidiaries. If, as a result, the corporation selling the product does not have a PE in the country, the taxable income from the final sales may only include commissions. In this case, the taxable income from that economic activity would not include income that results from the value of intangibles assumed to be regarding the product sales.

Market countries may argue that the international tax regime should be modified to provide them with income tax bases more in line with final sales activity, similar to what the U.S. market-sourcing states have argued. The desire of those states to tax an increasing share of the economic activity of multistate businesses has coincided with their desire to encourage investment and job creation, thus shifting state corporate income taxes more to a destination-based tax system from an origin- or source-based tax system.

As noted in the OECD action plan's background section, the BEPS project recognizes that "it is important to examine closely how enterprises of the digital economy add value and make their profits."[25] That understanding is a necessary first step in determining how to source income from intangibles across national borders. For an increasing number of U.S. states, the question of where to source income from intangibles (and services) has been answered by giving greater weight to market states in the apportionment of corporate taxable income.

The state lesson for the BEPS project is that market countries can be expected to argue for an increased share of the taxable income of multinational corporate taxpayers. Even though the focus of the BEPS project is on reducing base erosion, that potential redistribution of the tax base among countries may become an important policy issue to be resolved in reaching a new consensus on international taxation.

V. Conclusion

The OECD BEPS action plan is attempting to shore up the existing international corporate income tax system by altering the international tax standards embedded in domestic tax laws and treaty agreements to reduce "stateless income" and tax-induced profit shifting. However, based on decades of experimentation in taxing corporate income in open-border economies, the U.S. state corporate income tax experience suggests that reaching consensus on needed changes will be very difficult and, if reached, any agreement may not be stable over time because of changing economic conditions and business developments across countries.

The U.S. state experience provides several relevant insights applicable to the global tax policy debate on BEPS:

- Like U.S. states, countries have two potentially conflicting policy objectives: one, collecting sufficient taxes from multinational businesses to finance government services; and two, attracting multinational business investment and jobs to encourage economic development. In a sense, the first objective is consistent with an emphasis on preventing base erosion, while the economic development objective focuses more on reducing taxes for corporations that have significant in-country investments and employment.

  Different countries will apply different weights to the two competing tax policy objectives. The weights may also shift over time within a single country depending on changes in the economy. The tension between objectives, combined with competition among countries, can be expected to result in continuing tax policy adjustments by countries in response to changing economic conditions and business developments, as has been the case with individual U.S. states.
- Economic theory does not provide a clear, normative prescription for the "best" way to divide taxable income from cross-border economic activity among trading countries (or states) in actual practice. The arm's-length principle has a strong theoretical underpinning, but in practice, valuation issues and the unavailability of true third-party comparables make geographic assignment of taxable income through transfer pricing quite difficult.

  On the other hand, the U.S. states' experience highlights the subjectivity of the apportionment approach to assigning income. As a consequence, it has been difficult to invoke tax policy principles to defend UDITPA's three-factor apportionment formula. In any case, the overriding objective for states and countries is to reach agreement on a fairly consistent set of principles and procedures that avoids double taxation while ensuring single taxation.

  A state or country's perception of the preferred way to assign multistate and multinational taxable income will change with economic conditions and the expansion of interjurisdictional trade and investment. With increased concern over interstate tax competition, the U.S. states are reducing headline corporate tax rates and electing to move toward single-sales-factor apportionment (based on destination sales) to reduce corporate income taxes on in-state investment of mobile capital. The same evolution can be expected if the EU or OECD supranational groups establish a new, uniform system for assigning income geographically.

[24]The BEPS action 1 discussion draft, "BEPS Action 1: Address the Tax Challenges of the Digital Economy" (Mar. 2014), includes an initial discussion of possible tax policy options to reduce base erosion related to the digital economy. Options include: modifications of exemptions from PE status and alternative nexus concepts based on a digital or virtual presence. Those alternatives are related to the concept of economic presence being asserted by some U.S. states.

[25]OECD plan, at 10.

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- The U.S. state experience in sourcing corporate income is that greater weight is increasingly being given to market state sales of goods and services, including intangibles, in determining the geographic location of U.S. corporate income. In the extreme case of an apportionment formula using only destination sales, the assignment of taxable income is independent of the presence of payroll and tangible property in a state. In other words, states are reducing the link between the location of real economic activities and the method used to assign income geographically, going in the opposite direction being discussed in the BEPS project.

  One byproduct of that development is that consumption tax concepts (such as destination sales and marketplace states) have been introduced into the discussion of the geographic division of multistate corporate taxable income. That combination of consumption and corporate income tax concepts increases the complexity of the tax policy debate over how to tax cross-border economic activities. In basic terms, it is difficult for legislators to understand what type of tax they are dealing with when income tax and consumption tax concepts are mixed together; that makes changing tax policy more challenging. A lesson for the BEPS project is that it will be important to educate stakeholders on the distinction between consumption and corporate income tax concepts as the OECD debates alternatives for reducing BEPS.
- It will be very difficult for the G-20 members to establish consensus-based new global tax rules to allocate or source income across borders. It should be expected that the new international tax system will be more complex than the current one. That will occur as the system shifts from the traditional residence versus source country distinction to a broader framework that includes determining how to divide up "source" income among different countries based on measures more closely aligned with the geographic location of economic activities. The choice of the allocation mechanism, whether it is a reformed separate accounting, arm's-length pricing framework, or a more formulaic approach, will be a key component of a new global tax consensus. Given the challenges to distributing income from diverse sources — tangibles, services, and intangibles — the new international tax structure may include elements of both formula apportionment and arm's-length pricing.
- In addition to any new revenue that may be raised by reducing stateless income, a likely outcome of any significant change in the global tax system will be a redistribution of taxes among countries. The issue of redistribution will become increasingly evident as the OECD BEPS debate proceeds. The challenge will be to balance the conflicting objectives of reducing stateless income, mitigating the degree of tax redistribution among countries, and creating national tax systems that encourage economic development within countries.

In conclusion, if the U.S. state corporate income tax experience provides any guidance for global tax reform, it suggests that the OECD BEPS project designed to reduce stateless income may expand beyond the initial objective of making marginal changes in the separate accounting, international tax system to consider broader corporate income tax reforms. For example, a hybrid system may evolve that combines the source-based system with a mechanism for assigning income from intangibles (and perhaps services) to different countries based on geographic measures of economic activity, including market sales. To build consensus, any new system will have to provide an acceptable compromise between the potentially conflicting interests of source and residence countries, the objective of preventing double taxation, and the competing objectives of protecting the corporate income tax base and creating more competitive corporate income taxes in promotion of local economic development.

While the U.S. state experience illustrates the difficulty of achieving and maintaining uniformity in multijurisdictional corporate income tax systems among sovereign governments, opportunities should exist for greater harmonization in the global tax system. Examples include greater uniformity in the definition of a PE and greater consistency in domestic tax law provisions affecting MNEs. While a new global tax consensus may involve a more complex international tax system, it may also result in the adoption of tax policies, in some cases implemented through multilateral instruments, which provide greater certainty and less controversy for taxpayers and administrators.

VI. Appendix

Differences in Terminology

Although there are strong similarities in the cross-border tax issues facing U.S. states and countries, it is often difficult to recognize the similarities because of differences in the language used to describe tax systems' features and tax policy issues. The table provides a comparison of the terminology for selected features of U.S. state corporate income taxes and international tax provisions in national tax systems.

The following bullets compare selected terms and provide a perspective on how the concepts are evolving:

- The tax terms describing the issue of global nontaxation of corporate income include double nontaxation or stateless income; in the U.S. states' setting, the issue is described as nowhere income. Nowhere income in state taxation can result from features such as differing apportionment formulas, lack of nexus to tax in an individual state, and differences in the definition of taxable income among the states.
- U.S. states and countries use different terms to describe the minimum conditions for determining when a business is subject to the corporate income tax in their jurisdiction, although in both arenas the basic

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Comparison of Terms Used to Describe U.S. State and Global Taxation of Cross-Border Activities		
Concept	**States**	**Global**
Nontaxed income	Nowhere income	Stateless income/double nontaxation
Minimum connection for jurisdiction to tax	Substantial presence/nexus	Effectively connected income/PE
Geographic business income assignment	Apportionment with limited transfer pricing	Separate accounting with arm's-length transfer pricing
Treatment of affiliates	Separate taxpayers or combined unitary group	Separate taxpayers or voluntary consolidated group
Jurisdictions with right to tax income	Origin (production) state, destination (market) state, state of domicile	Residence country, source country
Nonbusiness income assignment	Allocable income	Income not connected to a trade or business (passive or mobile income)

requirement is physical presence. Generally, a business must have a PE to be taxable in a treaty country (compared with income effectively connected with a U.S. trade or business under U.S. domestic law), while the corresponding concept at the U.S. state level is one of substantial presence, or nexus.

However, states are broadening the nexus concept in response to the growing importance of cross-border remote sales. Thirty-three states now assert (statutorily, administratively, or judicially) that an economic presence, not a physical presence, is sufficient to subject a business to state corporate income taxes. The BEPS project may also debate broadening the PE nexus concept, particularly taking into account aspects of the digital economy.

- The U.S. state corporate income tax system has evolved into an apportionment system — based on the distribution of economic activities or factors — to determine the geographic assignment of income earned by a multistate company.

In the global arena, separate entity accounting is still the general system used to determine what portion of a multinational company's income is taxable in a country. It is the mechanism used to limit taxation of business income to the income from economic activities occurring within a country. Arm's-length transfer pricing principles are used in determining the in-country income attributable to each taxpayer.

- The U.S. state corporate income tax system includes two different perspectives on the taxation of affiliated corporations: separate filing and combined reporting. The initial separate taxpayer approach has been replaced in roughly half the states with a unitary business concept. The unitary approach combines the income of affiliated companies (engaged in the same trade or business) in determining the total taxable income to be apportioned. In the remaining states, each affiliate corporation files as a separate taxpayer based on its own income. In the combined reporting states, the affiliated group of companies generally excludes non-U.S. subsidiaries. That is described as a water's-edge combined group.

The global tax system generally treats each legal corporation as a separate entity or stand-alone taxpayer. In other words, most national tax systems, with the exception of controlled foreign corporation provisions, do not combine income of affiliated companies.[26]

- In U.S. states' apportionment systems, a distinction is made between business and nonbusiness income. Nonbusiness income is generally allocated or assigned to a single state, usually the state of domicile.[27] The remaining income (business income) is apportioned to the states. In the global tax arena, income is generally attributed to the country where a company is resident or to the country where the company earns income, the source country. The division of income is achieved through bilateral tax treaties and domestic CFC rules.[28] For example, source-based interest, dividends, and royalties that are not related (effectively connected) to a trade or business in the source country are generally subject to a withholding tax. However, tax treaties often include provisions that reduce or eliminate the withholding tax. The effect is that the source country cedes the right to tax that income to the resident country. ✰

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[26]The U.S. corporate income tax system does allow an election to consolidate the income of affiliated domestic companies.

[27]The distinction between apportioning business income and allocating nonbusiness income is provided for in UDITPA.

[28]The bilateral tax treaties are also voluntary agreements between selected countries. The treaties are designed to reduce the potential problem of double taxation of nonbusiness income. The OECD action plan calls for an analysis, and potential development, of a multilateral instrument — similar to the Multistate Tax Compact in the United States — for implementing some BEPS action items.

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