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Formulary Apportionment

- a realistic alternative to the arm's length principle within the EU?

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Contents

Summary

The international accepted standard today, which is used for tax purposes to attribute profits between related enterprises operating in different countries, is the so-called arm's length principle. The arm's length principle states that transfer prices between related enterprises have to be the same amount as transfer prices in comparable transactions between unrelated enterprises. The principle has been criticized mainly because it does not take into account the interrelation and integration that exists between related enterprises and because the method is difficult to administrate. On the other hand, the principle is rather flexible and works well in most cases.

In several federal states, for instance between the individual states in the US, a formulary apportionment is used. Instead of employing separate accounting as in the arm's length principle, this method determines the geographic source of corporate taxable income on the basis of a predetermined formula. The most commonly used formulas in the US are payroll, property and sales. A formulary apportionment method defines first the apportionable tax base. This depends on whether the income, property etc. belongs to the unitary business which is conducted in a particular state. Thereafter, it apportions the taxable income of the unitary business between the local state jurisdiction and the rest of the involved states on the basis of the amount of payroll, property and sales that is assignable to each state. A formulary apportionment method is less flexible than the arm's length principle but it takes into account the fact that related business groups are integrated and interdependent and demands a less administrative burden both for tax administrations and taxpayers.

A formulary apportionment method demands a rather homogenous economy to work efficiently which is the reason why it is used mainly in federal states. Since the integration and harmonization of rules in the European Union goes further and further, the question arises whether a formulary apportionment method may be an alternative to the arm's length principle within the EU. Especially since the progress made in the field of a common currency and common accounting standards, shows that a formulary apportionment may work well in the EU. However, the conclusion of the thesis is that the EU is still not ready for a shift from the arm's length principle to a formulary apportionment method. The reason for this is the fact that the EU is still not such a homogenous area as the US and the fact

that it would be an almost overwhelming task for the Member States to reach agreements on questions such as, what should constitute a unitary business and which factors should be used, and the fact that the EU in the foreseeable future will accept a number of new member States, all with different tax systems.

Abbreviations

ECJ	European Court of Justice
EC	European Community Treaty
EEC	European Economic Community
Etc	Etcetera
EU	European Union
FASB	Financial Accounting Standards Board
IASC	International Accounting Standards Committee
KL	Kommunalskattelag (1928:370)
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
UDITPA	Uniform Division of Income for Tax Purposes Act
US	United States

1 Introduction

Transfer prices are compensation for the transfer of goods, intangibles and the provision of services and loan capital paid between related enterprises. Transfer pricing has always been a very important subject for both legislators, tax administrations and taxpayers for several reasons. Firstly, almost 70 percent of cross-border trade in the world take place between related enterprises.[1] Secondly, the transfer pricing rules and practice determine the allocation of income among different tax jurisdictions arising from related party transactions.[2]

In the international sphere the arm's length principle is the main criterion governing transfer pricing practice. This is also the method that is recommended by the OECD.[3] According to the arm's length rule, transfer prices between related parties have to be the same amount as if they were charged between unrelated parties under similar circumstances. It looks to the fair market value in a third market place.[4]

At a sub-national level, formulary apportionment methods are sometimes used instead to allocate income among the tax jurisdictions in question. This is the case, for instance, in the Canadian provinces, the German municipalities, the Swiss cantons and the states of the United States. Formulary apportionment methods allocate profits within a controlled group according to a predetermined formula, for example, a formula based on a combination of turnover, costs, assets and payroll.[5]

1.1 Purpose and outline

The European Union is moving slowly towards more and more integration and completion of the internal market. Today, the arm's length principle is

[1] Hamaekers, H., Arm's length – How long? In International Transfer Pricing Journal, 2001, number 2, p. 30.
[2] Samuels, L., Remarks on Revenue Estimating and the OECD Transfer Pricing Guidelines. In Intertax 1995/2, p.65.
[3] Hamaekers, H., Arm's length – How long? In International Transfer Pricing Journal, 2001, number 2, p. 30 et seq.
[4] Hammer, R., Will the Arm's Length Standard stand the Test of Time? The Specter of Apportionment. In Intertax 1996/1. p. 3.
[5] Maisto, G., Transfer pricing in the absence of comparable market prices. General Report of 1992 Cancun Congress. Studies on International Fiscal Law by the International Fiscal Association. P. 50 et seq.

the standard in transfer pricing issues between the Member States. The arm's length principle is not, as will be shown, without its critics and with increased economical integration in the EU it seems natural to investigate how other integrated economical areas, such as federal states, have solved transfer pricing issues and issues relating to attribution of profits between related enterprises. The purpose of this thesis is to investigate whether a formula apportionment method would be a realistic alternative to the arm's length principle within the European Union.

The thesis will in chapter two focus on the arm's length principle as applied by the OECD. This will be followed in chapter three by an account of formulary apportionment in the United States. Chapter four will deal with the discussion in the US about a worldwide formulary apportionment and the OECD and United Nations approach to this. Thereafter, in chapter five the current situation in the EU concerning direct taxation and corporate tax will be presented. Finally, chapter six will discuss whether a formula apportionment method is a realistic alternative to the arm's length principle within the EU.

1.2 Limitations, Material and Method

The thesis will focus only on the formula apportionment method used between the states in the US and which is set forth in the UDITPA (the Uniform Division of Income for Tax Purposes Act, see supplement). It is not the intention to investigate the arm's length principle as completely as the formula apportionment method. The chapter dealing with the arm's length principle is intended to give the reader an overview of the application of the arm's length principle as expressed in the OECD Model Tax Convention on Income and on Capital.

The material used in this thesis includes legal literature, articles from the United States and Europe, cases, communications, conventions, directives, regulations, reports, resolutions and treaties.

The method applied is mainly descriptive except in the analysis where a comparative and analytic method is applied.

2 The arm's length principle

The most generally recognized method in the world today, which is used for tax purposes to attribute profits between related enterprises operating in different countries, is the so-called arm's length principle. The three standard methods generally applied to reach a price at arm's length are the comparable uncontrolled price method, the resale price method and the cost-plus method.[6] The principle originates from the US and was included probably for the first time in an official document in the draft multilateral treaty of the League of Nations in 1933.[7] The arm's length principle is also the method which is recommended by the OECD. The OECD Model Tax Convention on Income and on Capital[8] has adopted the arm's length standard in article 7, on business profits, and article 9, on associated enterprises. The arm's length principle has been the subject for three OECD reports in 1979, 1984 and 1995.[9]

This chapter will focus mainly on the provision in article 9 in the OECD Model Tax Convention and the transfer pricing guidelines from 1995. The chapter will first give an overview of the arm's length principle as defined in the OECD Model Tax Convention. Thereafter, an account of the three traditional methods applied to reach an arm's length price will be given.

2.1 The arm's length principle in the OECD Model Tax Convention

As noted above, the arm's length principle is dealt with in article 9 in the OECD Model Tax Convention which states that where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between

[6] Hamaekers, H., Arm's length – How Long? In International Transfer Pricing Journal, number 2, 2001. p. 30.
[7] Hamaekers, H., Arm's length – How Long? In International Transfer Pricing Journal, number 2, 2001. p. 39.
[8] Model Tax Convention on Income and on Capital. OECD Committee on Fiscal Affairs, 1992. Updated as of 1st September 1995.
[9] See Report 1979 of the OECD Committee on Fiscal Affairs. Transfer Pricing and Multinational Enterprises, Report 1984 of the OECD Committee on Fiscal Affairs. Transfer Pricing and Multinational Enterprises. Three Taxation Issues, and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements.

independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”. This means that the arm’s length principle follows the approach of treating the members of an multinational enterprise group as separate entities rather than as inseparable parts of a single unified business. Article 9 is the base for the most bilateral tax treaties involving OECD member countries and for an increasing number of non-member countries when dealing with transfer pricing.[10]

If transfer pricing does not properly reflect the market forces, there is a risk that the tax liabilities of the associated companies and the tax revenues of the specific country will be distorted. For this reason, agreements between the OECD member states have been concluded to allow adjustments for tax purposes when it is necessary to correct a distortion and thereby ensure that the arm’s length principle is satisfied. The need to make adjustments to approximate the arm’s length price is not dependent on any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize taxes.[11]

Paragraph 2 of article 9, deals with corresponding adjustment. In cases when a state taxes profits of an enterprise, which an enterprise in another state has been taxed for, and the profits would have been accrued the first mentioned state if the conditions made between the two enterprises hade been similar to those conditions which would have been made between two independent enterprises, then that state shall make an appropriate adjustment.

The arm’s length price in the OECD version contains six basic principles. Firstly, the arm’s length price must be established with respect to one single transaction. Secondly, this single transaction must be compared with another similar or identical transaction having similar or identical characteristics. The transaction can be hypothetical or actual. Thirdly, the arm’s length price must consider legal obligations entered into by the contracting parties and, thus, the legal effects of the transaction in question cannot in principle be disregarded. Fourthly, an arm’s length price must be based on market conditions and, thus, reflect ordinary business practices. A result of this is

[10] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 1.6.
[11] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 1.2 et seq.

that the price must be established on the basis of data which is available to the taxpayer when the transaction occurs. Fifthly, the arm's length price must take into account the particular circumstances which characterize the transaction in question. For example, if a supplier aims to increase his market share, he may fix the price below the fair market value of the product. Sixthly, the arm's length price must take into account the particular functions performed by the related enterprises.[12]

There are several reasons why the OECD member countries have favoured the arm's length principle to other methods. The OECD mention the fact that the arm's length principle provides a broad similarity of tax treatment for multinational enterprises and independent enterprises. Another major reason is that the principle has been found to work efficiently in the vast majority of cases.[13]

However, the OECD is also aware that the arm's length principle has disadvantages. An argument which is often brought forward is that the principle is insufficient since the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. A practical problem is the fact that related enterprises may engage in transactions that independent enterprises would not undertake. For example, if you cannot estimate the profit potential of an intangible, then an independent enterprise may not be willing to sell it. A transaction of this kind within a multinational enterprise group does not create the same risk since the profit stays within the overall group's profit. Therefore, the arm's length principle can be difficult to apply in some cases because there is little or no direct evidence of what conditions would have been established by independent enterprises.[14]

There are also administrative difficulties with the arm's length principle. If there are significant numbers and types of cross-border transactions, this may result in an administrative burden for both tax administrations and taxpayers. Applying the arm's length principle also demands a significant amount of data because you have to compare transactions and activities of

[12] Maisto, G., Transfer pricing in the absence of comparable market prices. General Report of 1992 Cancun Congress. Studies on International Fiscal Law by the International Fiscal Association. P. 28 et seq.
[13] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 1.7 et seq.
[14] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 1.9 et seq.

related enterprises with transactions and activities of independent enterprises.[15]

In Swedish internal law the arm's length principle is expressed through the so called "korrigeringsregeln" in 43 § 1 mom KL. It is applicable on international transactions between related business parties when the transfer price is fixed incorrectly. The starting point in forming the judgement is that the Swedish enterprises' income has become lower because of that the agreement differs from what would have been agreed between two unrelated parties. Furthermore, the Swedish enterprise must be liable to tax in Sweden and the terms of the agreement must be based on an economical community of interest between the involved parties. Thus, there has to be a connection between the incorrect price and the economical community of interest.[16]

2.2 The basic methods used to apply the arm's length principle

The comparable uncontrolled price method, the resale price method and the cost plus method are the traditional transaction methods which are used to apply the arm's length principle. The most appropriate and direct way to determine the arm's length price is, according to the OECD, to use the comparable uncontrolled price method. Sometimes this method is difficult to apply, for example, when evidence is not available or is impracticable to collect, or because the related transactions are not comparable. Therefore, the OECD also recommends other methods. The secondary methods of establishing a reasonable arm's length price, which OECD gives priority to is the resale price method and the cost plus method.[17] According to the OECD, as a last resource where there is no data available to apply the traditional methods, or where the data available is not sufficient enough, some other methods may be used.[18]

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[15] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 1.11 et seq.
[16] Pelin, L., Internationell skatterätt ur ett svenskt perspektiv. Andra omarbetade upplagan. Studentlitteratur, Lund, 2000. p. 71 et seq.
[17] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.1 et seq.
[18] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.48.

2.2.1 The comparable uncontrolled price method

The comparable uncontrolled price method compares the price charged for property or services between related enterprises with the price charged for property or services between two unrelated parties in comparable circumstances. If differences in the price are found, this may indicate that the financial and commercial relations of the related enterprises are not at arm's length. One of two conditions have to be met, according to the OECD, to decide if the transactions are comparable. The differences (if any) between the transactions being compared do not materially affect the price in the open market, or reasonable adjustments can be made to eliminate the material affects of such differences. The OECD recommend a flexible approach to the comparable uncontrolled price method. When difficulties arise to apply the method, tax administrations may supplement the method by other appropriate methods, which should be evaluated according to their relative accuracy. [19]

There are difficulties in identifying comparable transactions. Situations where price comparison are difficult to make may be as follows. Firstly, when products involved are not similar by nature, quality, novelty etc. Secondly, markets are not always comparable in terms of size and characteristics. Thirdly, the transactions could be incomparable when they are highly different in volume. Fourthly, financial conditions and currency are often different and depend upon the financial integration of the parties. Fifthly, the goods involved are advertised differently or incorporate different trademarks, or intangible property associated with the sale are not similar.[20]

However, where an independent enterprise sells the same product as is sold between two related parties this method is particularly reliable. For example, if an independent enterprise sells unbranded coffee beans from Colombia, of a similar type, quality and quantity as those sold between two related enterprises and that these two transactions occur at about the same time, in the same stage in the production chain and under similar circumstances, the method works well. If the independent enterprise, instead of Colombian unbranded coffee beans, had sold unbranded Brazilian Coffee beans, you

[19] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.6 et seq.
[20] Maisto, G., Transfer pricing in the absence of comparable market prices. General Report of 1992 Cancun Congress. Studies on International Fiscal Law by the International Fiscal Association. P. 34.

need to investigate if this difference has a material effect on the price. If it has a material effect on the price, some adjustment would be appropriate. If you cannot make a reasonably accurate adjustment, the reliability of the comparable uncontrolled price method would be reduced and you might use a combination of other methods, or use such methods instead.[21]

The provisions concerning transfer pricing in most countries do not establish an explicit priority to the comparable uncontrolled price method over other methods. However, most tax authorities recognize in practice the primacy of this method along the lines of the OECD reports.[22]

2.2.2 The resale price method

The starting-point of the resale price method is the price at which a product that has been purchased from a related enterprise is resold to an unrelated enterprise. From this price, a reduction is made for the expenses the reseller has to cover for its selling and other operating expenses together with a reasonable margin of profit. Sometimes it is also necessary, with adjustments of other costs, that are associated with the purchase of the product, for example customs duties. What is left after reduction and adjustment can be regarded as the arm's length price for the original transaction between the related enterprises.[23]

A simple illustration of the resale price method could be as follows. Assume that a subsidiary sells a product to its parent company for 50. The resale price is 100. If a normal margin profit is 40 percent, the arm's length price will be 60 (100-40) instead of 50 (100-50).

To determine a reasonable profit margin, the resale price margin that a reseller earns on items purchased and sold in comparable uncontrolled transactions, may serve as a guide. As under the comparable uncontrolled price method the transactions have to be comparable. Thus, the transaction between the related enterprises has to be compared to a transaction between two independent enterprises. However, broader product differences can

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[21] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.11.
[22] Maisto, G., Transfer pricing in the absence of comparable market prices. General Report of 1992 Cancun Congress. Studies on International Fiscal Law by the International Fiscal Association. P. 35.
[23] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.14.

usually be allowed in the resale price method since minor product differences are less likely to have as material an effect on profit margins as they do on price.[24]

The resale price method is most appropriate and easiest to apply in those cases where the reseller adds relatively little value to the product. The greater the value of the functions performed by the reseller, the more difficult to determine an appropriate resale margin for purposes of the resale price method. This is the case where the goods, before resale, are further processed or incorporated into a more complicated product so that their identity is lost or transformed. Another case where you have to be careful applying the resale price method, is when the reseller through trademarks or trade names contributes substantially to the creation or maintenance of intangible property associated with the product. Furthermore, the activities performed by the reseller will influence the amount of the resale price margin. Some resellers will just perform minimal services as agents when others will take on the full risk of ownership together with the full responsibility for advertising, marketing, distributing and guaranteeing the products and other connected services. The resale price margin should also be expected to vary according to whether the reseller has the exclusive rights to resell the goods.[25]

2.2.3 The cost plus method

The cost plus method starts with the suppliers' costs for the property in a controlled transaction provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. After adding the cost-plus mark up to the above costs, the arm's length price of the original controlled transaction is reached. The method is most appropriate to use where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.[26]

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[24] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.15 et seq.
[25] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.22 et seq.
[26] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.32.

When establishing the cost plus mark-up of the supplier in the controlled transaction, the cost plus mark-up that a supplier earns in comparable uncontrolled transactions may serve as a guide. As under the resale price method, adjustments should be made to account differences that materially affect the cost plus mark-up earned in the controlled and uncontrolled transactions. However, fewer adjustments have to be made to account for product differences under the cost plus method than under the comparable uncontrolled price method. A simple illustration of the cost plus method could be as follows. Assume that a company A sells toasters to a related distributor and that company B sells irons to an independent distributor. Assume also that the profit margins on selling basic toasters and irons are about the same in the small household appliance industry. If the cost plus method is applied, the profit margins compared in the two transactions are the difference between the selling price by the companies to the distributors and the costs of manufacturing the product. However, if company A is much more efficient in its manufacturing processes and therefore has lower costs, an adjustment will be appropriate.[27]

The most difficult aspect of applying the cost plus method is the determination of costs. The cost plus method is based upon a comparison of the mark up on costs achieved by the controlled supplier of goods or services and the mark up achieved by one or more uncontrolled companies on their costs with respect to comparable transactions. It is important to consider differences in the level and types of expenses associated with functions performed and risks assumed by the parties or transactions being compared. Furthermore, an important aspect to consider is accounting consistency. If the accounting practice differs in the controlled transaction and in the uncontrolled transaction, adjustments should be made to the data used to ensure that the same type of costs are used in each case to ensure consistency. Even if the accounting standards may vary, there are three basic costs for an enterprise. Firstly, there are direct costs of producing a product such as the cost of raw materials. Secondly, there are indirect costs of production such as the costs of a repair department that services equipment used to produce different products. Thirdly, there are operating expenses of the enterprise as a whole such as administrative expenses. Another problem with the determination of costs is the fact that you have to limit the costs to those of the supplier of the goods or services. This means that you have to allocate some costs between the supplier and the purchaser. The allocation

[27] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.33 et seq.

should be based on an analysis of functions performed by the respective parties.[28]

[28] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Chapter 2.36 et seq.

3 Formulary Apportionment in the United States

To determine the geographical source of income earned by an enterprise operating in several states within the US, the states typically use a predetermined formula to apportion the taxpayer's nationwide income among the states in question. The formula is based on the economic activity of the enterprise carried out in the various states.[29] Instead of deriving income on a basis of formal geographical or transactional accounting, this method calculates the tax base by first defining the scope of the "unitary business", and then apportions the total income of that unitary business between the local state tax jurisdiction and the rest of the states on the basis of a formula.[30] The theory of apportionment by formula is based on the fact that certain factors or elements of a business will fairly reflect the measure of the tax attributable to a state.[31]

As will be shown below, the most common factors to use in a formulary apportionment are property, payroll and sales. A simple illustration of a formula could be as follows: A corporation is doing business in California and Colorado. It has 40 percent of its property, 35 percent of its payroll and 15 percent of its sales in California and 60 percent of its property, 65 percent of its payroll and 85 percent of its sales in Colorado. California's apportionment percentage would be 30 ([40+35+15]/3) and Colorado's apportionment percentage would be 70 ([60+65+85]/3). Thus, 30 percentage of the corporation's taxable income would be apportioned to California and the rest, 70 percentage, would be apportioned to Colorado.

This chapter will first consider the limitations of formulary apportionment settled by the constitution, i.e. the unitary business principle and the fair apportionment. This will be followed by an account of the UDITPA formula, which is the most commonly used formula apportionment method among the states.

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[29] McLure Jr, C., European Integration and Taxation of Corporate Income at Source: Lessons from the US. In Beyond 1992: A European Tax System,. Proceedings of the fourth IFS Conference, Oxford, 1989. p. 42.
[30] See Container Corporation of America v. Franchise tax board. Supreme Court of the United States, 1983. 463 U.S. 159, 103 S.Ct. 2933.
[31] Hellerstein, State and local taxation, p. 410.

3.1 Constitutional limitations

There are two principal constitutional restraints, which have to be considered when the states are using a formula apportionment method. These are the outer limits of apportionability, which depends on the unitary business principle, and the fair apportionment requirement.[32]

The Supreme Court establishes the outer limits of apportionability as a matter of federal constitutional law. There is nothing, however, which forbid the states to apply a more restrictive approach.[33] The states in the US are relatively free to define taxable income as they wish and to impose their own tax rates. There are, however, some vague and broad constitutional limitations found in the Commerce Clause and the Due Process Clause.[34] These impose that there has to be a minimal connection or "nexus" between the business activities carried out by the enterprise and the taxing state and that income attributed to the state is related to values connected with the taxing state. Furthermore, an apportionment formula used by a state must be fair and not result in discrimination against interstate or foreign commerce. The component of fairness imposes that the formula does not result in double taxation if applied by every jurisdiction. One who attacks a formula of apportionment has the burden of proof to show that the apportionment has led to a "grossly distorted result" or is "out of all appropriate proportions" to the business activities carried out in the taxing state.[35]

3.1.1 Unitary business principle

One of the fundamental questions relating to formulary apportionment is to determinate the apportionable tax base, i.e., what property, income or receipts should properly be included in the share of which the particular state is attempting to take since much of a taxpayer's property, income or receipts may be located outside the state's jurisdiction. The answer to this

[32] Hellerstein, State and local taxation, p. 560.
[33] Hellerstein, State and local taxation, p. 533.
[34] McLure Jr, C., European Integration and Taxation of Corporate Income at source: Lessons from the US. In Beyond 1992: A European Tax System. Proceedings of the fourth IFS Conference, Oxford, 1989. p. 40.
[35] See Container Corporation of America v. Franchise Tax Board. Supreme Court of the United States, 1983. 463 U.S. 159, 103 S.Ct. 2933.

question depends on whether the property, income or receipts belong to the unitary business that the taxpayer carries on within the taxing state.[36]

An example of the problems arising when determining the apportionable tax base may be as follows. An enterprise in California doing business with Colombian Coffee beans has affiliates in the state of Colorado and Colombia. The parent company in California owns 100 percent of the company in Colombia which is producing coffee beans and is fully integrated with the parent company. On the other hand, the company in Colorado is owned by the California company with only 49 percent. Furthermore, the Colorado company is doing business with lawn mowers. The question is then if the state of California is allowed to include income from the California company's affiliates in Colorado and Colombia in the tax base? The answer depends on if the affiliates in Colorado and Colombia belongs to the unitary business of the California company.

The idea is that the enterprise files a combined report where it shows all combined profits of all affiliated firms which is engaged in a unitary business and then apportioning this income on the basis of the combined property, payroll and sales factors of the unitary corporate group. This is contrary to practice in the international sphere, where separate accounting is the standard.[37]

The unitary business principle has it roots in the "unit rule", which was developed in the nineteenth century for apportioning property values among the states from railroad, telegraph and express companies.[38] The Supreme Court held in 1884 that a track must be considered as an unit since it is of little value if it is not treated as one track from one end of it to the other. The court therefore approved a method used by the city of Cheyenne to tax the value of the track as a percentage of the value of the entire railroad line.[39] In Adams Express the court recognized that the principles permitting a state to tax the capital stock of a railroad, telegraph, or sleeping car company by reference to its unitary business principle also allow proportional valuation of a unitary business in enterprises of other sorts.[40] In Underwood

[36] Hellerstein, State and local taxation, p. 411.
[37] McLure Jr, C., European Integration and Taxation of Corporate Income at Source: Lessons from the US. In Beyond 1992: A European Tax System. Proceedings of the fourth IFS Conference, Oxford, 1989. p.43.
[38] Hellerstein, State and local taxation, p. 412.
[39] See Union Pacific Railway Co. v. Ryan. 113 U.S. 516 (1884).
[40] See Adams Express Co v. Ohio State Auditor, 165 U.S. 194 (1897).

Typewriter Co. v. Chamberlain, state taxation based on the unitary business principle was permitted for taxation on corporate income, as well as property and capital.[41]

The term "unitary business" itself can be traced to a Supreme Court decision from 1924. In Bass, Ratcliff & Gretton v. State Tax Commission the court pointed out that the state of New York was justified in using formula apportionment to attribute a "just proportion of the profits earned by the company from such unitary business", which included the brewing of ale in England and its sale in New York.[42]

According to the Supreme Court in the Allied-Signal case, there are too many complications and uncertainties in allocating income from multistate business and, therefore, they permit the states to use an apportionment formula to tax a corporation. Furthermore, the unitary business principle not only authorizes a state to devise formulas for an accurate assessment of a corporation's intrastate value or income. It also limits a state's possibilities to tax since it can not tax values or income which can not in fairness be attributed to the company's activity within the state.[43]

In the Mobil Oil case, the question arose whether the state of Vermont could tax income in the form of dividends, received by a domestic corporation with its principal place of business in New York but doing business in Vermont, from subsidiaries and affiliates incorporated and doing business in other states and abroad. Mobil argued that the dividends lacked a satisfactory nexus with the activities in Vermont. The court held that dividends from subsidiaries and affiliates, abroad, and in US are income to the parent company earned in a unitary business as long as these dividends reflect profits originating from a functionally integrated enterprise. In cases where the activities in the subsidiary have nothing to do with the activities in the parent company, Due Process considerations might, according to the court, preclude apportionability because of the lack of a unitary business. According to the court, it does not matter how you choose to organize your business because it is the underlying activity that is important when

[41] See Underwood Typewriter Co. v. Chamberlain. Supreme Court of the United States, 1920. 254 U.S. 113, 41 S.Ct. 45.
[42] See Bass, Ratcliff & Gretton v. State Tax Commission. 266 U.S. 271 (1924).
[43] See Allied-Signal Inc. v. Director, Division of taxation. Supreme Court of the United States, 1992. 504 U.S. 768, 112 S.Ct. 2251.

determining the propriety of apportionability. In this case, Mobil failed to prove that the business activities in the subsidiaries and affiliates were unrelated to the activities carried on in the parent company. According to the Mobil case, the essential thing about apportionability in the field of state income taxation is the unitary business principle. The court stated that the existence of a unitary business depends on whether any of the following factors are present; functional integration, centralization of management and economies of scale. Furthermore, there is no need for a flow of goods between a parent and a subsidiary to constitute a unitary business, if instead there is a flow of value between the entities. This means that there has to be sharing or exchange of value between the enterprises. It is not enough with flow of funds arising out of a passive investment or a distinct business operation.[44]

In Container corporation of America v. Franchise tax board, the court clarified that functional integration, centralization of management and economies of scale could respectively be shown by: transactions not undertaken at arm's length, a management role by the parent which is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business.[45]

In the Exxon case, the state of Wisconsin applied its apportionment formula to the total corporate income of a petroleum company. The company had no exploration, production or refining operations in Wisconsin and performed only marketing operations in the state. The different operation departments were treated by Exxon as independent profit centres. The court held that the states have a right to apply an apportionment formula if a company is a unitary business. To exclude certain income from apportionment, the company must prove, according to the court, that the income is unrelated to the activities carried out in the particular state. Thus, the company have the burden of proof that the income derives from unrelated business activity. The court found that Exxon had not showed that its marketing operations in Wisconsin were unrelated business activities.[46]

[44] See Mobil Oil Corporation v. Commissioner of taxes of Vermont. Supreme Court of the United States, 1980. 445 U.S. 425, 100 S.Ct. 1223.
[45] See Container Corporation of America v. Franchise tax board. Supreme Court of the United States, 1983. 463 U.S. 159, 103 S.Ct. 2933.
[46] See Exxon Corporation v. Wisconsin Department of revenue. Supreme Court of the United States, 1980. 447 U.S. 207, 100 S.Ct. 2109.

It is, however, very difficult to define exactly what constitutes a unitary business. The fundamental thing about the unitary business principle is the interdependence, integration and interrelation between the parts of a commonly owned business. It is this necessary unity that allows a state to look to the property, payroll and sales outside its borders.[47] The legal structure of the business is irrelevant.[48] In our example above, with the parent company in California, The affiliate in Colombia would probably be a part of the parent company's unitary business since it is completely owned and controlled by a company incorporated in the US. On the other hand, the company in Colorado would probably not be a part of the unitary business since the California company's share is only 49 percent and, thus, is not fully controlled. Furthermore, the business activities in the Colorado company are not in line with the activities in the rest of the business group.

Even if the Supreme Court establishes the outer limits of the unitary business concept, the state courts are free to adopt a more restrictive view.[49] The broadest view of the scope of a unitary business has been taken by the California courts, while the courts in Louisiana and Mississippi have taken more restrictive views of the unitary business.[50] The California Supreme Court uses a three unity test to establish a unitary business. A business is unitary if there are; 1) unity of ownership; 2) unity of operation such as central purchasing, advertising, accounting and managements divisions; and 3) unity of use of its centralized executive force and general system of operation.[51]

An intermediate view, called the basic operations interdependence test, have been taken by the courts in New Jersey and Pennsylvania. Under this test controlled corporations are regarded as being part of a unitary business only if they engage in unitary basic operations that are substantially interdependent on the operations of other companies in the group. Basic

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[47] Coffill, E. and Willson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington,Va, May 24, 1993. p. 1114.
[48] McDaniel, P., NAFTA and Formulary Apportionment: An Exploration of the Issues, in Intertax 1994/3, p. 107.
[49] Hellerstein, State and local taxation, p. 533.
[50] Hellerstein, J., Federal income taxation of multinationals: replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1143.
[51] See Dental Insurance Consultants, Inc. v. Franchise tax board. Court of Appeal, First District, Division 5, California, 1991.

operations are, for example, the various stages of an enterprise, such as producing, refining, manufacturing, transporting, buying and selling etc. Interrelations as centralized control or management or supporting service do not establish a unitary business under this test.[52]

3.1.2 Fair apportionment

After having determined the apportionable tax base the question arises whether the tax base has been fairly apportioned to the taxing state. This depends on if the tax the state has attributed to itself by using a formula reasonably reflects the activities carried on by the taxpayer in that particular state.[53] If it produces a grossly distorted result, or an apportionment which is out of all appropriate proportion to the taxpayer's activities in the taxing state, the formula is regarded as unfair. The Supreme Court has, as a matter of fact, never held an apportionment formula unconstitutional on its face, but has only insisted that an apportionment formula not be inherently or intrinsically arbitrary.[54] Anyone who attacks a formula apportionment has the burden of proof and must show by clear and cogent evidence that it results in extraterritorial values being taxed.[55]

According to the court in the Hans Rees' Sons case, all the factors in a unitary business are generally important to the realization of profits. Therefore, it is rather difficult to make an exact apportionment. The court stated that as long as the states' apportionment method is not in itself arbitrary, it will be sustained except from when a company shows that it is unreasonable and arbitrary in a particular case. In this particular case, the court found that it was sufficient to invalidate the assessment, since the state formula had produced a tax on 83 percent of the taxpayer's income when only 17 percent of that income actually had its source in the state.[56]

In the Container case, a Delaware corporation carried on business in California and other states as well as in a number of subsidiaries abroad.

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[52] Hellerstein, J., Federal income taxation of multinationals: replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1143.
[53] Hellerstein, State and local taxation, p. 411.
[54] Hellerstein, State and local taxation, p. 462.
[55] See Butler Bros v. McColgan. Supreme Court of the United States, 1942. 315 U.S. 501, 62 S.Ct. 701.
[56] See Hans Rees' Sons v. North Carolina Ex Rel. Maxwell. Supreme Court of the United States, 1931. 283 U.S. 123, 51 S.Ct. 385.

The subsidiaries were incorporated in the countries where they operated. The appellant argued that the application of California's three-factor formula was unfair since the foreign subsidiaries were more profitable than the parent company and that the cost of production was lower abroad primarily because of lower wage costs. The court held that both apportionment by formula and separate accounting are imperfect, but as long as there is no evidence that the margin of error is greater when applying the formula than when applying separate accounting, the apportionment is fair. Furthermore, even if most nations have adopted an "arm's length" approach, the rules differ and the possibility of double taxation exists. To force California to use an "arm's length" approach would therefore, according to the court, not eliminate the risk of double taxation and may even lead to more serious double taxation.[57]

A worldwide income approach has been opposed by many countries and only four states, most notably California, apply formula apportionment to worldwide income.[58] This means that these states include foreign source income when they decide the tax base, i.e. the unitary business. The Container case led to a proposed federal legislation, restricting the states ability to apportion and tax foreign source income. A working group was established under President Reagan but they never succeeded in reaching an agreement on the legislative options that they considered. Instead they agreed on three principles guiding state policy in this area. Firstly, formulary apportionment applied by the states should be restricted to a certain "water's edge unitary combination".[59] Secondly, federal administrative assistance and cooperation with the states should be increased. Thirdly, competitive balance for US multinationals, foreign multinationals, and purely domestic business. The legislation was never enacted since many states adopted a "water's edge" approach and provided for relief for foreign source dividends.[60]

[57] See Container Corporation of America v. Franchise Tax Board. The Supreme Court of the United States, 1983. 463 U.S. 159, 103 S.Ct. 2933.
[58] Hammer, R., Will the Arm's Length Standard stand the Test of Time? The Specter of Apportionment. In Intertax, 1996/1. p. 6.
[59] This restricts the application of formulary apportionment to a certain water's edge group. The working group never succeeded to precise the scope of this group but at minimum it would include US corporations included in a consolidated return for federal income tax purposes, US possessions corporations, enterprises incorporated in US, tax havens corporations and foreign corporations with a threshold of business activity in US.
[60] Hellerstein, State and local taxation, p. 529 f.

In the Mobil case, the appellant claimed among other things, that taxation of its dividends by the state of Vermont would result in multiple taxation since New York, the state of commercial domicile, had the power to tax dividend income without apportionment. The court rejected Mobil's argument since no actual multiple taxation was demonstrated. Furthermore, the court stated that if there would have been a New York tax, there was no reason why it should be exclusive. The dividends reflect income from a unitary business which is conducted in other states, and thus, the income bears relation to benefits and privileges conferred by several states.[61]

In the Barclays Bank case, the question arose whether California's use of worldwide combined reporting on a foreign based business group was in line with the constitution. The Barclays Group was a multinational enterprise including more than 220 corporations in approximately 60 countries. Two of its corporations did business in California, and California determined their tax liability on the basis of worldwide combined reporting. Barclays argued that the risk of multiple taxation was more impending with a foreign based multinational than with a US based multinational since most of their operations were conducted outside the US. The court held that the risk of multiple taxation was not the inevitable result of the California tax and that the alternative, the arm's length rule, would not eliminate the risk of multiple taxation.[62]

3.2 UDITPA Formulary apportionment

When the tax base has been determined, the next step is to attribute a taxpayer's income to a particular state. There are generally three different methods provided by the states for attributing a taxpayer's income: Allocation, apportionment and separate accounting. Separate accounting is, however, an exception and is usually only permitted when the allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in a state. When income is allocated, it is attributed to the particular state, which is considered to be the source of the income. Apportioned income is, on the other hand, divided among the different states in which the taxpayer derives such apportionable income. The determination whether the income is going to be allocated or apportioned, depends on

[61] See Mobil Oil Corporation v. Commissioner of Taxes of Vermont. The Supreme Court of the United States, 1980. 445 U.S. 425, 100 S.Ct. 1223.
[62] See Barclays Bank PLC v. Franchise tax board. 512 U.S. 298, 114 S.Ct. 2268 (1994).

whether the income constitute business income or non-business income (see below).[63]

The mechanism for apportioning income in many states is the three-factor formula set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was drafted by the National Conference of Commissioners of Delegates on Uniform State Laws and was approved by the American Bar Association in 1957. Important to know is that UDITPA assumes that the taxing state has jurisdiction to tax and that the tax base already is defined. The question UDITPA tries to address is which amount of the total base that should be assigned to a particular jurisdiction.[64]

The three factors used by UDITPA to determine what portion of an enterprise's overall income that is attributable to a particular state are property, payroll and sales. 23 of 46 states with corporate income tax had in 1997 adopted UDITPA and most of the other states had adopted similar versions or modifications of UDITPA. In a few states the taxpayer has an option to choose between the UDITPA formula and the state's alternative apportionment formula or allocation method.[65] Many states have also been increasing the weight of the sales factor. For instance, approximately half the states have adopted a double-weighted sales factor and Minnesota has adopted a formula weighted 70% for sales.[66] An illustration with a double-weighted sales factor could be: If a corporation has 40 percent of its property, 35 percent of its payroll, and 15 percent of its sales in California, it would apportion 26 percent ([40+35+15+15]/4) of its income to the state of California.

3.2.1 Business income

Not all income is apportioned under the three-factor formula of UDITPA. There are two different categories of income under UDITPA. Business income, which is apportioned, and non-business income, which is allocated to a particular state, see UDITPA sec 9. Business income is, according to UDITPA sec 1(a), "Income arising from transactions and activity in the

[63] Hellerstein, State and local taxation, p. 576 et seq.
[64] Coffill, E. and Willson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1106.
[65] Hellerstein, State and local taxation, p. 560.
[66] Hellerstein, State and local taxation, p. 475.

regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." All income, which does not constitute business income, is regarded as non-business income, see UDITPA sec 2(e).

The interpretation of UDITPA's business income definition has divided sharply in the states' courts. There are mainly two different judicial interpretation to determine whether income is apportionable or allocable: the transactional test and the functional test.[67] In the transactional test you focus on the statute's first clause: "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Thus, it is the nature of the particular transaction giving rise to the income, which is the important factor. Furthermore, important factors being considered are the regularity of similar transactions, the former practice of the business and the former use of the assets.[68]

Under the functional test the focus is on the statue's second clause: "…income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The use or function of an asset is not a determinative criterion under the transactional test, but under the functional test, the income from the sale of an asset will be considered business income if the asset produced business income while it was owned by the taxpayer. Advocates for the functional test treat this clause as an independent test by which income is classified, while advocates for the transactional test treat the clause as clarifying language to the first clause.[69] The most widespread test is the functional test and most of the UDITPA states have adopted it through their uniform regulations, court decisions, or administrative practices.[70]

[67] Hellerstein, State and local taxation, p. 585.
[68] See General Care Corporation v. Martha B. Olsen, Commissioner of Revenue. Supreme Court of Tennessee, 1986. 705 S.W.2d 642.
[69] See General Care Corporation v. Martha B. Olsen, Commissioner of Revenue. Supreme Court of Tennessee, 1986. 705 S.W.2d 642.
[70] Hellerstein, State and local taxation, p. 585 et seq.

3.2.2 Property factor

When the tax base and the apportionable income is determined the tax payer must then apportion this tax base among the different states where he carries on business activities. As noted above, the weight that the states gives to the different factors can differ, as well as the precise definition of the factors. The first individual factor is the property factor.[71]

Under UDITPA sec. 10, the property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in the taxing state during the year, and the denominator is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the year.

The property factor includes, according to UDITPA sec. 10, "the taxpayer's real and tangible personal property owned or rented and used." Intangible property is excluded from the property factor and no states take it into account in the property factor. This has, however, come under increasing challenge, since income from intangible property is more and more important.[72] Some critics have claimed that the failure to include intangibles in the property factor have seriously distort the apportionment. Others argue that this is not important since the receipts from intangibles, as dividends, interest, sales payment from patents, trademarks etc., are taken into account by the sales factor.[73]

Rented property was traditionally not included in the property factor, but with the growth of leasing and sale-leaseback many states have changed their statutes and now-a-days include rented property in the property factor. The question of how to treat inventory in transit between the states differs in the states. Some states exclude inventory in transit while others consider it to be at the destination for purposes of the property factor.[74]

The Amoco case shows how the precise definition of the property factor between a state and UDITPA can differ. A company called Amoco was

[71] Hellerstein, State and local taxation, p. 609 et seq.
[72] Hellerstein, State and local taxation, p. 613 et seq.
[73] Hellerstein, J., Federal income taxation of multinationals: replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1141.
[74] Hellerstein, State and local taxation, p. 613 et seq.

licensed to do business in Alaska in the field of exploration and production of oil and gas. No major amount of oil or gas had yet been discovered or produced. Amoco claimed that the value of the leasehold was incorrectly included in the apportionment formula's property factor, since it was not yet used. Under UDITPA sec. 10, the property has to be used. The Supreme Court of Alaska held that "the exploration and development of what later turn out to be unproductive oil or gas wells is a necessary and integral part of Amoco's eventual discovery and exploration of productive oil and gas wells." Therefore, it would be, according to the court, to ignore Amoco's actual business activities just to include property values associated with oil and gas leases which are known to produce major quantities of oil and gas.[75]

As well as the precise definition of the property factor differs there are differences among the states determining the value of the property. According to UDITPA sec. 11, the value of the property should be determined at its original cost. Most states also determine the property at its original cost but some states use as the valuation standard instead the depreciated book value or the fair market value.[76]

3.2.3 Payroll factor

According to UDITPA sec 13, the payroll factor is a fraction, the numerator of which is the total amount paid in the taxing state during the year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the year.

Compensation is defined by UDITPA sec. 1(c), as "wages, salaries, commissions and any other form of remuneration paid to employees for personal services." UDITPA sec. 14 states that compensation is paid in the taxing state if (a) " the individual's service is performed entirely within the state; or (b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or (c) some of the service is performed in the state and (1) the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is

[75] See State of Alaska, Department of Revenue v. Amoco Production Company. Supreme Court of Alaska, 1984. 676 P.2d 595.
[76] Hellerstein, State and local taxation, p.615.

directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in the state."

The payroll factor does not arise as many controversial questions as the other factors. Most states use the same or a similar definition of compensation as UDITPA, which can be derived from the definition of wages in the Federal Unemployment Act.[77] There are, however, problems in determining what compensation is, and in drawing lines between employee compensation, which is included, and compensation paid to independent contractors, which is not included.[78]

3.2.4 Sales factor

The sales factor (or the receipts factor) is defined in UDITPA sec. 15 as a fraction, the numerator of which is the total sales of the taxpayer in the taxing state during the year, and the denominator of which is the total sales everywhere of the taxpayer.

The sales factor is the factor, which arises the most controversial questions and which is the most difficult factor to calculate and administer. The terminology varies between the states but the sales factor usually has a very broad scope. It includes not only sales of tangible personal property, but also of real and intangible property as well as performance of services.[79] According to UDITPA sec. 1(g), "sales means all gross receipts of the taxpayer not allocated."

The most common way of attributing receipts from sales of tangible personal property is to use the destination test. This attributes a sale to the state in which the goods are shipped to the customer, or in which they are delivered to the customer. Other sales than sales of tangible personal property are generally attributed to the state in which most of the income-producing activity is performed. This follows principally also from UDITPA sec. 16 and 17.[80]

[77] Hellerstein, State and local taxation, p. 616.
[78] Coffill, E. and Willson P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1107.
[79] Hellerstein, State and local taxation, p. 619.
[80] Hellerstein, State and local taxation, p. 619.

In cases where the taxpayer is not taxable in the state of destination, UDITPA sec. 16 contains a so-called “throwback” rule. This means that when the taxpayer is not taxable in the state of destination, the sale is reassigned from the state of destination to the state of origin. The purpose of this rule is to ensure that sales not taxable in the state of destination do not escape taxation altogether.[81]

3.2.5 Relief provisions

UDITPA sec. 18 contains relief provisions for varying statutory formulas in cases when the apportionments “do not fairly represent the extent of the taxpayer’s business activity” in a particular state. In such cases, UDITPA sec. 18, authorize the use of separate accounting, exclusion of one or more of the factors, inclusion of one or more additional factors, or the use of any other method. The party who is seeking the relief has the burden of proof and it is not enough merely by showing that another method would give a lower tax.[82]

In the Twentieth Century Fox case, the Supreme Court of Oregon held that a party must show two things to invoke relief. Firstly, it is not only enough that one factor does not fairly represent business activity but the formula as a whole must be unfair. Secondly, the party must show that the alternative method proposed is reasonable.[83] This is also the policy of most states and experience has shown that relief is rarely permitted. It is only allowed in very limited and specific cases where unusual situations have led to absurd results.[84]

3.2.6 Methods of apportionment for special industries

UDITPA sec. 2 excludes from its scope business activities which consist of financial organization, public utility, or the rendering of personal services by an individual. In line with this provision, most states exclude the application

[81] Coffill, E. and Willson, P., Federal formulary apportionment as an alternative to arm’s length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1109.
[82] Hellerstein, State and local taxation, p. 640.
[83] See Twentieth Century-Fox Film Corporation v. Department of Revenue, State of Oregon. Supreme Court of Oregon, 1985. 299 Or. 220, 700 P.2d 1035.
[84] Coffill, E. and Willson, P., Federal formulary apportionment as an alternative to arm’s length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1110.

of the standard formula when the business activities consist of public utilities such as transportation, communication, gas and electric utilities. The same is true for many specialized industries. Financial business is typically subject to bank-specific taxing provisions and insurance companies are usually taxed on their gross premiums attributable to the state. Furthermore, the states use special formulas for some particular industries. For example, many states have developed different formulas for the transportation industry, i.e. railroads, motor carriers, air lines and pipelines, based on factors such track mileage, revenue miles, flight time and barrel miles.[85]

3.2.7 The Multistate Tax Compact

As we have seen there is diversity among the states in issues relating to apportionment methods. The forum to solve these kind of issues on the state level is the Multistate Tax Compact. It was developed and became effective in 1967 and there are today 19 member states and 16 associate member states. The Compact has incorporated UDITPA and its purpose is to promote uniformity or compatibility in the different tax systems. The governing body of the Compact is the Multistate Tax Commission, which is composed of one representative from each member state. The Commissions task is to adopt merely advisory and not binding uniform regulations. The states can then choose to adopt the regulations.[86]

[85] Hellerstein, State and local taxation, p. 643.
[86] Hellerstein, State and local taxation, p. 565 et seq.

4 Worldwide Formulary Apportionment

This chapter will give a brief overview of the discussion about whether a formulary apportionment method should be used at the international sphere. It will mainly focus on the discussion in the US where advocates of formulary apportionment have proposed using it even at the federal level. An account will also be given of the OECD approach to formulary apportionment and the approach taken in the United Nations Report on International Taxation and Developing Countries.[87]

4.1 The discussion in the US

At the federal level, the US is using the international accepted arm's length rule. The use of arm's length pricing, or separate accounting, in federal income taxation of corporations that are part of multinational controlled enterprises, is based on section 482 of the Internal Revenue Code.[88] There have been, however, discussions about using formulary apportionment even on this level.[89] Some authors have proposed, as a first step, using NAFTA (North American Free Trade Agreement) to introduce formulary apportionment at the international level. They suggest that establishing a formulary apportionment system between US, Canada and Mexico would give a major boost to worldwide adoption of formulary apportionment.[90]

4.1.1 Advocates of worldwide formulary apportionment

Authors have criticized the current system of arm's length pricing in different ways. Some say that arm's length pricing is inherently illogical and unworkable. Others claim that the current system is abused by multinational

[87] The United Nations Report on International Taxation and Developing Countries – Transfer Pricing Abuses and Developing Countries, UN, 1994.
[88] Hellerstein, J., Federal income taxation of multinationals: replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1132.
[89] Coffill, E. and Willson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993, p. 1103 et seq.
[90] See for example McIntyre, R. and McIntyre, M., Using NAFTA to Introduce Formulary Apportionment. In Tax Notes International, April 5, 1993. p. 851 et seq.

enterprises to reduce US taxes and in that way compete unfairly against US enterprises in the US market.[91] Advocates of formulary apportionment usually do not argue that their method is without defects but rather that these defects are less significant compared to the arm's length method.[92]

According to Hellerstein, one of the fundamental problems with separate accounting is that it turns reality into fancy. It ignores the interdependence and integration of a multinational unitary business and treats it as if it was separate, independent and non-integrated. In fact, Hellerstein claims, that it is just the integration which to a considerable extent creates the wealth, profits and power in a multinational unitary business. That is why separate accounting is unacceptable since it ignores the unitary character of such businesses and makes it impossible to establish a fair arm's length price.[93]

The same criticism is given by other authors. Kauder states that the present system with arm' length pricing does not accomplish a reasonable allocation to the US of the profits of multinational groups. In this context formulary apportionment is more efficient and fair according to Kauder. An important advantage with formulary apportionment is the fact that it accepts the actuality of the integrated multinational enterprise and is not, like arm's length pricing, based on a fiction that an affiliate of a multinational enterprise operates separately from the group of which it is a part.[94]

According to Miller, the arm's length standard is indeed the international norm but even if most nations have adopted the arm's length approach in its general outlines, Miller argues that the precise rules differ substantially. He claims that the US is in fact the only country that can claim to having a highly developed set of standards for making an arm's length determination and to having an audit force that attempts to enforce the arm's length standard.[95] According to Miller, since there are no uniform rules under the

[91] McDaniel, P., NAFTA and Formulary Apportionment: An Exploration of the Issues, in Intertax 1994/3. p. 106.
[92] Miller, B., A reply to "From the frying pan to the fire", in Tax Notes, Arlington, Va, October 11, 1993. p. 242.
[93] Hellerstein, Federal income taxation of multinationals: replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1136.
[94] Kauder, L., Intercompany pricing and section 482: A proposal to shift from uncontrolled comparables to formulary apportionment now. In Tax Notes, Arlington, Va, January 25, 1993. p. 488.
[95] Miller, B., A reply to "From the frying pan to the fire", in Tax Notes, Arlington, Va, October 11, 1993. p. 243.

arm’s length approach, a US adoption of formulary apportionment would not create chaos at the international level.[96]

Miller claims that the arm’s length method is based on false pretences. Neither the arm’s length method nor the formulary apportionment is a perfect system, but formulary apportionment acknowledges, according to Miller, that there is no one arm’s length price and that, therefore, one cannot be found. Formulary apportionment recognizes that transactions between related parties are not done on an arm’s length basis and that they are not comparable to third-party activities. Miller argues that the formulary apportionment method accepts an approximate answer since there is no possibility of obtaining a precise answer.[97]

The determination of the scope of the unitary business is one of the most difficult questions in state taxation and critics to a worldwide formulary apportionment have pointed out the problems this would lead to at the international level. Miller argues, however, that the reason for this is that the unitary business principle is the subject of interpretation by the courts of 45 states and that many of the controversies involving the definition of a unitary business could be eliminated by a single ownership test commonly used by all tax administrations.[98]

There has been criticism that the formula rules are too specific to be able to conform to a worldwide environment. Miller states, however, that there is no need for precise accuracy in calculating an individual formula factor, since the formula factor is used for assignment purposes only. Moreover, a particular factor is only one of several elements used to make the assignment of the tax base. Together, the three factors are generally correct. The three formula factor used in UDITPA reflects, according to Miller, the most important activities contributing to the earning of income. The property factor reflects the value and contribution of capital, the payroll factor reflects the contribution of labour, and the sales factor reflects the contribution of the market. Furthermore, there is no reason why every single activity has to be included in the factor for a fair apportionment, For example, there is no need, according to Miller, to include every element of

[96] Miller, B., A reply to “From the frying pan to the fire”, in Tax Notes, Arlington, Va, October 11, 1993. p. 248.
[97] Miller, B., A reply to “From the frying pan to the fire”, in Tax Notes, Arlington, Va, October 11, 1993. p. 247 et seq.
[98] Miller, B., A reply to “From the frying pan to the fire”, in Tax Notes, Arlington, Va, October 11, 1993. p. 245 et seq.

property in the property factor. Miller shows this by an illustration of the exclusion of intangibles. A patent has a value, but its creation and maintenance is reflected in the payroll factor and the receipts are reflected in the sales factor.[99]

Miller has responded to many critics' fears that international use of an apportionment formula would give rise to a great variation in the formulas used. Miller claims that the experience of the states shows that these variations are relatively small. The majority of the states use the three factor formula of property, payroll and sales, and the biggest individual variation occurs in the weighting of the factors, with a trend to uniform double weighting of the sales factor. Moreover, a uniform formula will result in no overtaxation. A tendency toward a standard formula will arise naturally, since enterprises will avoid jurisdictions whose rules disadvantages them or lobby for fairer rules. [100]

4.1.2 Advocates of the arm's length rule

The formulary apportionment method has been criticized on various grounds. The underlying assumption of formula apportionment is that each dollar of payroll, property, and sales produces an equal amount of income or an equal quantity of product. Critics have claimed that this assumes comparable economic and taxing conditions in the various jurisdictions. This may be expected among the states in the US but hardly on a worldwide basis and would result in distortion and misattribution of income.[101] Furthermore, formulary apportionment has been attacked on the ground that it is almost impossible to define exactly what constitutes a unitary business.[102]

Leslie B. Samuels has pointed out some fundamental problems with using formulary apportionment at the international level instead of the arm's

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[99] Miller, B., A reply to "From the frying pan to the fire", in Tax Notes, Arlington, Va, October 11, 1993. p. 249 et seq.
[100] Miller, B., A reply to "From the frying pan to the fire", in Tax Notes, Arlington, Va, October 11, 1993. p. 251 et seq.
[101] Cofill, E. and Wilson, P., Formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1115.
[102] Hellerstein, J., Federal income taxation of multinationals: Replacement of separate accounting with formulary apportionment, in Tax Notes, Arlington, Va, August 23, 1993. p. 1140 et seq.

length rule. Firstly, the arm's length standard is international accepted and most of the world also agree that this should be the international norm. Secondly, using formulary apportionment would demand that basic agreements could be reached on the choice of the formula, which factors that should be used and a common definition of the taxable base. This would be very difficult at an international level and require a great deal of coordination among tax administrations over the world. At the state level, these kind of issues are resolved by the Multistate Tax Commission. Thirdly, one of the most significant disadvantages with formulary apportionment is its lack of flexibility. A predetermined formula disregards individual facts and circumstances and can not adopt different approaches depending on available data. On this point, the arm's length rule is considerable more flexible.[103]

Before a formulary apportionment could be adopted at the federal level there are, according to Coffil and Wilson, a large number of problems to be solved. Formulary apportionment is a fundamentally different theory compared to the arm's length rule. The entire scheme of foreign taxation would need to be re-examined, including sourcing rules, foreign tax credits, taxation of intangibles, and so forth.[104] The authors are pointing out the problems with achieving uniformity concerning the weight of the factors in the formula at the state level within the US. These problems would be enormously difficult to deal with at an international level. There is no assurance that all countries will use the same formula. Labour intensive countries may favour a formula emphasising a payroll element, countries with an intensive high-technological industry may favour a formula emphasising the siting of intangibles to the place of manufacture, and so forth. The result would be, according to Cofill and Wilson, that retaliatory and protectionist formulas would be a real possibility. Moreover, there would have to be special formulas for industries like airlines, financial institutions, banks etc., that do not conveniently fit within the standard formula.[105]

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[103] See Samuels, L., Remarks on Revenue Estimating and the OECD Transfer Pricing Guidelines, in Intertax 1995/2, p. 66 et seq.

[104] Cofill, E. and Wilson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. P. 1104.

[105] Cofill, E. and Wilson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va,May 24, 1993. P. 1111.

The same authors are pointing out the problem of determining what constitute worldwide income. Differences in currency and accounting methods make it difficult to allocate profits. This is unlike the situation at the state level in the US where you have the same currency and accounting principles in a relatively homogeneous economy.[106]

Furthermore, Cofill and Wilson claims that it would create overwhelming problems for the taxpayers when calculating the income. Taxpayers with global operations would not only have to prepare consolidated financial statements but also convert that statement to the tax principles of the taxing jurisdiction. This would require reconciliation of inventory methods and depreciation methods, solving of foreign currency conversion issues, and reconciling of various elections that may be available in particular jurisdictions that would effect the tax base.[107]

There are also, according to Cofill and Wilson, foreign policy concerns. Formulary apportionment is not the international standard. A shift from the arm's length method to formulary apportionment would create a situation where different countries would use different apportionment/allocation standards when dividing the income from a multinational enterprise. This would hardly lead to an international tax system that would work fairly and efficiently.[108]

4.2 The OECD approach

OECD has made comments on, and clearly rejected a global formulary apportionment as a realistic alternative to the arm's length principle. In their reports from 1979 and 1995,[109] the OECD states that a global formulary apportionment method would be too arbitrary since it would disregard

[106] Cofill, E. and Wilson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. P. 1108.
[107] Cofill, E. and Wilson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1112.
[108] Cofill, E. and Wilson, P., Federal formulary apportionment as an alternative to arm's length pricing: From the frying pan to the fire? In Tax Notes, Arlington, Va, May 24, 1993. p. 1116.
[109] See Report 1979 of the OECD Committee on Fiscal Affair. Transfer Pricing and Multinational Enterprises, and The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements.

market conditions and particular circumstances of individual enterprises as well as the management's own allocation of resources.[110]

The main objection is however, according to the OECD, the international co-ordination that would be necessary to avoid double taxation and ensure single taxation. There should be international agreements on the measurement of the global tax base of a multinational enterprise group, on the use of a common accounting system, on which factors that should be used and finally how to measure and weight those factors. Taking this into account a global formulary apportionment system would, in the opinion of the OECD, result in too much political and administrative complexity and require an unrealistic level of international co-operation. According to OECD, there would be a risk that countries emphasize factors which lead to favourable results for the particular country. In addition, there would be possibilities for taxpayers to arrange matters such that emphasis is placed on factors that move profits to low-tax countries.[111]

Furthermore, the OECD points out the problems with exchange rate movements and the global formulary apportionment's insufficiency to recognise important geographical differences, separate company efficiencies, and other factors specific to one company or sub-grouping within a multinational enterprise group.[112]

4.3 The United Nations approach

The United Nations Report on International Taxation and Developing Countries is rather positive to apportionment methods. The most attractive parts of apportionment methods are, according to the report, its relative ease of administration and high degree of predictability. To use the method requires, in general, only an established formula and such data as total profits of the enterprise, total sales, total payroll, total capital etc.

The report points out as the major problem the substantial risk of conflicting determinations which produce over or under taxation of the total profits of

[110] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Section 3.67.
[111] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Section 3.64 et seq.
[112] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Report of July 1995 with supplements. Section 3.68 et seq.

the enterprise in question. There are three situations, under which these conflicts can arise. Firstly, if some of the countries taxing the enterprise use an apportionment method and others use the arm's length principle, the results are likely to conflict with each other. Secondly, even if all countries taxing the enterprise are using an apportionment method, conflicts may arise because of different apportionment formulas. Thirdly, even if all countries involved use the same formula, conflicts may arise over the interpretation of the various factors used in the formula.

Another major problem with an apportionment method is the record keeping burden it imposes on foreign enterprises, since they have to translate their foreign economic activities into the local currency of the host country, in order to apply an apportionment method. Furthermore, the method sometimes produces undesirable results. If, for example, using the arm's length approach a multinational enterprise makes a profit in one jurisdiction, but losses in all other jurisdictions, the apportionment method may lead to there being no taxable income at all in the profitable jurisdiction.

The conclusion of the report is that when compared to the arm's length principle, an apportionment method unquestionably produces greater risks of conflicting determinations, but it also reduces the opportunities for transfer pricing abuses.[113]

[113] The chapter is based on the United Nations Report on International Taxation and Developing Countries – Transfer Pricing Abuses and Developing Countries, UN, 1994. p. 24 et seq.

5 EU and direct taxation

To be able to discuss if a formulary apportionment method is a realistic alternative to the arm’s length method within the EU, it is important to know the current situation in the EU in the field of direct taxation and corporate tax.

This chapter will first consider the legal basis for Community intervention concerning direct taxation. In this context a brief overview of the non-discrimination provision in article 12 EC[114] and the fundamental Community freedoms will be presented. A formula apportionment method must correspond to these fundamental principles of Community law. Thereafter, an account of the harmonization efforts on corporate tax and accounting standards in the EU will be given. Finally, the EU approach to formula apportionment will be considered.

5.1 The legal basis for Community intervention

As a principal rule, direct taxation falls within the competence of the member states, except to the extent that directives have been passed. The member states must, however, exercise their competence consistently with Community law. Community intervention in the area of direct tax issues has been derived from three different bases. The first springboard for the development of direct tax is the general articles in the treaty which permits the Commission to develop initiatives to promote the common market. The articles in question, which proposals for development in direct taxation have derived from are article 94, article 293, and article 308 of the EC Treaty.

Article 94 EC gives authority to the Council to “issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market.” Notice that fiscal provisions require unanimity, see article 95 (2) EC. According to article 293 EC, the member states are obliged to enter into negotiations with each other when it is necessary to abolish double

[114] All references are to the E.C. Treaty as amended by the Treaty of the European Union (Maastricht Treaty 1992) and as renumbered by the Treaty of Amsterdam (1997).

taxation within the Community. Article 293 EC is supposed to be used only when other provisions are inadequate. Article 308 EC imposes the Council to take appropriate measures "if action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers." Article 308 EC has, however, not yet been used in the tax area.

The second basis for Community intervention are the provisions of the Treaty that provide for a general prohibition of discrimination based on nationality, article 12 EC, and the freedom of establishment, article 43-48 EC. Compared to the progress made by the Commission, these provisions have been the legal basis for much more radical development of direct taxation by the European Court of Justice.

The last basis for Community intervention in the area of direct taxation are the rules concerning state aid, article 87-89 EC. According to article 87 EC, "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member states, be incompatible with the common market."[115]

5.1.1 Non-discrimination

According to article 12 EC, any discrimination on grounds of nationality shall be prohibited. The article has seldom been applied since the court only apply the article where there are no specific Community rules concerning the situation in question. Discrimination arising in cases concerning the four freedoms will be decided on the basis of the EC treaty articles governing the relevant freedom. There are as yet no cases involving direct taxation which have been held by the court to infringe article 12 EC alone.[116]

The discrimination can be both direct and indirect. Cases where national provisions discriminate on basis of nationality will amount to direct discrimination. Cases where national provisions use different criteria to

[115] The chapter is based on Eden, S., Corporate Tax Harmonisation in the European Community. In British Tax Review, number 6, 2000. p. 625 et seq.
[116] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p. 12.

differentiate between situations, but which in reality are discriminating against the majority of nationals in a specific category, may amount to indirect discrimination.[117]

In ECJ case law, discrimination has been explained as follows. Firstly, similar situations shall not be treated differently unless differentiation is objectively justified.[118] Secondly, the different treatment of non-comparable situations does not lead automatically to the conclusion that there is discrimination.[119] Thirdly, an appearance of discrimination in form may correspond to an absence of discrimination in substance.[120] Fourthly, discrimination in substance consists in treating either similar situations differently or different situations identically.[121] Finally, comparable situations must not be treated differently and different situations must not be treated in the same way unless such treatment is objectively justified.[122]

5.1.2 The four freedoms and the freedom of establishment

As noted above, article 12 EC has never been applied in the field of direct taxation. The practical application of non-discrimination is instead through specific articles protecting the free movement of workers, article 39 EC, the free movement of services, article 49 EC, the free movement of goods, article 28 EC, the free movement of capital and payments, article 56 EC, and the freedom of establishment of business in articles 43 – 48 EC.[123]

There are basically two principles that the four freedoms are comprised of. Firstly, it gives a right to cross the borders of Member States. Secondly, it forbids discrimination on grounds of nationality or origin. There has to be a balance between the sovereignty of the Member States and the interest of the Community in making progress towards the completion of the internal market. Therefore, the ECJ has accepted that the freedoms are not absolute freedoms. The ECJ has to consider if a national provision, which appears to be in conflict with a Community freedom, serves a legitimate public interest

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[117] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p. 9.
[118] Case 117-76 and 16/77, Ruckdeschel [1977] ECR 1753.
[119] Case 13/63, Italian Refrigerators [1963] ECR 165.
[120] See Italian Refrigerators, above.
[121] See Italian Refrigerators, above
[122] Case 106/83 Sermide, [1984] ECR 4209.
[123] Eden, S., Corporate Tax Harmonisation in the European Community. In British Tax Review, number 6, 2000. p. 626.

and whether the restrictions in question are reasonable in relation to the protection of that interest. This has become known as the “rule of reason” test.[124]

The “rule of reason” test was introduced by the ECJ in the case of Cassis de Dijon. The case concerned the free movement of goods but the approach has a wider application to the other freedoms. There are five questions, according to the court, essential to determine whether the national restriction can be justified. Firstly, does the restriction discriminate between domestic and imported goods? Secondly, has the EC legislated to harmonize the protection of the interest concerned? Thirdly, is the interest concerned protected by the law of the Member State of origin? Fourthly, is the interest concerned a sufficient public interest to outweigh the Community freedom? Fifthly, is the restriction appropriate to its stated purpose and proportionate in its effects to the realization of that objective?[125]

Article 39 EC, which provides for free movement of workers, is directly applicable in the legal system of every Member State.[126] The article entails the right to accept offers of employment, to move freely within the territory of Member States for this purpose, to stay in a Member State for the purpose of employment and finally, to remain in the territory of a Member State after having been employed. The definition of who is a worker is determined by EC law and the work concerned must have a genuine and effective character.[127]

Article 49 EC prohibits restrictions on freedom to provide services within the Community. According to article 50 EC, services in particular include activities of an industrial character, of a commercial character, of craftsmen and of the professions. The same article makes it clear that the provisions on free movement of services will apply only in so far as a particular restriction is not covered by the provisions on free movement of goods, persons or capital.

[124] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p. 8.
[125] Case 120/79, Cassis de Dijon [1979] ECR 649.
[126] Case 167/73, Commission v. French Republic [1974] ECR 359.
[127] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2 2000. p. 10.

The free movement of goods involves abolition of all tariff and non-tariff barriers at national borders.[128] According to article 25 EC, the imposition of customs duties and any charges with equivalent effect is prohibited. Quantitative restrictions on imports and other measures with equivalent effect are prohibited by article 28 EC. In the Dassonville case, the court interpreted this latter rule as prohibiting "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade.[129]

The freedom of capital and payments are expressed in article 56 EC and prohibits all restrictions on the movement of capital and payments between Member States and between Member States and third countries. This right is, in contrast to the other freedoms, based mainly on legislation instead of case law. The scope of the right is very broad since the article prohibits all restrictions, not just those measures which are discriminatory. The major influence on the removal of the remaining restrictions are for the moment the progress towards the European and Economic Monetary Union.[130]

The freedom of establishment is expressed in articles 43–48 EC and includes two rights. Firstly, it gives a right of primary establishment making it possible for any EC national who intends to exercise economic activity to establish an undertaking in another Member State. Secondly, it gives a right of secondary establishment making it possible for any EC national to establish more than one place of business within the territory of the Member States. The freedom includes all EC nationals, dual nationals, third-country nationals and all profit seeking legal persons formed under the law of a Member State with their registered office, central administration or principal place of business in the European Union. Since the right depends on if the company has an effective and permanent link to the economy of one Member State, it is not a sufficient connection with only a mailbox-registered office in the European Union.[131]

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[128] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p. 9

[129] Case 8/74, Dassonville [1974] ECR 837.

[130] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p.11.

[131] Bater, P., Setting the Scene: The Legal Framework. In European Taxation, number 1-2, 2000. p. 10 et seq.

5.2 Harmonization efforts on corporate tax

Since the EEC Treaty came into effect on 1 January 1958 the Commission has paid attention to fiscal questions. In the early stages of the Community's development, the efforts and studies were, however, concentrated on indirect taxation.[132] The first proposal concerning corporate taxation was the report prepared in 1962 by the Neumark Committee.[133] In the report, corporation tax systems were recommended to be harmonized as part of a second stage of a three stage program. This was followed by further discussions and reports during the next decades. Despite this, the only proposal which actually was adopted prior to 1990 was the Mutual assistance directive, Directive 77/799, adopted in 1977. The directive gives a framework for the exchange of information between the member states, but has not been used much in practice since these kind of issues usually are dealt with in tax treaties.[134]

In 1985, the Commission issued the White Paper.[135] The paper stated the existing physical, technical, and tax barriers to free movement of goods, people and capital. It also proposed measures for the elimination of those barriers, which were going to be completed by the end of 1992. The White Paper was not of a major importance for the harmonisation of corporate taxes. Nevertheless, the elimination of tax barriers to cross-border business activities was an important element of the completion of a single internal market. Efforts were made to adopt proposals aimed at preventing double taxation, i.e. the merger, parent-subsidiary, and transfer pricing proposals. In 1990, this resulted in the adoption of the merger directive,[136] the parent-

[132] Farmer, P. and Lyal. R., EC Tax Law. Clarendon Press, Oxford, 1994. p. 13 et seq.
[133] Report of the Fiscal and Financial Committee. In the EEC Reports on Tax Harmonisation, International Bureau of Fiscal Documentation, 1963.
[134] Eden, S., Corporate Tax Harmonisation in the European Community. In British Tax Review, number 6, 2000. p. 627 et seq.
[135] COM (85) 310 final. Completing the internal market: white paper from the Commission to the European Council.
[136] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, and transfers of assets and exchanges of shares between companies of different Member States, OJ L 225 1990.

subsidiary directive,[137] and the transfer pricing proposal,[138] which was adopted as a convention rather than as a directive.[139]

The merger directive applies to mergers, divisions, transfers of assets and exchange of shares concerning enterprises of different member states. The preamble to the directive states that the disadvantages for cross-border grouping and reconstructing operations, compared to domestic operations constituted an obstacle to transnational co-operation between enterprises in the Community. The aim of the directive is to reduce these tax obstacles associated with the grouping and restructuring of enterprises from different member states.[140]

The parent-subsidiary directive tries to eliminate disadvantages when enterprises from different member states choose to arrange groups of parent companies and subsidiaries, compared to when enterprises from the same member state arrange the same kind of groups. The directive states that when an intra-group cross border payment of dividends is made, this payment must be exempt from withholding tax by the member state from which the payment is made. At the same time, to grant double tax relief the member state of receipt must exempt or provide a tax credit for the dividends.[141]

The above-mentioned transfer pricing proposal resulted in an arbitration convention to settle transfer pricing disputes. The aim of the convention is to solve the problem of double taxation which may arise when transfers are made between related companies in different member states, since the tax authorities in the member states may not arrive at the same calculation of the appropriate transfer price.[142]

In the so-called Ruding report from 1992, harmonization of the corporation taxes of the Member States is strongly favoured. Inter alia, the report proposed the elimination of corporation tax obstacles to cross-border

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[137] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 1990.
[138] Convention on the elimination of double taxation in connection with the adjustment of the profits of associated enterprises. OJ 1990, L225/10.
[139] Farmer P. and Lyal. R., EC Tax Law. Clarendon Press, Oxford, 1994. p. 30 et seq.
[140] See Directive 90/434/EEC above.
[141] See Directive 90/435/EEC above.
[142] Convention on the elimination of double taxation in connection with the adjustment of the profits of associated enterprises. OJ 1990, L225/10

investment, harmonization of corporation taxes with minimum tax rates and a harmonized tax base.[143] Some of the proposals were, however, rather radical and the report gained less support from the Member States than it needed to succeed.[144]

In 1997, the Commission proposed three measures to tackle harmful tax competition.[145] The first measure is a proposal for a directive providing for minimum withholding tax on interest. However, this proposal is more concerned with individual than corporate investments. The second proposal is a directive on cross border interest and royalties between associated enterprises, which states that no tax shall be withheld on payments between associated Member State companies. The final proposal is the establishment of the Code of Conduct.[146] The Code of conduct was signed by the Finance Ministers of the Member States in December 1997. According to the Code, tax measures are to be regarded as potentially harmful if they provide for a significantly lower level of taxation than which is generally applied in the particular Member State. Important to know is that the Code of Conduct is adopted in the form of a resolution. Thus, there is no method by which the Commission can enforce the Code.[147]

In a communication from 2001, the Commission sets out the priorities in the taxation area for the next years. The Commission emphasizes the importance of a solid and stabilised Community tax law to the largest extent, since the enlargement of EU will lead to a number of new Member States, each with their own unique tax systems. Furthermore, the development of e-commerce increases the mobility of economic activity and capital. To avoid fraud and to ensure that the right tax is paid at the right time in the right place, the Commission would like to see increased co-operation between the Member States. Moreover, the tax systems of the Member States must be made simpler and more transparent. This means, according to the Commission, that the focus should be put on the elimination of

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[143] Report of the Committee of Independent Experts on Company Taxation. Commission of the European Communities, March 1992.
[144] Eden, S., Corporate Tax Harmonisation in the European Community. In British Tax Review, number 6, 2000. p.631.
[145] COM (97) 564 final. A package to tackle harmful tax competition in the European Union.
[146] Resolution of the Council and the representatives of the governments of the Member States, meeting with the Council of 1 December 1997 on a Code of conduct for business taxation.
[147] Eden, S., Corporate Tax Harmonisation in the European Community. In British Tax Review, number 6, 2000. p.633.

inefficiencies linked to the operation of 15 different tax systems and the simplification of these tax systems. In the sphere of company taxation, a study of company taxation in EU is currently prepared and the results will be presented in the nearest future.[148]

5.2 Harmonization efforts on accounting standards

The accounting standards differ from country to country. This has created unequal conditions for companies and particular problems associated with the growth of the global capital markets. As a result of this, the EU has tried to harmonize the accounting standards at the European level. In the EU, this is a part of the company law harmonization program and there are three directives that deal with accounting harmonization, which were incorporated in the Member States during the 80's and 90's. The most important is the 4th directive[149] dealing with accounts of individual companies. The 7th directive[150] deals with group accounts and the 11th directive[151] dealing with information about filials.

The process in this area has been rather slow but in 1995 the Commission took a new approach. In a Communication it was proposed that the EU should put its weight behind the international harmonization process and the International Accounting Standards drawn up by the IASC (International Accounting Standards Committee).[152] The IASC was created in 1973 by the profession after a British initiative and was a reaction towards the American influence on accounting. Its aim was to prescribe changes and harmonize accounting. The corresponding body in the US is FASB (Financial Accounting Standards Board). The set of rules drawn up by FASB is more detailed and standardized then the rules of IASC.

[148] COM(2001) 260 final. Tax policy in the European Union – Priorities for the years ahead.
[149] Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, OJ L 222, 1978.
[150] Directive 83/349/EEC of 13 June 1983 based on Article 54 (3) (g) of the Treaty on consolidated accounts, OJ L 193, 1983.
[151] Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State, OJ 395, 1989.
[152] COM 1995 (508). Communication from the Commission. "Accounting Harmonisation: A Strategy vis-à-vis International Harmonisation", November, 1995.

This year, the Commission has decided to propose a regulation on the application of international accounting standards.[153] Instead of that the EU itself attempts to produce accounting standards, the Commission claims that the international recognised set of standards applied by the IASC is the most suitable basis for financial reporting in the EU. According to the proposal, all listed EU companies shall apply International Accounting Standards by the year 2005. These rules will, however, be additional to the above-mentioned directives. The directives will remain applicable to maintain a base level of comparability for all limited companies within the EU.[154]

5.3 The EU approach to Formula Apportionment

The above-mentioned Ruding report[155] from 1992, examined the question whether a formula apportionment method could be an alternative to the arm's length method regarding taxable income from companies operating within the Community. According to the Committee, an apportionment method might be an alternative when a single country has separate and local tax jurisdictions. Thus, there are too many disadvantages when tax systems of more than one country are involved.

The Committee listed the following disadvantages with an apportionment formula in the Community. Firstly, there is a need for an advanced degree of integration, i.e. common currency, common company law, common accounting standards and common expertise in the tax administrations. Secondly, there is a danger that profits are apportioned to countries in which they were not earned. Thirdly, a shift from the arm's length method to a formula apportionment method would involve a renegotiation of all tax treaties between Member States and possibly also with third countries. Fourthly, using a formula apportionment method within the Community and an arm's length method outside the Community may make the resolution of double taxation disputes more difficult. Fifthly, it may create problems when

[153] COM(2001) 80 final. Proposal for a Regulation of the European Parliament and of the Council on the application of international accounting standards.
[154] The chapter is based on Kristina Artsberg, Discussion paper. Lobbyism in European and international accounting, Economic aspects of European integration. Swedish network for European studies in economics and business. Grand hotel, Mölle, May 15th-18th, 2001.
[155] Report of the Committee of Independent Experts on Company Taxation. Commission of the European Communities, March 1992.

tax administrations have to apply two separate standards to a transaction involving more than one Member State and a third country.

There is no reason, according to the Committee, to shift from an arm's length method to a formula apportionment method within the Community in the foreseeable future. However, the committee pointed out that when a much higher level of integration between Member States is achieved, there might be reasons to reconsider an introduction of a formula apportionment within the Community.[156]

[156] Report of the Committee of Independent Experts on Company Taxation. Commission of the European Communities, March 1992. p. 130.

6 Analysis and conclusion

The EU moves towards more and more integration and harmonization in many fields. The progress in the field of direct taxation appears to have been less successful than in other areas except in recent years when several important directives have been adopted. Although, even if the integration in the field of direct taxation has been limited, the question whether it is time for the EU to abandon the arm's length principle may be justified. As we have seen, the arm's length principle has its critics and, therefore, it is interesting to investigate how the transfer pricing issues have been solved in other well integrated economical areas.

This chapter will focus on the question whether the formula apportionment method, used between the States in the US, is a realistic alternative to the arm's length principle within the European Union. Firstly, a comparison will be made between the arm's length principle and the formula apportionment method. Thereafter, the formula apportionment method's relevance for the European Union will be discussed.

6.2 The arm's length method contra a formulary apportionment method

It is important to bear in mind that a formula apportionment method is fundamentally different from the arm's length principle. Formula apportionment methods seek, instead of employing separate accounting, to determine the geographic source of corporate taxable income on the basis of a predetermined formula. When using a formula apportionment method, the tax liability is not closely related to profits actually earned in a particular jurisdiction. Instead, it is related to profits throughout the group of jurisdictions. This means that even if separate accounting indicate that there is a loss in a particular jurisdiction, the business group will pay tax in this jurisdiction if it is indicated by the formula.

The most significant disadvantage with the arm's length principle seems to be the fact that it treats related business transactions as if they were performed between two unrelated parties. This means that the method does not take into account the interdependence and the interrelation that exists within an integrated business group. The integration of a business group creates possibilities to keep down the costs in many areas and when this integration is ignored it makes it difficult to establish a fair arm's length price. Another major disadvantage with the arm's length principle is that it demands a significant amount of administration and data since you have to compare related and unrelated transactions. With an increasing number of cross-border transactions within the EU this may result in an administrative burden both for tax administrations and enterprises.

Although, a very important advantage with the arm's length principle is that it is international accepted and the standard all over the world. It is open to discussion whether the arm's length principle even may constitute international custom and, thus, international law. If this is the case, it would imply another obstacle against the introduction of a formula apportionment method. Furthermore, the arm's length principle seems to work well in the most cases and the possibility to make corresponding adjustments is an important advantage to avoid double taxation.

A formula apportionment method takes the interrelations in a business group into account but on the other hand it is not so flexible in a particular case as the arm's length principle since it is a predetermined formula. Furthermore, the use of a formula apportionment method demands a major co-operation between the countries and tax administrations involved since agreements have to be reached about the factors etc.

A formula apportionment method seems to assume that each dollar of payroll, property and sales (if one uses these factors) produces a rather equal amount of income or an equal quantity of product. Thus, the formula apportionment method demands much more comparable economic and taxing conditions than the arm's length principle. Furthermore, since the companies have to file combined reports, it creates an administrative burden for the enterprises if the accounting principles and currency vary in the involved jurisdictions. This is probably the reason why formula apportionment methods are only used in rather homogenous areas such as federal states.

6.3 Relevance for the European Union

A formula apportionment method, following something like the American model, is of course not the only choice for Europe. It is just one of several alternatives. Another way of preventing manipulation of transfer prices may be to aim for as equal tax rates in the EU as possible. If the tax rates were more uniforms, less would be gained by companies changing the source of income for tax purposes. Although, there are still reasons for governments to worry about the problems with accurate attribution of income among jurisdictions.

With regards to the difference between the arm’s length principle and a formula apportionment method, a shift within the EU would demand the solution of a large number of issues. There would be a need for renegotiation of all tax treaties between the Member States since these are based on separate accounting.

It is important to understand that a formula apportionment method includes two parts, which have to be distinguished between. Firstly, there is a need to define the apportionable tax base (the unitary business principle in the US). This raises questions as to whether you are going to include just one company, or extend the tax base to subsidiaries and affiliates and, in that case, which subsidiaries and affiliates? Some of them may be wholly owned and controlled as a part of a business, while others are rather independent. Furthermore, are you going to include subsidiaries all over the world? These are important questions since a formula apportionment method implemented on a firm-to-firm basis raises opportunities for tax abuses on transfer prices in the same way as separate accounting. An example may illustrate this. A company in country A (with a substantial tax on corporate income) makes computer games and then sells them to a legally separated affiliated firm, which distributes the games, located in country B (with no tax on corporate income) at just enough to cover costs and eliminate country A taxable income. Thus, the affiliate in country B would realize the income attributable to the production of the computer games, as well as that arising from distribution of the computer games. Although, the affiliate might pay some tax to country A under formula apportionment, based on its computer games selling in country A, it would pay far less than would be the case in the absence of manipulation of transfer prices.

The second part of a formula apportionment method, after defining the tax base, is the apportionment itself. This raises the question of which factors are going to be used and what weight should be given to the different factors.

If the European Union should shift to a formula apportionment method the abovementioned questions would be some of the most difficult to solve. Firstly, the Member States have to reach agreements about what would constitute a unitary business. Probably, there would be no disagreements about not extending the apportionable tax base to subsidiaries outside the EU which have no real connection to the EU. However, in some way the Member States have to include controlled and integrated subsidiaries and affiliates located within the EU to avoid manipulation with transfer prices. Following the Supreme Court in the US, the definition should emanate from the interdependence, integration and interrelation between the parts of the business group. Although, as has been shown, the definition of a unitary business differs from state to state in the US, the EU should strive after uniformity as far as possible to reach a fair and foreseeable taxation of corporate income. Some sort of "water's edge approach" would probably also be needed to restrict the application of the formula to far outside the jurisdiction of the Member States.

The next step, and perhaps the most difficult to reach agreement on, is to decide which factors should be used and how to weight these factors. Even if the experience in the US shows that the variations of the formulas used are relatively small, the Member States in the European Union are still not as homogeneous as the states in the US. There are large cultural, historical and linguistic differences within the EU and the citizens of the EU do not identify themselves with the European Union in the same way as the citizens of the US identify themselves with the United States. This indicates that there is a risk that protectionist and self-interested ideas may characterize the different Member States' choice of factors and the weight given to these factors. To reach an agreement which all Member States could accept is an almost overwhelming task and would demand a great deal of willingness to co-operate among the Member States. If agreements could be reached on common factors etc., it is important that the provisions would be interpreted in the same way. A shift to formula apportionment in the EU would probably demand the creation of some sort of central administration, similar to the Multistate Tax Compact in the US, working with the uniformity of the rules. Without a body like this, there is a risk that the provisions applied in the different Member States would essentially diverge. Concerning interpretation this may be a subject for the ECJ. If interpretation would be a subject for, as in the US, the courts in every single Member State there would be a substantial risk of controversy.

There would also be a need for agreements about some sort of relief provisions similar to the provisions included in UDITPA. A formula apportionment method works with a predetermined formula and, thus, it does not have the same possibility as the arm’s length principle to take into account individual circumstances and facts in a particular case. Furthermore, if different factors are used, this may create double taxation. Thus, agreements about corresponding adjustments would be necessary, similar to those regarding the arm’s length principle.

An almost absolute condition before a shift to a formula apportionment method could be a reality, is that the accounting standards within the EU are as harmonized as possible. Without accounting harmonization, such as reconciliation of inventory methods, depreciation methods etc., it is an almost overwhelming task for a business group to file a combined report of all affiliated firms which are engaged in a unitary business in different Member States. In the US, the same currency is used all over the country and detailed and standardized rules on accounting have been drawn up by FASB. In the last years, the process in this area in the EU seems to have been successful even if the accounting principles drawn up by the IASC are more general and not so detailed as the corresponding rules in the US. The fact that the accounting principles within the EU have become, and will become, more harmonized, and the fact that the EU has created a common currency, indicates that the accounting problems would be surmountable if the EU did shift to a formula apportionment method.

An introduction of a formula apportionment method must, obviously, fall within the competence of the EU and be in line with Community law and the EC treaty. The articles in the EC treaty which permit the EU to intervene in the area of direct taxation are rather general, i.e. article 94, article 293 and article 308 of the EC treaty, and as long as a formula apportionment system promotes the common market it will probably fall within the competence of the EU. Furthermore, as long as the Member States are able to agree on the same factors, and how to weight those factors etc., there is probably no risk that a formula apportionment method would infringe the non-discrimination provisions and the fundamental freedoms in the EC treaty. However, if the Member States do use different factors, weight them differently etc., then this may conflict with the abovementioned provisions.

As has been shown, a formula apportionment method demands, to work efficiently, a rather integrated economical area and it is uncertain if the EU has reached that level of integration yet. The fact that the EU is still not as integrated as, for example a federal state like the US, speaks against a shift from the arm's length principle to a formula apportionment method in the EU. However, the progress which has been made in the field of accounting and the fact that the EU now-a-days has a common currency are major advantages when introducing a formula apportionment method. Moreover, with an increase in cross-border activity, the formula apportionment method seems to be easier to administrate than the arm's length principle.

If the EU should decide to shift to a formula apportionment method, it would demand a major co-operation. All tax treaties would have to be renegotiated and it is uncertain whether the Member States would be able to reach agreements on a uniform system. This is probably the major obstacle against a shift. Another problem is enlargement of the EU. In the foreseeable future new Member States with different tax systems will enter into the Union and it will take time for these to be fully integrated into the EU. Thus, even if a formula apportionment method is an attractive choice, especially in an integrated area such as the EU, it is doubtful whether the EU is ready for a formula apportionment method. There seems to be too many obstacles at the moment. With increasing cross-border activity, there will obviously be problems when using the arm's length principle, but until the EU has become a more integrated area and co-operation has reached that level where it seems to be more realistic that the Member States will reach agreements on the basic conditions of a formula apportionment method, a shift would involve insurmountable obstacles.

Supplement

UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT

Sec. 1. As used in this Act, unless the context otherwise requires:

(a) “Business income” means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.
(b) “Commercial domicile” means the principal place from which the trade or business of the taxpayer is directed or managed.
(c) “Compensation” means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.
(d) “Financial organization” means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company], private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.
(e) “Non-business income” means all income other than business income.
(f) “Public utility” means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil products or gas.]
(g) “Sales” means all gross receipts of the taxpayer not allocated under sections 4 through 8 of this Act.
(h) “State” means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Sec. 2. Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Act.

Sec. 3. For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income regardless of whether, in fact, the state does or does not.

Sec. 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute non-business income, shall be allocated as provided in sections 5 through 8 of this Act.

Sec. 5. (a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state: (1) if and to the extent that the property is utilized in this state, or (2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

Sec. 6. (a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if (1) the property had a situs in this state at the time of the sale, or (2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

Sec. 7. Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

Sec. 8. (a) Patent and copyright royalties are allocable to this state: (1) if and to the extent that the patent and copyright is utilized by the payer in this state, or (2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Sec. 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Sec. 10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

Sec. 11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

Sec. 12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the [tax administrator] may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

Sec. 13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

Sec. 14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or
(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or
(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or

controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Sec. 15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

Sec. 16. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or
(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Sec. 17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or
(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Sec. 18. If the allocation and apportionment provisions of this Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;
(b) the exclusion of any one or more of the factors;
(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Sec. 19. This Act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.

Sec. 20. This Act may be cited as the Uniform Division of Income for Tax Purposes Act.

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