

# **SAME QUESTIONS, DIFFERENT ANSWERS: A COMPARATIVE LOOK AT INTERNATIONAL AND STATE AND LOCAL TAXATION**

John A. Swain \*

*This Essay is a primer on the income taxation of cross-border transactions, comparatively examining the approaches of the U.S. federal government and the American states, and focusing on the problems of residency, enforcement jurisdiction, sourcing, and transfer pricing. The sourcing rules of each level of government share common flaws, while the approaches to the problem of transfer pricing offer the sharpest contrast. The differences between the two systems often are explained by the higher level of integration within the federal system, but as the global economy continues to integrate, the approaches may begin to converge.*

## **INTRODUCTION**

Income tax law is notoriously complex. The reasons are several. To begin with, economic life is complex, and increasingly so. A tax system seeking to equitably extract a portion of a person's or entity's net income will almost of necessity mirror this complexity. Additionally, taxes are not economically trivial. Taxpayers are thus highly motivated to avoid them. As a consequence, taxpayers and taxing authorities are engaged in a never-ending game of cat and mouse. Taxpayers adopt forms of transactions that avoid negative tax consequences while achieving the same economic result. Taxing authorities then close the loophole, prompting the inevitable countermove, and the game continues. The Internal Revenue Code can be likened to a slow exposure photograph that has captured every zig and zag in the chase. After a while, the picture becomes hopelessly opaque. As Joseph Isenbergh laments, "[f]or much of the Code, at least on first encounter, the only way to know what it means is to know what it means."<sup>1</sup>

The sub-specialty of international taxation is no exception. Again, Joseph Isenbergh waxes eloquently:

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\* Associate Professor of Law, University of Arizona James E. Rogers College of Law. I would like to thank Walter Hellerstein, whose "same questions, different answers" quip inspired the title of this essay.

1. JOSEPH ISENBERGH, INTERNATIONAL TAXATION 8 (2d ed. 2005).

Viewed at close range U.S. international taxation is a profusion of rules, mostly narrow and impervious to apprehension through reading, bound together by no evident first principles or overarching themes. The subject matter cannot be derived in Euclidean fashion from basic postulates . . . Rather, the U.S. international tax system is made up of specific, piecemeal responses to the way international investments or business operations are carried out across national boundaries. It is a Ptolemaic system, held together with epicycles added to the structure over time as national tax authorities come to grips with changing pathways of international commerce and investment.<sup>2</sup>

To fast-forward Isenbergh's allusions a millennium and a half, it seems he is counseling us to turn back, "abandon hope, ye who enter."<sup>3</sup>

Indeed, to explain the tax law at close range is daunting, and we shall not make that attempt here. We can, however, endeavor to identify the basic problems that the tax rules attempt to address, and the general contours of those solutions. Here we focus on the problem of what is known in the vernacular as the taxation of cross-border transactions. Again in the parlance of specialists, cross-border transactions are of two types: outbound and inbound. In more accessible terminology, we shall examine the problem of taxing residents of a jurisdiction that are doing business in or receiving income from other jurisdictions, as well as the problem of taxing non-residents who earn income in the local jurisdiction.

In the United States we face this problem at both the subnational and national levels. Most American states impose an income tax and so face the problem of taxing the locally derived income of nonresidents and taxing the out-of-state income of residents. Similarly, the federal government is faced with the challenge of developing rules for the taxation of resident income earned abroad, and non-resident income earned in the U.S. Given that the same questions arise in two contexts, it is only natural that we compare the answers. We then ask more questions, particularly if the answers diverge. What explains the divergence? Is it context, or greater wisdom?

This Essay begins by examining the problem of cross-border taxation generally. It then explores and comparatively analyzes four major aspects of the U.S. national and subnational cross-border taxation regimes more closely: nationality and residence, enforcement jurisdiction, sourcing, and transfer pricing. The Essay is intended to be both accessible to the non-specialist and meaningful to the specialist. It is hoped that the former will learn and ponder, and that the latter will at least ponder, having taken the time to take a half-step back from the enormous complexity of it all.

## I. THE PROBLEM OF CROSS-BORDER TAXATION

As problematic as the taxation of residents who never venture physically or economically outside a jurisdiction may be, it pales in comparison with the taxation of more venturesome persons and entities, for two major reasons. First, it

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2. *Id.* at 3.

3. DANTE, THE DIVINE COMEDY (INFERNO), Canto III, l. 9.

is relatively easy for the taxing authority to find a purely domestic taxpayer, grab him by the ankles, and shake out whatever money is due. Enforcement jurisdiction is easily had. Taxpayers residing abroad and who have few assets within the jurisdiction are harder to nab. Second, it is easier to measure the income of a purely domestic taxpayer. There is no need to parse the income or to account for taxes that the taxpayer might have paid to other sovereigns.

The vexing problem of cross-border taxation can be illustrated by a simple example. Assume that T, a cell phone manufacturer, has manufacturing facilities in (country or state) A, research and development facilities in B, and customers in C. In this example, all three jurisdictions appear to have a legitimate claim to some of T's income, but how much? Should income be sourced based solely on customer location? What if title to the goods passes at the place of origin, rather than destination? Should all income then be sourced to state A, the state of origin? Additionally, A and B might be expected to take the sensible position that manufacturing and research and development contribute to the production of income. If so, how do we measure the respective contributions of T's operations in A and B? The contribution in B is particularly troublesome, since B is neither the source nor the destination of any sales. One solution might be to separately account for T's activities in B. The problem of calculating expenses might not be insurmountable in this example, but how would we establish an arms-length price for the research and development services rendered in B?

Further, C could have a collection problem, because T might have no assets in C other than inventory in transit. Unless C can impose effective border controls, require customers of P to withholding a portion of their payments to T, or obtain full faith and credit for its tax judgments in A and B, C may not have any practical means of enforcement.

Thus far, this example has explored a theory of assigning income based solely on the source of the income. A, B, and C might also (or instead) have a rule that assigns T's income to its place of residence. The jurisdiction of residence might then allow a credit for taxes paid to other jurisdictions based on source.<sup>4</sup> Here we run into similar problems. For individual taxpayers, residency might be determined based on the number of days spent in the jurisdiction. Alternatively, residence may be where the heart is. For corporations, residence may be the place of incorporation, or more substantively, where the business is managed and controlled.<sup>5</sup>

Because there are several equally plausible theories for the sourcing of T's income and for determining T's residence, the rules for assigning income to A, B, and C may either overlap or underlap, resulting in either the overtaxation or undertaxation of T's income. Assume, for example, that A adopts a sourcing rule

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4. This is the typical rule for residence-based taxation. Residents pay tax on their worldwide income but are allowed a credit for taxes paid to foreign jurisdictions on their foreign source income.

5. The U.S. federal rule is the place of incorporation, while the rule in some foreign jurisdictions is the place from which the corporation is managed and controlled. I.R.C. § 7701(a)(4) (2006) (U.S. rule); REUVEN S. AVI-YONAH, *INTERNATIONAL TAX AS INTERNATIONAL LAW*, 33 (2007) (discussing managed and controlled rule).

based on the origin of the sale, and C adopts a sourcing rule based on the destination of the sale. In this case, T's income would be double taxed: first in A (the place of manufacture) and again in C (where the customers are located).<sup>6</sup> Now assume that the opposite is the case: A adopts a destination sourcing rule and C adopts an origin sourcing rule. Here, T's income would not be sourced to either A or C, escaping taxation altogether (unless T is a resident of either A or C). Similar issues arise in connection with residency. T may be managed and controlled in A, but incorporated in B. If B has a place of incorporation residency rule, while A has managed and controlled residency rule, T risks having its worldwide income fully taxed in two jurisdictions.

Overtaxation and undertaxation are both inequitable and economically inefficient. Remembering that purely domestic competitors of T will pay one and only one tax, P will either be subsidized (undertaxed) or penalized (overtaxed) unless the tax rules of A, B, and C are coordinated. Note further that T, as an economically rationale firm, can be expected to arrange its affairs to minimize overtaxation and exploit opportunities for undertaxation.

In summary, the general problem of cross-border taxation has five major facets:<sup>7</sup> First, determining residence. Second, obtaining jurisdiction over non-resident taxpayers. Third, sourcing income. Fourth, determining arm's length transfer prices. Fifth, the problem of tax coordination among the jurisdictions, as well as its antithesis, tax competition. This Essay focuses on the first four facets: residency (and nationality), enforcement jurisdiction, sourcing, and transfer pricing.<sup>8</sup> This is done by comparatively examining the rules applied at the national and subnational levels in the United States.

## II. NATIONALITY AND RESIDENCE

### A. Nationality

U.S. citizens and U.S. residents are taxed on the basis of their worldwide income for federal income tax purposes.<sup>9</sup> In contrast, nonresidents are taxed only on their U.S. source income.<sup>10</sup> Nationality is a particularly strong hook. A citizen

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6. One might think that one of the jurisdictions might allow a credit for taxes paid to the other. However, most jurisdictions only allow a credit for *foreign source* income, and the domestic rules are applied for making this determination. Thus, because both A and C source the income domestically and not to a foreign jurisdiction, a foreign tax credit would not be allowed by either jurisdiction for the tax paid to the other jurisdiction.

7. If we look more closely at the specific problem of taxing inbound and outbound transactions, a number of other significant categories of issues can be identified, such as the computing tax credits for nationals and residents who pay taxes to other jurisdictions, addressing the deferral of income earned and held by foreign entities controlled by domestic persons or entities, distinguishing between passive and active income, identifying income that is "effectively connected" with a U.S. trade or business, and taxing "branch profits." See generally ISENBERGH, *supra* note 1, at chs. 5-7, 9-18.

8. For a superb overview of international tax coordination and competition, see AVI-YONAH, *supra* note 5, at 1-21, 182-88.

9. See I.R.C. §§ 7701(a)(30), (b)(1)(A) (defining "United States person" and "resident alien").

10. See *id.* § 7701(b)(1)(A) (defining of "resident alien").

is taxable on her worldwide income even if the citizen is not a resident. Thus for example, a U.S. citizen who has lived and worked exclusively in a foreign country, possibly without setting foot on American soil for many years, is still a U.S. taxpayer.<sup>11</sup> This is not to say that a tax credit will not be allowed for taxes paid on foreign income, or that the citizen may not be eligible for certain statutory exclusions allowed expatriates.<sup>12</sup> Nevertheless, the citizen is still a U.S. taxpayer even though she is not a U.S. resident and has no U.S. source income.

Moreover, U.S. rules go even further and treat as citizens for an additional 10 years persons who repudiate their citizenship for tax avoidance purposes.<sup>13</sup> In the past, it has been very difficult for the IRS to prove that citizenship has been repudiated for tax purposes, but recent legislation has shifted the burden of proof to the taxpayer in these cases.<sup>14</sup> Time will tell whether this shift in the burden of proof serves its intended purpose of making it more difficult to repudiate U.S. citizenship to avoid taxes.

The states do not have a corresponding concept of citizenship for state tax purposes. Unlike U.S. citizenship, one is not a California citizen regardless of where one actually resides. Setting aside U.S. constitutional constraints, this distinction from the federal rule is grounded in the political reality that the states do not offer the kinds of protections and benefits that the U.S. government provides to citizens residing abroad. Indeed, domestically, it is the federal government that provides these protections to “citizens” of the various states, rendering unnecessary, for example, the establishment by the individual states of diplomatic missions or the maintenance of standing armies.<sup>15</sup>

### ***B. Individual Residence***

One could imagine a world in which tax is imposed based solely on citizenship. In such a world, the thorny problem of the sourcing of income could be avoided, although where citizenship rules are inconsistent, the risk of overtaxation and undertaxation would still exist. This is not the world in which we live for two major reasons. First, as an empirical matter, jurisdictions will inevitably seek to tax income arising from within regardless of the nationality of the person engaged in the income-producing activity.<sup>16</sup> Second, and of greater importance to the discussion that follows, the temptation to establish a tax haven

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11. Almost no other country follows this rule. Instead nearly all countries treat citizens residing abroad as non-taxpayers. AVI-YONAH, *supra* note 5, at 22–23.

12. See, e.g., I.R.C. § 911 (annual foreign source income exemption and housing allowance for U.S. nationals living abroad).

13. *Id.* § 877.

14. *Id.* § 877(f).

15. See, e.g., U.S. CONST. art. IV, § 2, cl. 1 (privileges and immunities clause).

16. Taxation of nonresidents is normatively supportable as the political prerogative/entitlement of the sourcing jurisdiction, and because the persons engaged in the income producing activities are receiving benefits from the source jurisdiction. See William F. Fox, LeAnn Luna, and Matthew N. Murray, *How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT'L TAX J. 139, 141 & n.4 (2005) (discussing the strengths and weaknesses of the benefits-received and entitlement justifications of the corporate income tax).

nationality would be too great under a nationality based system. For this reason, all nations have expanded the concept of nationality to encompass residency as well. Thus, a citizen of the Cayman Islands who spends a sufficient amount of time in the U.S. during the tax year will be treated as a U.S. taxpayer taxable on her worldwide income regardless of the person's (presumably) strong political allegiance to the Cayman Islands.

Both a permanent resident of the United States (a "green card" holder) as well as a person who has resided in the U.S. 183 days or more during the tax year are treated as residents for income tax purposes.<sup>17</sup> It should be noted that some days are excluded for these purposes, such as time spent in the U.S. by foreign faculty on exchange programs, by foreign students, and by persons who come as tourists and later have to be hospitalized.<sup>18</sup> The number of days can be fewer if time was spent in the U.S. during the preceding two years.<sup>19</sup> A mathematical formula is applied to make this determination.<sup>20</sup> Persons who meet the arithmetic test solely by reason of having spent time in the U.S. in the prior two years (i.e., who spent less than 183 days in the current tax year yet still met number of days requirement) may avoid U.S. resident treatment by showing that they have both a "tax home" in and a "closer connection" with a foreign country.<sup>21</sup> Additionally, the U.S. and its treaty partners have committed to resolving disputes involving double residency by the application of a series of somewhat more subjective tie-breaking tests, geared largely toward ascertain the taxpayer's fiscal domicile.<sup>22</sup>

Similarly, the American states generally tax residents on their worldwide income, but the test for residency is usually much more subjective than merely counting the days spent in the state. Typical tests include "domicile" in the state, presence in the state for other than temporary or transitory purposes, and the maintenance of a permanent place of abode.<sup>23</sup> The difference between the arithmetical federal approach and the more subjective approach of the states can be explained in large part by the different enforcement experiences of each level of government. The federal government previously had applied a more flexible residency standard, but it was changed in 1984 due to the difficulties of administering a subjective test.<sup>24</sup> The experience of the states, however, is that arithmetical standards are easily manipulated because there is much more interstate mobility than international mobility. Additionally, without border controls, it is much more difficult for states to administer and enforce residency rules based solely on in-state days. Still, the price that the states pay for adopting more

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17. I.R.C. § 7701(b).

18. *Id.* §§ 7701(b)(3)(D), (b)(5).

19. *Id.* § 7701(b)(3).

20. *Id.*

21. *Id.* § 7701(b)(3)(B).

22. See ISENBERGH, *supra* note 1, at 235–36 (discussing U.S. Model Treaty residency provisions).

23. 2 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 20.03 (3d ed. rev. 2003).

24. JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION B1.02[2][c][i] (1991 & Supp. 2007).

substantive residency tests is greater uncertainty, and the cases addressing state tax residency questions are “legion.”<sup>25</sup>

An additional difference between the state and federal approaches is that there is no network of treaties to protect state taxpayers from double residency determinations. Instead, state taxpayers are loosely and imperfectly protected by Commerce Clause constraints on statutes that impose a risk of multiple taxation,<sup>26</sup> and are more rigorously protected by the near-universal practice of allowing state residents a credit against taxes paid to other states on out-of-state income.<sup>27</sup>

### C. Corporate Residence

On the federal level, the determination of the residency of a corporation for income tax purposes is quite simple and mechanical. A corporation is a resident of the country in which it is incorporated.<sup>28</sup> Thus, a Delaware corporation is a U.S. resident corporation subject to tax on its worldwide income. Its foreign subsidiaries, however, are only taxable in the U.S. on their U.S. source income. As a result, by the simple expedient of separately incorporating activities which generate income offshore, a U.S. corporation can avoid paying tax on “its” worldwide income until such income is repatriated by its foreign affiliates in the form of a dividend, liquidation, or similar transaction.<sup>29</sup> Well, not quite. Though beyond the scope of this essay, the Internal Revenue Code is replete with “elaborate structures”<sup>30</sup> designed to prevent this from happening.

The concept of corporate tax residence plays a much more limited role in the state tax context than in the federal tax context. State corporate income taxes are essentially source-based, with residence-based taxation limited to such items such as portfolio dividends having no relationship to the corporation’s activities outside of its state of residence (commercial domicile).<sup>31</sup> In the vernacular of international taxation, the state taxation of corporation income is largely a territorial system, rather than a system based on residence and source. Another way of thinking about the distinction is that the residence and source principles are mutually exclusive in the state corporate income tax context (because of constitutional restraints) whereas they are overlapping concepts in the international context.<sup>32</sup> This is probably the sharpest distinction between state and federal cross-border taxation of corporate income,<sup>33</sup> and is one of the most interesting areas of

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25. HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 20.03.

26. *Id.* ¶ 20.04[1][a].

27. *Id.* Federal taxpayers are also generally allowed a foreign tax credit.

28. I.R.C. § 7701(a)(4) (2006).

29. The foreign subsidiary will pay tax to the foreign jurisdiction, but the rate may be lower.

30. AVI-YONAH, *supra* note 5, at 33.

31. 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 8.02[1] (3d. ed. Supp. 2007).

32. Walter Hellerstein, Georg W. Kofler & Ruth Mason, *Constitutional Restraints on Corporate Income Tax Integration in the EU and the US*, TAX L. REV. (forthcoming).

33. State personal income taxes more closely resemble the international norm, because states generally tax their residents without regard to source and grant a credit

comparative analysis. Rather than initiate that analysis here, however, we need to fully develop the concepts of sourcing and transfer pricing, which we address after first examining enforcement jurisdiction over non-residents.

### III. ENFORCEMENT JURISDICTION OVER NONRESIDENTS<sup>34</sup>

Almost all nations and states tax nonresidents on their income from sources within the jurisdiction. Simply because a potential taxpayer has income that is sourced to a jurisdiction, however, does not mean that the jurisdiction will have the practical or legal power to enforce a tax against the person earning the income. For foreign persons earning passive income, this problem is solved on the federal level by the expedient of imposing a withholding tax obligation on payors.<sup>35</sup> Otherwise, federal income tax is imposed only on foreign persons carrying on a “trade or business” in the U.S.<sup>36</sup> This is generally interpreted to mean that the foreign person must be physically present in the U.S. or have physically present agents in the U.S.<sup>37</sup>

Additionally, the U.S. has entered into bilateral tax treaties with most of its trading partners, raising the threshold for enforcement jurisdiction even higher. These treaties require a person who is a resident of a signatory state to have a “permanent establishment” in the foreign jurisdiction before the foreign jurisdiction may impose an income tax.<sup>38</sup> Though permanent establishment can be an elusive concept, it is clearly a higher threshold than carrying on a trade or business. For example, it is expressly defined to exclude both facilities used solely for the storage, display, or delivery of goods belonging to the enterprise, as well as a fixed place of business used solely for the purpose of purchasing goods.<sup>39</sup>

The power of the American states to assert enforcement jurisdiction on a nonresident taxpayer is limited constitutionally by the Due Process and Commerce Clauses. Physical presence is not required under the Due Process Clause,<sup>40</sup> but the Commerce Clause question is closer. In *Quill Corporation v. North Dakota*, the Court held that a physical presence is required for states to impose a *sales or use tax* collection obligation on remote sellers.<sup>41</sup> In reaching this decision, the Court

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against taxes imposed by other states on a source basis. HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 20.04[1][a] (3d. ed. rev. 2003).

34. The definitive treatment of enforcement and substantive jurisdiction on the national and subnational levels is Walter Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 GA. L. REV. 1 (2003).

35. See, e.g., I.R.C. §§ 871(a), 881 (imposing withholding tax on payments to foreign persons of various categories of “fixed or determinable” income, such as interest and dividends).

36. *Id.* §§ 871(b), 882.

37. There is no decisive authority on this point, but *Piedas Negras Broadcasting v. Commissioner*, 43 B.T.A. 297, 307 (1941), *aff’d*, 127 F.2d 260 (5th Cir. 1942), suggests this rule.

38. U.S. MODEL INCOME TAX CONVENTION art. 5 (2006).

39. *Id.*

40. *Quill Corp. v. North Dakota*, 504 U.S. 298, 307–08 (1992).

41. *Id.* at 309–19.



relied in part on the doctrine of *stare decisis*, having required physical presence in an earlier case involving sale and use tax collection.<sup>42</sup> This left open, however, the question of whether physical presence is required in order for the states to impose and enforce other types of taxes, including the income tax. The clear trend, however, has been for courts to limit the holding in *Quill* to sales and use taxes and not to require physical presence for state income tax purposes.<sup>43</sup>

It is easy to understand why the jurisdictional threshold would be lower in a federal system comprised of subnational states than in an international system comprised of sovereign nations. The U.S., for example, enjoys a common legal tradition, overlapping legal institutions, a common currency and language, geographic continuity, and a highly integrated economy—all features that support a low jurisdictional threshold for persons doing business across state lines. The international system, however, is comprised of far more heterogeneous participants. That said, technology and economic integration are putting severe strains on the traditional permanent establishment test, and there are calls for reform from many quarters, all alluding to the now commonplace observation that modern technology allows national markets to be penetrated and exploited without a physical presence to a far greater extent than ever before.<sup>44</sup> Thus, more and more income escapes taxation at the source because of the resilience of the now quaint notion that physical presence is a reasonable proxy for identifying substantial economic presence.

#### IV. SOURCING OF INCOME

In a world in which taxpayers conduct business across borders, it is necessary for income tax regimes to adopt sourcing rules unless they choose collectively to adopt a pure residence-based system worldwide. As previously noted, adoption of a pure residence-based system is unlikely if for no other reason than foreigners are convenient to tax. On the federal level, the Internal Revenue Code includes a hodgepodge of sourcing rules for various types of income.<sup>45</sup> Some of the rules are formalistic: Dividends and interest are sourced to the residence of the payor<sup>46</sup> (regardless of where the underlying assets are located); capital gains (other than from real estate) are sourced to the residence of the seller<sup>47</sup> (regardless of the where the underlying assets are employed); and the sale of inventory is

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42. Nat'l Bellas Hess v. Dep't of Revenue, 386 U.S. 753 (1967).

43. 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 6.11[3] (3d ed. rev. 2006).

44. *See, e.g.*, AVI-YONAH, *supra* note 5, at 82–84.

45. The sourcing rules apply to both resident and non-resident taxpayers. Here we are concerned solely with the sourcing of non-resident income to the U.S. Though beyond the scope of this essay, it is also important to source the income of resident taxpayers because a foreign tax credit is allowed only with respect to foreign taxes paid on *foreign source* income. I.R.C. § 904(a).

46. *Id.* §§ 861(a)(1), 862(a)(1) (interest); *id.* §§ 861(a)(2), 862(a)(2) (dividends). There are, however, exceptions when the payor's economic activities occur largely in countries other than its residence. *Id.*

47. *Id.* § 865(a)(1).

sourced where title passes<sup>48</sup> (an easily manipulated legal formality). Other rules are more substantive: Royalty income is sourced to where the intangible asset is used,<sup>49</sup> and services are sourced to where performed.<sup>50</sup> The advantage of formal rules is that they are easier to administer, but they are also easier to manipulate. The advantage of substantive rules is that they more closely track economic reality and are more difficult to avoid, but they also can increase administrative and compliance burdens.<sup>51</sup>

Characterization of income becomes extremely important under this hodgepodge of rules. Consider a payment by a resident of country A to a resident of country B connected with intangible assets employed in the U.S. by the country A resident. If the payment is structured as a royalty, then it is sourced to the U.S. (where the intangible is employed),<sup>52</sup> but if it is structured as an interest payment, then it is sourced to country A (the residence of the payor) and is not taxable in the U.S.<sup>53</sup> Or consider the case of a conductor hired to conduct a number of symphony orchestra performances in the U.S. that are recorded and then sold overseas, and who is paid a percentage of the gross sales.<sup>54</sup> If the conductor performed a service, it would be sourced to the U.S. (the place of performance).<sup>55</sup> If the conductor's receipts are royalties, however, then the income would be sourced to where the recordings were sold.<sup>56</sup>

For individual taxpayers, the American states usually impose rules somewhat similar but not identical to the hodgepodge of federal sourcing rules. Wage and services income is generally taxed where the services are performed,<sup>57</sup> and income from real and tangible personal property is usually sourced to the location of the property.<sup>58</sup> Income from intangibles is normally sourced to the residence of the income recipient under the doctrine of *mobilia sequuntur personam* ("movables follow the person") unless the property acquires a business situs in another state.<sup>59</sup>

The states take a substantially different approach to the sourcing of the income of corporate taxpayers (and other businesses). Under the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which has either been adopted or followed in concept by nearly all of the states that impose a corporate income tax,

48. *Id.* § 861(a)(6). As with so many of the rules governing U.S. taxation of international transactions, there are always exceptions. The "title passage" rules sometimes yield to a rule based on the office through which the sale is effectuated. *See id.* § 865(e).

49. *Id.* § 861(a)(4).

50. *Id.* § 861(a)(3). This rule applies even if the service is performed remotely.

51. For an excellent discussion of the role of formal and substantive sourcing rules, see AVI-YONAH, *supra* note 5, at 42–47.

52. *See supra* note 49 and accompanying text.

53. *See supra* note 46 and accompanying text.

54. This example is borrowed loosely from the case of *Boulez v. Commissioner*, 83 T.C. 584 (1984), *aff'd*, 810 F.2d 209 (1987).

55. *See supra* note 50 and accompanying text.

56. *See supra* note 49 and accompanying text.

57. 2 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 20.05[4].

58. *Id.* ¶ 20.05[5].

59. *Id.* ¶ 20.05[6].

the income of corporate taxpayers is first classified as either “business” or “non-business” income.<sup>60</sup> *Non-business* income is allocated under a set of rules somewhat similar to the rules generally followed for individual taxpayers.<sup>61</sup>

The *business* income of corporate taxpayers (which, of course, is usually most or all of their income) is sourced in a much different fashion. Instead of undertaking the enormous task of separately accounting for the income and expenses of a multistate taxpayer by application of specific sourcing allocation rules (and associated deduction allocation rules), the states apportion business income by application of an apportionment formula. Under UDITPA, an apportionment ratio is computed by averaging three factors: the property factor, the payroll factor, and the sales factor. The property factor is the ratio of the taxpayer’s in-state property to its property everywhere,<sup>62</sup> the payroll factor is the ratio of the taxpayer’s in-state payroll to its payroll everywhere,<sup>63</sup> and the sales factors is the ratio of the taxpayer’s in-state sales to its sales everywhere.<sup>64</sup>

The rationale underlying the use of formulary apportionment is twofold. First, in a highly integrated national economy, attempts to separately account on a geographic basis are administratively burdensome, are of dubious accuracy, and are subject to manipulation.<sup>65</sup> Inevitably, for example, formulary apportionment would creep into the equation as companies would be required to allocate overhead, R&D, licensing income, and so on, to each state. Second, formulary apportionment is a reasonably good proxy for where income is earned. The location of a taxpayer’s property and payroll reflect the contribution of the states of production, while the sales factor reflects the contribution of the market states.<sup>66</sup>

Is formulary apportionment an administrative and substantive panacea? In practice, the computation of the payroll and property factors have posed relatively little difficulty, but computation of the sales factor numerator presents many of the same problems that plague the federal rules. This is because in order to compute the numerator of the sales factor one must go through substantially the same exercise of sourcing receipts from various categories of income to the state, just as one must do under the federal rules. Additionally, the existing state rules for making these “sourcing” determinations are fraught with similar problems. For example, sales of services are sourced to the place of performance, while sales of tangible personal property are sourced to the destination of the sale.<sup>67</sup> This makes no difference in the case of a haircut, for which the origin and the destination of

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60. UNIF. DIV. INCOME TAX PURPOSES §§ 1(a), (e), 7A U.L.A. 147 (2002).

61. *Id.* §§ 4–8. An interesting twist is that *non-business* patent and copyright royalties are allocable to the state in which the patent or copyright “is utilized by the payer.” *Id.* § 8. This is the same rule that is applicable federally to all royalty receipts. *See supra* note 49 and accompanying text.

62. UNIF. DIV. INCOME TAX PURPOSES § 10.

63. *Id.* § 13.

64. *Id.* § 15. “Sales” in this context should be construed as “receipts.” 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 9.18 (3d ed. rev. 2006).

65. 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 8.03 (3d ed. rev. 2006).

66. *Id.* ¶¶ 8.05, 8.06.

67. UNIF. DIV. INCOME TAX PURPOSES §§ 14 (services), 16 (tangible personal property).

the service are the same. Increasingly, however, services are being performed remotely. Tax returns are being prepared overseas, and banking, legal, and accounting services are being rendered from hither and yon. Thus, as with the federal rules, characterization can have a significant impact on sourcing when a transaction involves a bundled mixture of sales and services. Significantly, the state rule for “sourcing” receipts for sales factor purposes are more substantively oriented with respect to sales of tangible personal property, which are sourced to the destination of the sale regardless of where title passage occurs.<sup>68</sup> UDITPA is more uncertain, however, with respect to business income royalties. Indeed, no specific rule is provided.<sup>69</sup>

In summary, formulary apportionment does not entirely avoid the problem of allocating receipts. It should be noted, however, that it does avoid the problem of allocating deductions and most of the other complexities of computing net income on a separate geographic accounting basis.<sup>70</sup> In the next section we examine the most attractive feature of formulary apportionment. That is, when coupled with “combined reporting” rules, formulary apportionment avoids the problem of transfer pricing.

## V. THE PROBLEM OF TRANSFER PRICING

Consider a cell phone company P that is incorporated in the U.S. and has manufacturing operations in the U.S. and distribution operations in country B. Assume further that in order to avoid U.S. taxation on its activities in country B, P separately incorporates its country B activities, forming a foreign subsidiary S.<sup>71</sup> Assume further that the cost of manufacturing phones is \$40 per unit and the sales price (the price S charges its customers) is \$100. How will P price the sale of phones to S? A plausible range of prices will be from \$40 to \$100. If priced at \$40, then P will have \$0 of U.S. income and S will have \$60 of country B income. If priced at \$100, then P will have \$60 of U.S. income and S will have \$0 of country B income. If the U.S. tax rates are higher than the country B tax rates, then an economically rational taxpayer would price the sale from P to S as low as possible in order to shift as much net income to country B as possible. If the U.S. has a relatively low tax rate, then the sale to S would be priced as high as possible, shifting as much income as possible to the U.S. This is the problem of transfer pricing.

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68. *Id.* § 16.

69. Curiously, the *nonbusiness* income rule for the sourcing of copyright and patent royalties mirrors the substantive place of use rule applied on the federal level, but this is not the rule for the computation of the sales factor which is applicable to business income. *See supra* note 61; *see also* 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 9.18[4] (3d ed. 2000) (discussing the attribution of receipts from intangibles to the sales factor).

70. Under the federal system, expenses must be matched to the various categories of income and similarly sourced in order to arrive at a final computation of net taxable income.

71. Recall that foreign corporations are not treated as U.S. residents and are only taxable on their U.S. income. *See supra* notes 28–29 and accompanying text.

On the federal level, the problem is addressed by imposing an arms-length pricing standard.<sup>72</sup> P cannot pick any price. It must pick the price that would be paid in a comparable arms-length transaction between unrelated parties.<sup>73</sup> In practice, however, the arms-length pricing standard is extraordinarily difficult to implement. Over 100 pages of U.S. Treasury regulations have been adopted under Section 482 for the purpose of implementing transfer pricing, and the problem becomes even more complex in the age of high-profit intangibles.<sup>74</sup> As one commentator observes:

As manufacturing and the importance of national borders shrink, cross-border transfers of valuable intellectual property within a single multinational [company] are becoming increasingly common. Unfortunately, this is the type of transfer pricing issue that poses the greatest challenge to the arm's-length method . . . . The simple reason is that intangibles by their nature are unique, and so it is always difficult—and frequently impossible—to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Administering the arm's-length method without comparables is like playing hockey without a puck.<sup>75</sup>

Closely related to the problem of complexity is the high cost of administration and compliance. In one celebrated case,<sup>76</sup> Exxon spent \$25 million in fees to outside counsel, experts, and witnesses.<sup>77</sup> An additional problem, as noted in our initial explanation of the transfer pricing problem, is the opportunity that it presents for tax avoidance, which is exacerbated by the tremendous difficulty of establishing correct transfer prices in the first instance. This creates a lot of wiggle room.

The states have developed a solution to the transfer pricing problem that couples formulary apportionment with “combined reporting.” Under a combined reporting regime, a group of affiliated entities engaged in a “unitary business” (loosely, an enterprise that is functionally and economically integrated) is treated as a single entity for tax reporting purposes.<sup>78</sup> This is best explained by example. Consider again a cell phone manufacturer P that does business in states A and B. P's manufacturing facilities are in state A, it has a sales office in state B, and it makes sales to customers in both states. Applying the formulary apportionment

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72. See I.R.C. § 482 (2006) (granting IRS authority to reallocate income and expenses “in order to prevent evasion of taxes or clearly to reflect . . . income”).

73. Treas. Reg. § 1.482-1(b)(1) (as amended in 2006).

74. The following discussion draws heavily from Walter Hellerstein, *Income Allocation in the 21st Century: The Case for Formulary Apportionment*, 12 INT'L TRANSFER PRICING J. 103 (2005).

75. Martin Sullivan, *With Billions at Stake, Glaxo Puts APA Program on Trial*, 103 TAX NOTES 388 (April 26, 2004).

76. Exxon Corp. v. Comm'r, 66 T.C.M. (CCH) 1707 (1993), *aff'd sub nom.*, Texaco, Inc. v. Comm'r, 98 F.3d 825 (5th Cir. 1996), *cert. denied*, 520 U.S. 1185 (1997).

77. See Hellerstein, *supra* note 74.

78. 1 HELLERSTEIN & HELLERSTEIN, *supra* note 23, ¶ 8.11 (3d ed. 2000). It should be noted that even a single entity can operate two or more “unitary businesses,” in which case each “unitary business” must be apportioned separately.

rules to determine taxable income in A and B, P would: (a) compute its total companywide income; (b) compute the apportionment ratios for each state based on the property, payroll, and sales factors described above; and (c) multiply total P net income by the state A apportionment ratio to determine taxable state A income. P would similarly calculate state B taxable income by applying the state B apportionment ratio. Under this approach, P would not be required to separately compute net income for each state, although it still would be required to track property, payroll and sales for the purpose of computing the apportionment ratio for each state.

Now assume that P separately incorporates its state B sales operations in subsidiary S. How would the formulary apportionment rules apply then? There are two basic possibilities. First, if states A and B use single entity formulary apportionment, then each company (P and S) would separately compute its total net income and apportionment ratios for the purpose of apportioning income to each state. Note, however, that because S is separately incorporated, the companies would need to determine a transfer price for sales from P (the manufacturer) to S (the distributor). This transfer price would affect both the net income of P and the net income of S,<sup>79</sup> and it would also affect the calculation of the sales factor of P.<sup>80</sup> In other words, the problem of transfer pricing is not solved by separate entity formulary apportionment.

Now assume that states A and B required combined reporting. In this case, P and S would report tax as if they were a single entity, and the intercompany transfers (and thus the transfer prices) would be ignored. Total apportionable net income and the apportionment factors would be computed just as if the combined group were a single entity. As a result, the problem of transfer pricing disappears, and income cannot be shifted from state A to state B or vice versa by virtue of adjusting the transfer price between separate entities within the combined group.<sup>81</sup>

So far I have generally described the ideal combined reporting/formulary apportionment regime (“CR/FA”). In actual practice, however, many states require or allow only separate entity reporting, and nearly all states adopt a “water-edge” approach, meaning the multinational businesses do not include their foreign affiliates in their combined returns. Thus, transfer prices must be established for transactions between members of the combined group and their foreign affiliates.

The question naturally arises as to whether increasing globalization is a sufficient predicate for the adoption of CR/FA on the international level, and an enormous amount of ink has been spilt on the subject.<sup>82</sup> Kimberly Clausing and

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79. The higher the price, the greater the income of P and the lower the income of S.

80. The higher the price, the greater the numerator and the denominator of the sales factor. The net effect on the sales factor would depend on the other sales activities of P.

81. Receipts and gross income would only be measured by sales of combined group members to non-members.

82. E.g., Hellerstein, *supra* note 74; Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in A Global Economy: A Proposal to Adopt Formulary Apportionment* (The Brookings Inst., The Hamilton Project, Discussion Paper

Reuven Avi-Yonah have identified four key advantages of adopting CR/FA for international tax purposes.<sup>83</sup> First, it better reflects the realities of a highly integrated global economy. Second, it eliminates the incentive to shift income to tax haven countries. Third, it increases simplicity in tax compliance and administration. Fourth, it either raises revenue (or facilitates a cut in the marginal tax rate).<sup>84</sup> The downside of CR/FA involves a number of implementation issues connected with the move away from the presently accepted international norm of separate geographic reporting. For example, there is evidence to suggest that CR/FA would shift income toward high-tax jurisdictions and away from low-tax jurisdictions.<sup>85</sup> Additionally, there are concerns about the effect of CR/FA on existing tax treaties and about the lack of tax coordination that would ensue if the U.S. moved unilaterally to adopt CR/FA. It is worth noting, however, that the European Commission is actively promoting the adoption of combined reporting and formulary apportionment in lieu of transfer pricing for attributing income to member states of the European Union under the proposed Common Consolidated Corporate Tax Base.<sup>86</sup>

### CONCLUSION

At the outset, we asked whether the differences between the U.S. national and subnational tax regimes might be explained by context, or greater wisdom. Context is usually the explanation. The United States is simply much more integrated economically, socially, culturally, and historically than the international system. Accordingly, context both demands and accommodates combined reporting/formulary apportionment and lower jurisdictional thresholds on the subnational level. As the world economy continues to integrate, however, the same forces that compel these peculiar U.S. subnational income tax rules are driving calls for adoption of similar rules on the international level.<sup>87</sup>

We also have noted that the sourcing of income on the federal level and the sourcing of receipts for sales factor computation purposes on the state level are plagued by various characterization issues and inconsistencies. Services, for example, are sourced to the place of performance both nationally and subnationally, while sales of tangible personal property are sourced to the destination on the state level and to where title passes on the federal level. In the past, services were performed largely at their destination, and so this rule was basically consistent with a destination sourcing approach. Now, however, many

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No. 2007-08, 2007), available at [http://www.brookings.edu/papers/2007/06corporatetaxes\\_clausing.aspx](http://www.brookings.edu/papers/2007/06corporatetaxes_clausing.aspx).

83. Clausing & Avi-Yonah, *supra* note 82, at 13–18.

84. If adopted by the United States. It may be a revenue loser for other countries. See *infra* note 85 and accompanying text.

85. Clausing & Avi-Yonah, *supra* note 82, at 25.

86. See generally Walter Hellerstein & Charles E. McLure, Jr., *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 INT'L TAX AND PUB. FIN. 199 (2004).

87. See generally *id.*; Walter Hellerstein, *Recent Developments in U.S. Subnational Taxation with International Implications*, IBFD BULLETIN (forthcoming) (discussing countries that are attempting to abandon the physical presence test for permanent establishment).

services are being performed remotely, driving a greater wedge between the sourcing rules for sales of personal property and the sourcing rules for service receipts. Here, context demands reform on both the national and subnational levels.

Larger economic forces are at work too. To tax income at origin is to tax capital, which is “more mobile than consumers and the destination of consumer purchases.”<sup>88</sup> Thus, capital can migrate more easily to low-tax jurisdictions. As a consequence, taxing jurisdictions are being compelled to adopt more destination-based income tax regimes. On the subnational level, for example, several states have adopted destination sourcing for services<sup>89</sup> and have super-weighted the sales factor of the apportionment formula.<sup>90</sup> Internationally, noted academics are calling for the same.<sup>91</sup>

In short, as the world economy continues to integrate, the same questions may prompt the same answers.

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88. See Fox, Luna, and Murray, *supra* note 16, at 148 (describing factor mobility at the subnational level).

89. For example, Georgia, Illinois, Iowa, Maryland, Minnesota, and Wisconsin have adopted this.

90. Fox, Luna, and Murray, *supra* note 16, at 148. A number of states have gone so far as to adopt single sales factor apportionment.

91. Clausing & Avi-Yonah, *supra* note 82, at 13–18 (advocating single sales factor apportionment and destination sourcing rules).