Sales Factor Formulary Apportionment of Global Profits as an Alternative System of Taxation of to the Current U.S. Federal Corporate Income Tax

To: Senate Finance Committee
Attention: Subcommittee on Business Income Tax
Subject: Sales Factor Formulary Apportionment of Global Profits as an Alternative System of Taxation of to the Current U.S. Federal Corporate Income Tax
Submitted on: April 13, 2015
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About Salesfactor.org

We are a group of individuals interested in fixing the corporate tax system. Concerns include leveling the playing field between domestic and multinational corporations and also improving U.S. competitiveness in world markets. Some of us are or were academics. Others have business backgrounds. Some are employed by research organizations. The three principals are: Jerry Wegman, a retired business law professor and a former judge and prosecutor. Bill Parks, a retired professor of finance and founder and president of NRS, a 100% employee owned company in the paddlesports industry. Walt Minnick, a former CEO of a fortune 1000 company and former Congressman from Idaho.

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INTRODUCTION

The Senate Finance Committee has invited these comments because it agrees with the common perception that our corporate tax code is broken. Proposals for reform will fall into one of two camps: those that maintain that a patchwork of modifications will suffice and those that maintain that an entirely new approach is needed. This comment falls into the latter category. We believe that the current corporate tax system is fundamentally flawed and cannot effectively tax multinational corporations (MNCs). It should be replaced with a unitary system that uses apportionment. We further believe that the most effective apportionment formula is one based solely on sales: Sales Factor Apportionment (SFA).

The current system is fundamentally flawed because it is based on a fiction. That fiction maintains that foreign subsidiaries of U.S.MNCs are separate companies so they are taxed as separate entities. This makes it easy to shift accounting income from the U.S. parent to, for example, a subsidiary in Cayman Islands, where there is no corporate income tax. In the extreme case, as Professor Kleinbard has pointed out, this can result in "stateless income" that is not taxed in *any* jurisdiction[1]. While this is good news for some companies, it has resulted in tax base erosion that threatens the integrity of our revenue collection system.

Unitary taxation, on the other hand, is not based on fiction but on economic reality. It treats a company and all of its world-wide subsidiaries and entities as a single enterprise. So for tax purposes it is irrelevant whether a dollar of profit was "earned" in California or in Cayman Islands. Unitary taxation aggregates all profits, from all entities in all countries. Total world-wide profits are then allocated, or apportioned for tax purposes to each country according to a formula. This is how the U.S. states tax companies that have earnings in more than one state. Their apportionment formulas vary from state to state but the most popular formula is based solely on sales.

Here is a short, simplified example of how it works: an MNC has 60% of its sales in the U.S., and 40% of its sales in foreign countries, using various entities. This company has total world-wide income of $10 billion. Under unitary taxation, with a sales-based formula, 60% of its income, or $6 billion, is taxable by the U.S. The other $4 billion is taxed by the foreign countries in which it is earned, and is exempt from U.S. tax. This is therefore a "territorial" system, which some companies have been seeking for many years. But while a conventional territorial system, without unitary taxation, would exacerbate income shifting and other tax avoidance practices, the territorial system associated with unitary taxation ends most of those offensive base-erosion practices. Income shifting becomes pointless, and the incentive for tax motivated inversions disappears.

SALES FACTOR APPORTIONMENT IN OPERATION

Sales Factor Apportionment (SFA) is a system for taxing firms that operate in multiple tax jurisdictions. It is territorial because the tax would apply only to the economic activity that takes place within the U.S.

[1] Kleinbard, E. "Stateless Income" *Florida Tax Review,* Vol. 11, 2011, p. 699. (This article provides numerous examples, which are too lengthy and complex to include in this paper).

Profits attributed to overseas economic activity are not taxed. After adopting an apportionment-based system, overseas profits may be repatriated immediately and with no repatriation tax.

The existing two trillion dollars of untaxed overseas profits presents a different problem. That money can be repatriated using a transition tax, as proposed by the administration. Or, as an alternative, SFA could be applied retroactively, to determine how much U.S. income was shifted abroad. Then only the shifted income would be taxed. Using SFA as a vehicle for repatriation is discussed in Appendix C, below.

SFA uses sales as a proxy for economic activity and a corporation's global profits as the tax base. The U.S. and most other countries have been using earnings as a proxy for economic activity when assessing income tax. But this proxy has proven to be ineffective, because accounting earnings can be easily shifted to low tax jurisdictions and to tax havens under our current system.

Though SFA is not a sales tax, it is method of allocating earnings for income tax purposes based on sales. It uses sales to determine how much of a company's worldwide income should be taxed in a given jurisdiction. Worldwide income includes both income from operations and passive income from investments. With SFA, foreign sales, operations, and profits are not taxed, exactly the same as with a conventional territorial system.

Why not then simply adopt a conventional territorial tax system? Because it would make matters worse—far worse. Under a conventional territorial system multinationals would have an even greater incentive to shift income to tax havens. As noted above, for every dollar shifted, a dollar of taxable U.S. income is taken away. All of the current tax avoidance practices would be intensified. The lost revenue to the Treasury would increase, and would have to be made up by higher tax rates or reduced spending [2].

ADVANTAGES OF UNITARY TAXATION AND SFA

1.Eliminates the International Competitive Disadvantage of our MNCs

Our multinational corporations (MNCs) complain that they suffer a competitive disadvantage in international markets because of our universal tax system and higher tax rates. SFA eliminates this disadvantage by leveling the competitive playing field for our MNCs in *all* countries. Consider the following example:

A UK company, "Limey Spirits", competes with a U.S. company, "Black Daniels" selling whisky in international markets. These two companies compete for whisky sales in Mexico. Under SFA there is no U.S. corporate federal income tax related to Black Daniels's sales in Mexico. Under UK law there is also no UK corporate income tax on Limey Spirits' sales in Mexico, because the UK uses a territorial system. However, both companies are subject to Mexico's corporate rate of 30% if they maintain permanent establishments there. The result is a perfectly level playing field between the U.S. Company and its UK competitor.

[2] This is why the U.K. recently acted a "diverted profits tax". They realize that what Starbucks did with its U.K. stores was more widespread than originally thought and that it was the U.K. territorial regime that encouraged this. The diverted profits tax is an attempt to remedy this income shifting without repealing their territorial system. It is really an admission by Her Majesty's Treasury that the conventional territorial system is deeply flawed.

Now consider investment under SFA. Let's assume that Black Daniels wants to increase its worldwide sales. In order to do that it plans to build a new distillery. Will the higher U.S. rate discourage location of that distillery in the U.S.? Regardless of where the distillery is built, corporate income tax assessed in the U.S. will be related only to the sales made in the U.S. Where it locates its distillery will make no difference to its U.S. income tax liability.

Countries can still compete for investment on the basis of climate, workforce, location, availability of natural resources, or other factors. So Black Daniels might decide to locate its new distillery in Ireland in order to be closer to the European market, but corporate income tax rates will not affect that decision.

2.Levels the playing field between U.S. domestic companies and their MNC competitors

Currently, purely domestic companies pay a higher U.S. corporate income tax rate than their MNC competitors. This is because income shifting to tax havens and other practices are not available to domestic companies. SFA will eliminate this unfair disparity because all companies' U.S. sales will be taxed at the same rate. Better still, by eliminating tax avoidance practices like income shifting, revenue collection will increase without any increase in rates. If Congress wants to make a shift to SFA revenue neutral, it could lower the statutory rate for *all* companies, again providing a level playing field between domestics and MNCs. This will be particularly helpful to small business, which is almost always purely domestic.

3.Eliminates The Most Egregious Tax Avoidance Practices

With SFA it does not matter where income is earned, since SFA taxes a percentage of a company's *worldwide* income. Whether an extra billion dollars was earned in the U.S. with its 35% rate or in the Cayman Islands with its zero % rate, would make no difference. The extra billion dollars would add to the company's worldwide income. If 60% of its sales were in the U.S., the company would owe income tax on 60% of its worldwide income, including the extra billion dollars, regardless of where the company asserted that the money was earned.

As a result, there would be no incentive to use creative accounting or uneconomic practices to shift U.S. earnings to tax havens. Tax avoidance practices like patent transfers, transfer pricing, and internal loans to create interest deductions in the U.S. would be pointless. Tax havens would lose their raison d'être. The incentive for a corporation to invert would also be eliminated, at least with respect to future earnings. And U.S. companies would no longer be subject to takeover by foreign companies that are motivated by tax savings.

4. Provide More Efficient and Transparent Tax Administration

SFA will be much easier to administer than the current separate accounting system. In order to curb egregious tax avoidance through the use of transfer pricing, countries attempt to use the "arm's length principal" (ALP) that bases transfer prices on comparable market prices. Unfortunately ALP has failed because of the absence of comparables for intangible like intellectual property[3], inconsistency in different countries' ALP rules, and abuses like the Swiss pharmaceutical company Hoffman-LaRoche's transfer price of £ 922 per kilo for an ingredient that could be obtained for £20 per kilo[4]. Given the pace of

[3] Sheppard, "Reflections on the Death of Transfer Pricing" *Tax Notes Today,* Sept. 17, 2008
[4] Picciotto, "Towards Unitary Taxation of Transnational Corporations" *Tax Justice Network,* 2012.

growth in innovative technologies like Facebook and Netflix, it is doubtful that comparables could ever be found for many of the most significant technologies being developed.

As the U.S. General Accounting Office (GAO) stated "the IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on inter-corporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers[5]". The GAO Report went on to recommend that the Treasury Department study unitary taxation and apportionment as an alternative to the current system.

In contrast, SFA is far more transparent and efficient. Companies publish their sales figures in their annual reports. If, for example, a company had sales of $1 billion in the U.S., this is a hard number, easily verifiable and far less subject to accounting manipulation than ALP prices. Calculating a company's tax obligation would be a simple matter of taking its U.S. sales as a fraction of its world-wide sales, and then applying that fraction to worldwide income. This simplicity offers much less opportunity to game the system and would greatly simplify tax administration. Companies will always seek to maximize their sales, whenever and wherever possible, because every dollar of sales adds to net profit.

Collectively, companies would substantially reduce their costs in legal, accounting and administrative fees by not having to maintain complex income-shifting programs. The need for two sets of books to be maintained--one reflecting economic activity and the other reflecting legal maneuvers to account for multinational sales and expenses in order to orchestrate a low "taxable income" as defined by the Internal Revenue Code (IRC) would all but vanish. Government revenue collection cost would also decline.

5. Will Stimulate Exports

U.S. exports will be stimulated because under SFA export sales would be free of corporate income tax. This added incentive will reduce the U.S. trade deficit that has existed for the last 30 years. Moreover, as U.S. production increased, good-paying jobs at home would be created.

Foreign competitors, seeing the benefits of SFA, might demand that their own governments adopt SFA also. This could help bring about the ideal condition where all nations use apportionment to equitably tax profits from multinational operations. But the success of SFA in the U.S. does not depend upon other nations also adopting an apportionment regime, as explained below.

REVENUE EFFECTS OF TRANSITIONING TO SFA

Would Allow a Rate Reduction While Maintaining Revenue Neutrality

As noted earlier, SFA eliminates most of the egregious tax avoidance practices some companies employ. Even though SFA does not tax foreign earnings, the increased revenue generated by closing loopholes more than compensates for this loss. As a result, moving to a unitary system with SFA would allow a minimum of a four percent reduction in the statutory rate, while maintaining revenue neutrality. Calculation of this rate reduction is complicated, so it has been placed in Appendix B, below.

SHORTCOMINGS OF UNITARY TAXATION

As the Committee well knows, no system of taxation will be perfect. The pressure to minimize taxes (a legitimate activity) will lead to creative solutions that were not intended or envisioned by Congress. But one principle is incontrovertible: the simpler and more transparent the system is, the less it will be subject to gaming. That is one of the essential strengths of unitary taxation using a single sales factor as its apportionment formula.

While we believe that a unitary/SFA system is best, we do not claim it is perfect. Shortcomings have been alleged. These shortcomings can be avoided or mitigated, as described below. The Committee should not allow the perfect to become the enemy of the good.

1. The Conduit Problem

The most common challenge to unitary taxation and apportionment has been called the "conduit problem". This involves the use of foreign third party agents who serve as conduits for export goods to be re-sold in the U.S.[6] In this way a firm's U.S. sales are made to appear as non-U.S. sales. The effect is to reduce the firm's SFA ratio, and therefore its taxable income.

If all of a firm's sales would fall neatly and easily into the categories of either U.S. sales or non-U.S. sales, SFA would work flawlessly. Alas, in the real world there will be some crossover between these two categories: some goods sold abroad will ultimately be re-sold in the U.S., and some goods initially sold in the U.S. will ultimately be resold and consumed outside the U.S. However, as we will show, this problem is minimal and manageable.

There are only two ways in which a company's U.S. sales can be made to appear to be non-U.S. sales: intentionally, or non-intentionally. We will first consider intentional, willful attempts by a company to use conduits in order to make some of its U.S. sales appear to be non-U.S. sales.

Intentional Crossover

The ratio of U.S. sales to worldwide sales may be called the SFA ratio. If a company lowers its SFA ratio, it lowers its tax liability. Companies will not want to actually lower their U.S. sales, because that will lower their profits. But if companies can make it *appear* that they have lower U.S. sales, their tax obligation declines. In order to do this, they would be tempted to enter into sales contracts with independent third party agents located in foreign counties. Those agents would serve as conduits, shipping the goods in to the US.

There are at least four ways to defeat an intentional, willful conduit strategy.

First, SFA rules could require that any firm claiming non-U.S. sales must have its CEO personally certify that SFA rules were complied with, including rules prohibiting willful conduit sales. CEO certification has been long been required by the Securities Exchange Commission for certain reports[7] submitted to it. This has enhanced the reliability of those reports.

Second, SFA rules could require that all non-U.S. sales must be confirmed by documentation that the goods actually left the U.S. or were manufactured and sold outside the U.S. SFA rules could include

[6] Gleckman, "Could the U.S. Fix Taxation of Multinational Corporations with a Sales-Based Formula?" *Tax Policy Center*, Aug. 26, 2014.
[7] 15 U.S.C. 78m, 280(d).

"safe harbor" practices that exporting firms could employ that would insulate them from liability in the event that export goods were ultimately sold in the U.S. These safe harbor practices could include:

a) Having the U.S. firm exercise due diligence to determine the bona-fides of foreign buyers.
b) Policing their U.S. distributors to make certain that they are not selling the firm's re-imported goods.
c) Terminating the distributorships of violators who sell re-imported goods.
d) Applying serial numbers that could be tracked by U.S. Customs Service.
e) Marking "not for sale in the USA" on export goods.
f) Requiring that all export contracts contain provisions barring re-sale in the U.S.

Third, SFA rules could include penalties making willful conduit sales a violation resulting in confiscation and fines. After all, willful violation is a form of tax fraud. These rules could make repeated willful conduit sales an offense punishable by jail sentences. SFA regulators would perform spot check audits of companies claiming export sales, to discover cheating and to deter violators. While there will always be a small number of rogue companies, like Enron, the great majority of U.S. firms seek legitimate profits.

Fourth, SFA could make effective use of the International Harmonized Tariff System[8] (HTS). This system uses an internationally established code that uniquely describes each product. When a company exports its product, the HTS code is noted. If a company then imported that same product, the HTS codes would match, and it would be easy to demonstrate that this was a conduit sale.

These four methods of preventing intentional conduit sales will discourage the practice, making this problem *de minimis*.

Unintentional Crossover

In spite of good faith efforts by corporations, a small amount of innocent non-intentional crossover is likely to occur. Consider the following examples:

A U.S. company, U.S. Motor (USM), manufactures fractional horsepower electric motors. This company sells its products primarily in large lots to other companies that use them as components in their own products. USM makes half its sales to customers in the U.S., and half to non-U.S. customers. Its SFA ratio is 50%.

USM might legitimately make 20% of its non-U.S. sales to a large, foreign distributor of component parts in Ireland, called Ireland Parts (IP). IP could assure USM that it did not intend to resell USM's goods in the U.S. market, and the USM-IP sales contract would contain the anti-import provisions described in safe harbor (f) above. Thus USM will have acted in full compliance with SFA rules, and is shielded from liability. Now let us assume that there is a worldwide shortage of fractional horsepower motors and IP sells some USM motors through brokers to U.S. manufacturers or distributors. Even though USM in good faith believed that the motors it sold to IP would remain outside the U.S., some have unintentionally crossed over back into the U.S. market.

But countervailing sales would also occur. As noted above, USM makes half its sales in the U.S. Let us assume that 10% of MSM's U.S. sales are to a large U.S. distributor of component parts, called U.S. Parts

[8] "Harmonized Tariff Schedule of the United States" *U.S. International Trade Commission,* 2014.

(USP). Due to the shortage of fractional horsepower motors, USP sells half its USM motors to a Swedish firm to drive that firm's high-tech vacuum cleaners. Most of those vacuum cleaners are sold in Europe. In that case some of USM's U.S. sales have unintentionally crossed over and become non-U.S. sales.

Even though there will be a small amount of innocent crossover in both directions, the net effect will likely be minimal and not worth pursuing. For SFA rules to require documentation of the complete supply chain would be unduly burdensome and inefficient. So long as companies make a good faith effort to comply with SFA rules, they will not be penalized. No taxation system is perfect[9], and this minor imperfection is vastly outweighed by other benefits of SFA.

2. The Component Parts Problem

A U.S. company might find sales opportunities overseas in which it knows that its products will become component parts of a product that will be sold in the U.S. For example Qualcomm, a manufacturer of computer chips, sells a million chips to Apple's manufacturing facility in China which are then used as component parts of Apple's iPhones. If some of those iPhones are then sold in the U.S., should Qualcomm's chips still count as non-U.S. sales for SFA purposes?

There are two possibilities. One is to require that a company claiming non-U.S. sales must provide evidence of the entire supply chain, in order to demonstrate that exported goods have not returned to the U.S. This places a significant record-keeping burden on U.S. exporting companies, and may not be feasible in all cases. A second possibility would be to allow component parts to return to the U.S. and still count as non-U.S. sales.

We favor the second approach. If a company like Qualcomm were taxed on its returning component sales, then it would be at a competitive disadvantage with respect to marketing its product in China. Apple's Chinese facility can source its needed chips from any country. There would certainly be no benefit to the Treasury if Apple chose to source those chips from Samsung in Korea, or from some other country. By choosing Qualcomm's chips, U.S. exports are increased and our balance of trade is improved. Our tax code is filled with instances of favorable tax treatment for desirable activities, and this would be one more instance.

Is this an imperfection in SFA as a tax system? Perhaps. But as noted below, no tax system is perfect, and this is a small flaw in an otherwise very efficient and effective system. This is another situation in which the International Harmonized Tariff System[10] (HTS) would be useful. The imported iPhones would have a different HTS code from the exported chips, clearly indicating that this was not a conduit sale situation.

3. Can The U.S. Act Alone?

It is alleged by some that a move to unitary taxation would require international cooperation and agreement. While coordinated international adoption of sales factor apportionment may be desirable, it is

[9] Mazerov, "The 'Single Sales Factor' Formula for State Corporate Taxes, A Boon to Economic Development or a Costly Giveaway?" Center on Budget and Policy Priorities, 2005, *www.cbpp.org/3-27-01sfp.pdf* (States that employ SFA occasionally encounter special situations in which application of the normal rules of SFA yields illogical results. They adopt special rules to deal with such cases).
[10] "Harmonized Tariff Schedule of the United States", note 7, above.

not a prerequisite for U.S. adoption. Different countries might choose different apportionment formulas, much as the U.S. states have. California uses a sales-only formula, while North Dakota uses a three factor formula with equal weight on sales, payroll and property. Each country is free to select a formula that meets its particular needs, just as each country selects its own tax rate. Writing in support of a unitary system of multinational taxation, Professor Sol Picciotto has stated that while it is "desirable that the allocation formula should be agreed among states … an agreed formula is not essential"[11].

The U.S. multinational tax system is already unique. While almost all other countries utilize a territorial system, we use a universal system. Our corporate rate is also out-of-step with most other countries. Moreover under the current system different countries use different transfer pricing rules and they have different standards for what constitutes a "permanent establishment". If the U.S. adopted SFA it is likely that other countries would follow our lead. The European Union has been considering moving to an apportionment system for at least a decade.

Following U.S. adoption of SFA, foreign-based multinationals would observe the advantages this system provides. Export sales are incentivized because SFA does not assess income tax on foreign sales. Labor organizations in foreign countries would see how domestic labor is favored under our sales-only formula, so they might also encourage SFA for their own countries. And all foreign multinationals would envy the relative simplicity and reduced compliance costs of our system.

When new ideas for international taxation come up in the discussion for tax reform, often a critique is that the United States cannot act independently of our economic partners (namely, member states of the Organization for Economic Co-operation and Development, the OECD).. However, the U.S. has been a successful first-mover in a number of international tax rules in the past—the prime example being the adoption of the Foreign Account Tax Compliance Act (FATCA), that requires every bank anywhere in the world to provide information on U.S. citizens who have accounts with them. The United States adopted this system independent of any consultation or agreement with foreign countries. Today more than 100,000 banks have signed agreements with Treasury and successfully use the special electronic network created to pass the information to the Internal Revenue Service (IRS). Another example of the U.S. being a successful first-mover is in the adoption of financial industry regulations included in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010. Many OECD members have since then passed laws similar to the provisions in the U.S. bill for regulatory reform.

4. Harm to Less Developed Nations

Some critics agree that SFA is clearly beneficial for the U.S. but they worry that it would further disadvantage less developed countries, particularly those with export driven economies with underdeveloped consumption sectors. However, the goal of a completely uniform worldwide tax system is not only unrealistic, but undesirable. While a sales-only apportionment formula will work best for the U.S. and perhaps other mature economies, there is no reason why every country should adopt that same formula. Countries like Malaysia or Nigeria, with export-based economies, might be best served by a formula that emphasized employment or investment.

The experience of the U.S. states has proven that tax jurisdictions with diverse apportionment formulas can co-exist profitably. California's sales-only formula serves the needs of that state, while North

[11] Picciotto, "Towards Unitary Taxation of Transnational Corporations" *Tax Justice Network*, 2012.

Dakota's three part formula works well there. Diverse apportionment formulas could also profitably co-exist internationally.

Apportionment is likely to be more beneficial to less developed countries than the current system. After selecting a formula that meets their needs, less developed countries would find that administration and tax collection are less costly than the complex system used today. Problems with transfer price determination and arm's length principles (ALP) discussed below, would disappear. The greater simplicity and transparency of apportionment would help less developed countries to collect income tax from sophisticated multinational corporations.

5. The Stateless Income Problem

Some critics of unitary taxation have alleged that it will increase the incidence of stateless income. Stateless income is income that is not taxed in any jurisdiction. It is an unfortunate feature of our current system. It has become the holy grail of multinational tax avoidance, and multinationals have become adept at it. Professor Kleinbard has called stateless income a "pervasive presence"[12]. An apportionment tax system, such as SFA, will not entirely cure this problem. However, the simplicity and transparency of SFA's unitary tax approach will likely help. In the apportionment system used by the U.S. states it is called "nowhere income"[13]. The U.S. experience is illustrative.

An example of nowhere income is when a company has all of its management and production in California, which uses a sales-only apportionment formula, but it sells all of its products in other states. That company's SFA ratio is zero, therefore it owes zero California income tax. If that company had no significant out-of-state operations, [14] (or "nexus", a concept analogous to the "permanent establishment" concept used internationally) then the California company would pay no state income tax on its U.S. income.

This potential problem was recognized early on. In 1957 the Uniform Division of Income for Tax Purposes Act (UDIPTA) addressed this problem with a "throwback rule". Under this rule when a corporation makes an out-of-state sale in a state where that corporation had no nexus (and therefore the income associated with that sale was not taxed) then that sale is treated as a sale within the home state. Throwback was subsequently adopted by the state legislatures of about half the states[15]. If the U.S. adopts SFA, it could also include a throwback rule.

There are other provisions for correcting anomalous results that might arise under apportionment. The U.S. Multistate Tax Commission has an alternative dispute resolution program to resolve claims by either taxpayers or collectors. Also, UDIPTA's Section 18 includes an "Equitable Adjustment" provision that can be applied by the courts of the taxing jurisdiction. These correctives could also be adopted in an international context.

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[12] Kleinbard, E. "Stateless Income" *Florida Tax Review,* Vol. 11, 2011, p. 699.
[13] "'Nowhere Income' and the Throwback Rule" *Institute on Taxation and Economic Policy: Policy Brief,* Aug., 2011.
[14] No nexus exists if a company sells its product directly to customers in other states, without having warehouses, an out-of-state sales force, or other significant operations in those other states.
[15] "Corporate Income Tax Apportionment and the 'Single Sales Factor'" *Institute of Taxation and Economic Policy,* Aug. 2012.

6. Double Taxation

We recognize that if other counties follow the U.S. and also adopt unitary taxation, there is the potential for double taxation of world-wide profits. This is because two countries may use different formulas for apportionment. The same issue exists today among the states of the U.S. The resolution of this potential problem internationally would follow the same system that today resolves double taxation issues among the states.. This system uses bilateral agreements to establish state-specific adjustments to a tax base and competent authority to resolve company–specific conflicts that the treaty does not provide a solution for. This system has worked successfully in the U.S. for a hundred years and there is no reason to think that it could not work as effectively in an international context.

7. Political Feasibility

Some might object that while unitary taxation with SFA would be a huge improvement, it is not politically feasible. This is because powerful interests benefit from the current system, and because experts in the field of international taxation have invested their careers in learning and refining the minutia of the current system, with its mind-numbingly complex arms-length principles (ALP). Even government agencies, including the Treasury Department, have resisted considering such a change.

Nevertheless, if given a fair hearing unitary taxation with SFA does have a chance to be adopted by Congress. This is because it has powerful appeal to both sides of the political spectrum. It appeals to the business community because it provides the territorial system it has long demanded. And, as noted above, it will eliminate any competitive disadvantage that our MNCs face, it will stimulate exports, it could result in lower corporate rates generally, and it will provide fairness to our purely domestic companies including small businesses.

At the same time unitary/SFA taxation will also appeal to liberal critics because it will end egregious tax avoidance practices that have allowed some companies to enjoy very low effective rates, at the expense of everyone else. It will address the current tax inversion trend that undermines revenue collection and encourages the attitude, famously expressed by Leona Helmsley that "only the little people pay taxes".

8. Is Single Sales Factor The Best Apportionment Formula?

Some will agree that a unitary system is best, but that the apportionment formula should include payroll and capital. This is because earnings are the product of both labor and capital, as well as sales. Three factor apportionment (equal weights for sales, assets and payroll) was the preferred formula first used by the states. The logic of a three factor formula worked well in the early twentieth century, particularly when taxing railroads. However, other industries found that they could reduce their state income taxes by moving assets and payroll out of the taxing state. In order to prevent these losses, more and more states have either reduced or eliminated payroll and property from their apportionment formulas. As Professor Stiglitz has pointed out, it is best to avoid taxing desirable things; employment and investment are desirable. This past summer, the U.S. Multistate Tax Compact unanimously voted to change UDIPTA's evenly weighted three factor formula to one that places more emphasis on sales[16].

[16] Griffith, "Single Sales Factor Apportionment May Be Inevitable, But Is It Fair?" *Forbes Magazine,* Sept. 18, 2014.

Economists tell us that any tax will create distortions in the economy. A sales-only apportionment formula will create the least amount of distortion because companies might make tax-motivated decisions with regard to locating employment or investment, but they will almost never sacrifice sales.

We believe that a sales-only formula will work best for the U.S. There are at least four reasons for this. 1) Of all of the factors commonly used for apportionment, sales is the least fungible and is the factor that companies will be least likely to forgo. As a result, a formula based solely on sales causes the least amount of economic distortion, thus maximizing economic efficiency. 2) It eliminates any competitive disadvantage that U.S. multinationals face because of our relatively high corporate tax rate. Income from sales in foreign countries would be taxed at those countries' rates. 3) It encourages exports because income from export sales is not taxed. 4) It levels the competitive playing field between U.S. domestic and all multinational companies.

While a sales-only apportionment formula will work best for high-consumption economies like the U.S. , there is no reason why every country should adopt that same formula. Countries like Malaysia, with export-based economies, rather than consumption based economies like the U.S., might be best served by a formula that emphasized employment or investment. The experience of the states of the U.S. has proven that tax jurisdictions with diverse apportionment formulas can co-exist profitably. California's sales-only formula serves the needs of that state, while North Dakota's three part formula works well there. Diverse apportionment formulas could also profitably co-exist internationally.

CONCLUSION

Unitary taxation using Sales as the apportionment formula is the preferred reform because it offers a more rational, efficient and transparent system of taxation while satisfying the demands of both liberal and conservative critics. It gives conservatives both the territorial system they want, and the competitiveness they need. It gives liberals an end to excessive tax avoidance strategies like income shifting and inversions that allow some companies to avoid paying their fair share.

SFA's unitary taxation approach is more rational and efficient because it more closely corresponds to economic reality. The current separate accounting system artificially treats foreign subsidiaries and affiliates as independent entities. Maintaining this fiction requires significant resources and complex, expensive tax administration both for corporations and for government taxing agencies.

SFA is not perfect, but its problems are manageable. There will be winners and losers, and probably unforeseen difficulties. But that will be true of any reform program. Winston Churchill once observed that "Indeed, it has been said that democracy is the worst form of government except for all those other forms that have been tried from time to time..[17]" The same might be said of SFA as a multinational tax system. It will not completely level the playing field between all companies in all industries. It will not frustrate every future tax avoidance plan that creative lawyers and accountants might devise. It will not be perfectly fair to everyone. But SFA will be a significant improvement over the current system. It will end the current crisis over tax inversions while stimulating U.S. exports. SFA will level the playing field between U.S. domestic and multinational companies. It will increase revenue available to the Treasury that can be used to reduce rates or to fund needed spending. SFA is not perfect, but it may be the least imperfect system of multinational taxation available.

[17] Churchill, *Speech in the House of Commons,* Nov. 11, 1947.

We urge the Committee to give serious consideration to this alternative approach to multinational taxation. We fully appreciate that powerful vested interests will adamantly oppose fundamental change, claiming that it is unrealistic or unworkable. But the evidence is overwhelming that the current system, with its income shifting, base erosion, and Byzantine arms' length principals (ALP) is not only unworkable but also grossly inefficient and unfair. The time for Band-Aid solutions is over. Only a bold, thoroughgoing approach can succeed.

APPENDIX A: CURRENT LOSS OF REVENUE DUE TO INCOME SHIFTING[18]

In 2010, the effective tax rate on repatriated foreign source income was 7 percent, while for domestic source income the effective tax rate was 33 percent. The ability to defer U.S. tax on foreign source income, allowing a multinational to control the timing of receipt of income for U.S. tax purposes, is a central benefit of the current tax system that has no analog for purely domestic companies. A consequence of this is that the *residual* U.S. corporate tax liability – the liability paid as tax to the U.S. Treasury – on foreign source income reported on U.S. corporate income tax returns is calculated at a tax rate that is roughly one-fifth of the tax rate that applies to domestic profits, as shown on the bottom two rows of Table 1 below.

Table 1. Taxable Income, Liability, and Average Rate for Corporate Income Tax Returns, 2008 through 2010, in $ billions

	2010	2009	2008
Income subject to tax (less REITs and RICs)	$1,022	$895	$978
Foreign taxable income*	$439	$404	$373
Domestic taxable income	$583	$490	$605
Income tax before credits	$355	$310	$340
Net income tax	$223	$205	$229
From foreign income	$30	$30	$22
From domestic income	$193	$175	$206
Effective average federal tax rate			
On foreign income	**7%**	**7%**	**6%**
On domestic income	**33%**	**35%**	**34%**

* Foreign taxable income calculated as the sum of subpart F income and repatriated earnings and profits of related foreign corporations, foreign branch income of U.S. parents, dividends received from foreign corporations and rents and royalties from foreign corporations.
Sources: Corporation Source Book, IRS Statistics of Income, 2008-10 and Form 1118, 2008-10.

Because 43 percent of corporate income reported on tax returns was foreign source income ($432 billion of $1,022 billion on the top two rows of table 1) the remaining 57 percent ($583 billion of $1,022 billion) was domestic source income. However, the amount of domestic source income reported on tax returns is much less than the amount of corporate profits reported annually by the Census Bureau. For 2010 the Census Bureau estimate of corporate profits was $1,254 billion, but this *amount includes $402 billion of understated corporate profits*. This is a large discrepancy between reported domestic corporate profits by the Census Bureau

[18] This section borrows heavily from "Sales Factor Apportionment of Global Profits as an Alternative Construction of a Corporate Income Tax Base" by Michael Udell and Aditi Vashist, Tax Notes July 14, 2014, at: http://districteconomics.com/wp-content/uploads/2014/07/USsalesfactorapportionment.pdf

and the amount of domestic corporate profits reported on tax returns and is largely due to multinational corporations shifting domestic profits overseas at which point the income becomes foreign source and eligible for deferral. Once domestic profits have been classified for tax purposes as foreign profits the deferral of foreign profits for tax purposes enables the very low effective tax rate on foreign source income show in table1 above. Unitary taxation with apportionment would largely eliminate this issue because sales factor apportioned profits of the current year would be taxable income of the current year. There is no deferral of current year profits. As the second row of table 2 shows understated domestic corporate profits on tax returns is a very large amount. This is where the current tax system has landed and we think that it is particularly unfair to purely domestic corporations who lack the pathways to convert domestic profits to foreign profits.

Table 2. Underreporting of Corporate Profits on Corporate Tax returns, as shown in The National Income and Product Accounts, 2008 through 2010, in $ billions

	2010	2009	2008
Total corporate profits (tax returns)	$1,254	$829	$903
BEA adjustment for misreporting profits on income tax returns	$402	$314	$287
BEA adjustment as a percentage of total receipts less reductions	32%	38%	32%

Sources: EconStats, U.S. National Income and Product Accounts, Section 7- Supplemental Tables.
Original source: U.S. Bureau of Economic Analysis, 2008 through 2010.

These two challenges – nearly unlimited elective deferral of foreign source income and the reclassification of domestic profits as foreign source profits - place purely domestic companies at a competitive disadvantage compared with multinational corporations. While tax policy has understood these challenges for decades, they persist.

APPENDIX B: RATE REDUCTION MADE POSSIBLE BY UNITARY TAXATION[19]

A reduction in the statutory rate for corporate income of at minimum of 6 percentage points will be possible, while maintaining revenue neutrality. Table 3 below provides an accounting of how easily this could be achieved.

Using annual financial statement data for U.S. and foreign domiciled corporations for 2010, Udell and Vashist show [20] that a corporate income tax base created from global profits[21] apportioned by sales in the United States could be as large as $1,572 billion for 2010 (see top row of table 3), compared with $798 billion of net income subject to tax reported for all corporations on 2010 returns.[22] Although this top-line estimate includes no policy adjustments such as contained in many tax expenditures, it is a near-doubling of the current tax base, and because it is sales factor apportioned to U.S. sales, consists entirely of domestic apportioned profits, and would raise the same revenue at a 13% statutory rate as is raised by the current U.S. corporate tax laws. That such a large corporate income tax base can be constructed under a sales factor apportionment rule not only means that there is a significant capacity to raise revenues, but also that there is a significant ability to lower the statutory rates for corporate income taxes considerably, all with the added bonus of achieving simplification for taxpayers and tax administration.

Of course, we recognize the need for Congress to be able to enact policy beyond the basic definition of the tax base constructed using global profits apportioned by geographic sales. For example, interest expense is a large deduction for corporations amounting to $597 billion on 2010 corporate tax returns, and is often considered one of the easiest means by which domestic profits can be reclassified as foreign profits. We do not dispute that companies should be allowed access to debt financing for investment in the United States. However, sales factor apportioned global interest expense could be considered as an alternative to the current interest expense measures reported on tax returns that exploit country-by-country separate accounting rules. Had global

[19] This section borrows heavily from "Sales Factor Apportionment of Global Profits as an Alternative Construction of a Corporate Income Tax Base" by Michael Udell and Aditi Vashist, July 14, 2014, at: http://districteconomics.com/wp-content/uploads/2014/07/USsalesfactorapportionment.pdf

[20] Udell and Vashist. 2014 op. cit.

[21] Global profits are defined as revenues less the sum of cost of goods sold, selling, general, and administrative expenses, and depreciation and amortization. This is a pre-tax, pre-interest expense, pre-other income definition of a tax base. For more information on book-tax adjustments, issues with GAAP versus IFRS accounting methods and geographic segment data, see Michael Udell and Aditi Vashist. 2014. op. cit. They argue that depending upon the importance of the differences, financial statement profits for some companies could be smaller than tax profits, and therefore it is not necessarily the case that U.S. apportioned global profits would be higher than reported tax profits.

[22] This is an estimate for all publicly traded C-corporations in the United States, excluding financial services including banks, securities dealers, mutual funds and real estate investment trusts. As the states have learned, this sector requires special rules for allocating income geographically due to the intangible nature of the business.

interest expense been apportioned by sales to the U.S., interest expense would have amounted to $259 billion, rather than $597 billion in 2010. Sales factor apportionment of a multinational corporation's global interest expense is agnostic as to the location of the lenders or business units. Because it is a global measure of interest expense *all intra-corporate debt is netted out* and cannot be used to create artificial deductions. Policing inflated interest expense deductions has been challenging for the current system, and sales factor apportionment eliminates this issue. Other major classes of offsets to corporate income tax such as a deduction for state and local taxes (shown on the third row) and *all* tax expenditures other than for foreign source income (shown on the fourth row) are also shown on table 3. Rather than beginning the discussion of tax reform by first eliminating all tax expenditures, table 3 shows that most could stay and Congress could decide which ones to eliminate or modify as part of a more reasoned policy discussion. The final row of table 3 shows sales factor apportioned global passive income which during 2010 was unusually small due to the global recession.

Table 3. Single Sales Factor Apportioned Global Profits Compared with $204 billion Corporate Income Tax Liability for All Industries Other Than Financial Services, in 2010, in $ billions [1]

Item	Amount of Adjustment	Tax Base	Static revenue at 35% rate	Static revenue neutral rate
Single Sales Factor Apportioned Global Profits		$1,572	$550	13.0%
Less sales factor apportioned global interest expense [2]	-$259	$1,313	$460	15.6%
Less U.S. taxes paid (SOI)	-$360	$953	$333	21.4%
Less tax expenditures other than for foreign source income [3]	-$291	$662	$232	30.9%
Plus sales factor apportioned global passive income [4]	$52	$714	$250	28.6%

[1] Net income on corporate income tax returns other than for financial services was $798 billion with after tax credit liability of $204 billion which is used to estimate the revenue neutral rate.

[2] Sales factor apportioned global interest expense is from financial statements. Tax return amount of interest expense for all industries excluding financial services was $597 billion in 2010. Because factors of production are not included in the apportionment factor for global profits, they have not been included in the allocation of interest expense.

[3] The tax expenditures excluded from this calculation are: inventory property sales source exception; deduction for foreign taxes paid instead of a credit; unavailability of symmetric worldwide method; apportionment of research & development expenses for determination of foreign tax credits; special rules for interest-charge domestic international sales corporations; deferral of active income of controlled foreign corporations; deferral of active financing income.

[4] Passive income defined as the difference between variables: Pretax Income and Operating Income After Depreciation less Interest Expense, as reported in the Compustat data base. Note that Compustat defines Pretax Income to be OIAD less Interest Expense, plus non-operating income, plus interest income. Thus, estimated U.S. share of passive income from financial statements is the sales-apportioned non-operating and interest income reported on SEC filings.

Allowing deductions for interest expense and state and local taxes paid, along with implementing *all* current tax expenditures[23] still raise as much revenue as under the current system, although with a statutory rate of under 31%. Additionally, adding back sales factor apportioned global passive income could further allow a reduction in the tax rate to less than 29%, effectively a full 6 point reduction in the statutory rate while still maintaining most tax expenditures.

The result: A sales factor apportionment regime could allow a minimum of a six percent reduction in the statutory rate, while maintaining revenue neutrality and allowing for all existing domestic policy measures implemented through the tax code, while greatly reducing the burden of compliance and administration on all actors in the tax system. Of course, in practice, there is likely to be greater benefit in the form of lower tax rates and increased revenues as the implementation of the SFA regime would allow Congress to reevaluate many of the loopholes and special interests that have unfortunately made their way into the Internal Revenue Code allowing preferential treatment to certain subgroups of taxpayers or activities, while making the Code much more difficult to comply with.

[23] Other than the foreign tax credit, which would be unnecessary since only the U.S.-share of global profits are taxed under sales factor apportionment.

APPENDIX D: HISTORY OF UNITARY TAXATION IN THE U.S.

For decades, U.S. states have adopted methods of formulary apportionment to define the portion of the federal corporate tax base attributable to each individual state, which is then used to determine the state corporate income tax liability for each company. This method allows the states to use the federal income tax system to define the overall base of corporate income subject to U.S. state taxes and then allocate it to individual states. Forty five states and the District of Columbia use a formula to apportion the portion of U.S. federal corporate taxable income to their state.

Historically, the formulas have been based on three inputs, or *factors*, to represent business activity, namely: sales (revenues), property (tangible assets) and payroll (employment). The sales factor is defined as sales in a given state, as percentage of total sales in the United States. The property and payroll factors are defined similarly, calculated as the portion of property or payroll in the state, as compared to total property and payroll of the entity within the United States. The original idea was for the state formulas to be based solely on property and payroll, founded on the theory that these factors lead to production, which generates income. However, states with greater consumption than production, often referred to as "market states," wanted the inclusion of a factor that would represent the source of the market for the business's product—and so a third factor, sales, was included. For many years, most states used *equal-weighted formulas* based on these three factors, i.e. giving equal importance to all three measures of business activity by taking an average of the three percentages. This resulted in the basic equal-weighted three-factor formula to calculate a business's state taxable income, from its total U.S. taxable income, as follows:

$$U.S\ Taxable\ Income\ \left[\frac{1}{3}\times\left(\frac{Sales\ in\ State}{Total\ Sales\ in\ U.S.}+\frac{Property\ in\ State}{Total\ Property\ in\ U.S.}+\frac{Payroll\ in\ State}{Total\ Payroll\ in\ U.S.}\right)\right].$$

However, as years progressed, individual states began to change the formulas to better suit their revenue needs and reflect business activity in their jurisdictions more accurately. For example, many states shifted towards a *double-weighted sales formula*, giving sales twice the importance as other factors (as of 2012, 22 of 45 states using formulary apportionment use an *over-weighted sales formula*). In the case of double-weighted sales, the formula to determine a business's state taxable income was modified to:

$$U.S\ Taxable\ Income\ \left[\frac{1}{4}\times\left(2\times\left(\frac{Sales\ in\ State}{Total\ Sales\ in\ U.S.}\right)+\frac{Property\ in\ State}{Total\ Property\ in\ U.S.}+\frac{Payroll\ in\ State}{Total\ Payroll\ in\ U.S.}\right)\right].$$

The motivation behind this shift stemmed from two reasons. The first was that states wanted to incentivize businesses to locate property (factories, offices etc.) and payroll (employees) within their boundaries, as it leads to further business activity—and state and local revenues in the form of property taxes from the business and its employees, as well as individual income and sales taxes from the employees for the business earning income and consuming goods within the state. The second reason for over-weighting the sales factor was due to the "stickiness" of sales. A company can more easily relocate their manufacturing plants, distribution centers, warehouses and offices (i.e., property) and their employees through training centers, sales forces, and management (i.e., payroll), than they can relocate sales. Businesses, with the goal of maximizing profits, will sell as much of their goods and services, wherever they can as long as it is profitable to do so. And the demand of goods and services is less in the control of a business than where they locate the inputs that go into creating their product. Economists refer to this as sales having a lower elasticity of business taxes, and property and payroll having a higher

elasticity of business taxes in any given location. In other words, business taxes in a location affect the inputs of property and payroll more than they affect sales. Through the decades, as states gained more experience with the implementation of formulary apportionment to determine the corporate state income tax base for businesses, many (as of 2014, 16 out of the 45 using formulary apportionment) gravitated towards what might be referred to as an "infinitely weighted sales formula," i.e., a *single sales factor formula* where the only factor used to determine the share of U.S. taxable income that makes up a state's taxable income for a business, is the sales factor, as follows:

$$U.S\ Taxable\ Income\ \left(\frac{Sales\ in\ State}{Total\ Sales\ in\ U.S.}\right).$$