Does Sales-only Apportionment of Corporate Income Violate International Trade Rules?

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In 1978, the year the U.S. Supreme Court sustained the constitutionality of Iowa's single-factor apportionment formula based on sales (at destination) of tangible personal property[1], almost all the states that imposed corporate income taxes placed equal weight on property, payroll, and sales. Now almost three-fourth of the states that have corporate income taxes place at least half the weight on sales, and eight base apportionment solely on sales.[2] It seems reasonable to believe that this trend will continue and that other states will adopt sales-only apportionment formulas in an effort to improve their competitive positions.[3] This note, which is intended to stimulate further analysis and debate, rather than provide a definitive conclusion, suggests that sales-only apportionment may violate international trade rules that prohibit export subsidies.[4] Given this purpose, we concentrate on the simplest case, involving the apportionment of income from the manufacture and sale of tangible personal property, where there appears to be a prima facie violation of international trade rules, inviting others to consider other more complex situations. Perhaps we should note at the outset that we are not arguing that international trade rules make sense; rather, we take them as given.

The international trade rules prohibiting export subsidies

Under international trade rules adopted during the Uruguay Round of multilateral trade negotiations in 1994, the world trade community reaffirmed and reinforced the long-standing prohibition against export subsidies embodied in preexisting trade rules and related understandings.[5] Specifically, the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM Agreement) defined a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance."[6] Prior to the adoption of the Uruguay Round Agreements, the General Agreement on Tariffs and Trade of 1947 (GATT 1947),

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The authors would like to thank Robert Green, Gary Hufbauer, Michael McIntyre, and an anonymous reviewer for helpful comments on an earlier draft of this article, which appeared as »Does Sales- Only Apportionment of Corporate Income Violate the GATT?« Working Paper 9060, National Bureau of Economic Research, July 2002. All errors are our own.

This article was previously published in Tax Notes, Vol. 96, No. 11 (September 9, 2002), pp. 1513-1520; State Tax Notes, Vol. 25, No. 11 (September 9, 2002), pp. 779-86; Tax Notes International, Vol. 27, No. 11 (September 9, 2002), pp. 1315–23.

[1] Moorman Mfg. v. Bair, 437 U.S. 267 (1978). This note concerns only the apportionment of income from the manufacture and sale of tangible personal property. Although some states assign sales from services on a market state or destination basis, most states assign sales from services on the basis of where the income-producing activity relating to those sales is performed. See Uniform Division of Income for Tax Purposes Act [UDITPA] § 17(a). Accordingly, single-factor apportionment of such sales often does not raise the issues addressed in this note, which concerns the exclusive use of a destination-based sales factor to assign income. Moreover, the original 1947 General Agreement on Tariffs and Trade (GATT 1947), discussed further below, applied only to goods. When the United States adopted the Uruguay Round Agreements, thereby extending the scope of international trade rules embodied in GATT 1947 to services under the General Agreement on Trade in Services (GATS), it explicitly reserved from the scope of the GATS national treatment requirement:

> Sub-federal tax measures which afford less favorable treatment to services or service suppliers of another Member based on the method of allocating or apportioning the income, profit, gain, losses, deductions, credits, assets or tax base of such service suppliers or the proceeds of a services transaction.

These reservations were submitted to the GATT on June 29, 1994 as a "Schedule of Specific Commitments for the U.S" in connection with its adoption of the Uruguay Round Agreements. The reservation quoted above was designated as "paragraph 3."

[2] See Mazerov (2001). Connecticut, Massachusetts, and Missouri are included in this count, since sales-only apportionment is available to manufacturers in the first two states and is an option in the third.

[3] Indeed, the California Assembly's Revenue and Taxation Committee has approved a measure that would change the state's current three-factor formula with double weight on sales to a single-factor formula based exclusively on sales, Pratt (2002a), and both incumbent Governor George Pataki of New York and one of his Democratic rivals (Andrew Cuomo) have supported New York's adoption of a single-factor sales formula. Plattner (2002). The California measure is currently on hold due to its revenue implications. Pratt (2002b).

[4] This is, of course, not all that is wrong with sales-only apportionment; see Hellerstein & Hellerstein (1998), at pp. 8-233 to 8-234; Hellerstein (1995); Mazerov (2001) and McLure (forthcoming). It appears at first glance that sales-only apportionment may also constitute a tax on imports that is prohibited by international trade rules. We do not discuss that possibility in detail, although we advert to it briefly in the notes below (see infra ns. 21&22), as there may be reasons why it would not actually have the effect of taxing imports, such as lack of nexus and the use of domestic affiliates of foreign corporations to make imports in states without single-factor sales formulas.

[5] In April 1994, after years of discussion, more than 100 participating countries signed agreements reached in the Uruguay Round of multilateral trade negotiations. The Uruguay Round negotiations were conducted under the auspices of the original 1947 GATT. The results of the Uruguay Round consist of the Agreement Establishing the World Trade Organization (WTO) plus 16 multilateral and two plurilateral agreements (including GATT 1947), which are annexed to the WTO Agreement, as well as many other annexes, decisions, and understandings referenced in the principal agreements. See generally Hellerstein (1995).

[6] Agreement on Subsidies and Countervailing Measures, Article 3.1(a).

which is now incorporated in the Uruguay Round Agreements[7], imposed general restraints on "any subsidy … which operates directly or indirectly to increase exports ."[8]

For many years, GATT's prohibition of export subsidies has been understood to prohibit so-called "border tax adjustments" (BTAs) for direct taxes, such as income taxes and payroll taxes, while permitting BTAs for indirect taxes, such as value-added taxes, sales taxes, and excise taxes.[9] Although the term BTA does not appear in GATT 1947, in 1970 a Working Group of the GATT described BTAs generically

> *as any fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products) (emphasis added).[10]

Sales-only apportionment appears to violate the international trade rules prohibition against providing export BTAs for direct taxes (hereafter simply "export subsidies").

The economics of formula apportionment[11]

The Need for Formula Apportionment

The American states have long recognized – and the Member States of the European Union are coming to realize – that geographically separate accounting is not practicable within a highly integrated economy such as the United States. First, economic interdependence within or between controlled corporations often makes it impossible to isolate the geographic source of profits on a separate accounting basis. Second, even if corporations undertook to account separately for the income earned in each state, the task would be fearfully expensive, because their books and records would need to be maintained to reflect the details of their business operations on a state-by-state basis. Third, separate accounting is vulnerable to the manipulation of actual or imputed transfer prices within the enterprise in a manner that shifts income to low-tax states. As a result, the states, like the provinces of Canada, have long employed formula apportionment to determine the portion of the income of multistate corporations they will tax.

Some states apportion the combined income of related corporations deemed to be engaged in a unitary business, rather than limiting apportionment to the income of separate legal entities. In the late 1980s, following a period in which some states combined the worldwide activities of commonly controlled corporations, the states, under political pressure from the federal government, foreign governments, and the business community, imposed "water's edge" restrictions on combined reporting.[12] A more detailed analysis of the basic question addressed in this note would take account of combination and other variations of state practice.

UDITPA and the multistate tax compact

During the first half of the twentieth century the states used a wide variety of divergent apportionment formulas, before converging toward the standard practice of employing three equally weighted factors of property, payroll, and sales in the formula used to apportion income. Throughout this period the quest was to find a formula that would accurately reflect the geographic source of income, tempered by the need to provide for a formula that

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[7] See supra note 5 and infra note 8.

[8] GATT 1947, Article XVI. The General Agreement on Tariffs and Trade 1994 (GATT 1994) consists of (1) GATT 1947 "as rectified, amended or modified" by the various legal instruments that entererd into force before the date of the WTO Agreeement; (2) provisions of legal instruments entered into force under GATT 1947 before the date of the WTO Agreement, including, among other things, "decisions of the CONTRACTING PARTIES to GATT 1947"; and (3) agreements reached during the Uruguay Round. GATT 1994, Paragaphs 1(a) -1(d).

[9] Hufbauer (2002a); Hufbauer (2002b). The prohibition of BTAs for direct taxes was originally implied by silence, but was made explicit in the Illustrative List of Export Subsidies contained in the Code on Subsidies and Countervailing Measures adopted in 1979 at the Tokyo Round and repeated in Annex I to the Uruguay Round Agreement on Subsidies and Countervailing Measures.

[10] The GATT Working Group on border tax adjustments, in its report of December 2, 1970, attributes this description to the OECD; see http://www.worldtradelaw.net/reports/gattpanels/bordertax.pdf, visited May 2, 2002. For a much more complete discussion, see Hufbauer and Erb (1984).

[11] For a more detailed exposition of the points covered in parts A and B of this section, see Hellerstein and Hellerstein (1998), Chapter 8.

[12] With the limited exception of oil companies in Alaska, all the states now limit mandatory combination to the "water's edge." That is, with limited exceptions for certain tax haven and other corporations whose activities are conducted predominantly in the United States, only domestic corporations are included in the combined groups and only the income of such corporations is apportioned. In some states, notably California, there is a water's-edge election; taxpayers that fail to make the election are subject to worldwide combined reporting.

fairly divided income among the states.[13] The broad consensus that emerged in favor of the equally-weighted, three-factor formula as a reasonable method for attributing income to the states embodied both traditional "sourcing" concepts in the weight accorded to capital (property) and labor (payroll) and the equitable claim of the "market" state to a share of the income tax base, as reflected in sales made into the state.[14] In 1957 the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law intended to provide the basis for uniform state taxation of corporate income. UDITPA, which was incorporated in the Multistate Tax Compact, codified the then standard equally weighted three-factor formula.[15] While 20 states are currently members of the Compact,[16] most have forsaken its underlying purpose to "[p]romote uniformity"[17] by abandoning the uniform apportionment formula and placing greater weight on the sales factor.[18]

The economic effect of sales-only apportionment

It is easy to understand why states have reduced the weight on property and payroll in their apportionment formulas and have increased the weight on sales. Formula apportionment has the economic effect of converting a tax on corporate income into a set of taxes on the factors in the apportionment formula[19] That is, the sales-related portion of the income tax is roughly equivalent to a destination-based sales tax[20], the payroll-related portion is equivalent to a tax on payroll, and the property-related portion is equivalent to a tax on property. Since both payroll and property are origin-based factors and sales is a destination-based factor, the shift in weights that is occurring reduces the weight on the *origin* of interstate sales used to assign income and increases the weight on the *destination* of such sales, thereby increasing the state's competitive position in both in-state markets and out-of state markets, including foreign markets. To see this in the case of foreign exports, consider the simple case of a corporate manufacturer, all of whose payroll and property are located in a single state, that either exports all of its output or sells all of it in the state where it is produced.

Exports. Under the equally weighted three-factor formula, if the corporation exported all its output, it would pay state tax on two thirds of its profits; under the formula that double-weights sales, it would pay state tax on half of its profits. By comparison, under sales-only apportionment, it would pay no state tax if it exported all its output.

Domestic (in-state) sales. Under any of the above formulas (equally weighted, double weighting of sales, or sales only), the corporation would pay state tax on all its income if it exported none of its output.

Net effect. These results can be summarized as in the Table. The net effect of placing greater weight on sales is to reduce the tax paid on income associated with exports, while leaving the tax on income associated with domestic (in-state) sales unaffected.[21]

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[13] In its comprehensive report to Congress on state taxation of interstate commerce, the Willis Committee observed that "[m]ost students of State taxation have assumed that the search for reasonable division of income rules necessarily resolves itself into a search for the 'sources' of income.'" Willis Committee Report (1964–65), p. 158. However, the Committee went on to note that a countervailing view held that the search for the "source" of income was misguided and that »the important issue is the proportion of the company's activities which take place in the each State, since 'these activities cause the state to incur the governmental costs which form the justification for its demand for a compensatory tax.« Id. at 158–59 (citation omitted). The Committee went on to point out the conflict between these two approaches, since

> [a] company with factories in two States … may conduct an unprofitable operation in one of the States by any standard which may be used for determining the source of income, but it can hardly be argued that its activities contribute to governmental costs only in the State in which its operation is profitable.

Id. at 159. On the history of the development of formula apportionment, see Hellerstein and Hellerstein (1998), Chapter 8; Weiner (1996).

[14] See Hellerstein and Hellerstein (1998), ¶ 8.06.

[15] Section 9 of UDITPA provides: "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three." Professor William J. Pierce, the principal draftsman of UDITPA, recognized that UDITPA's three-factor formula reflected both supply and demand factors and declared that the act "represents a compromise between the positions of consumer and manufacturing states." Pierce (1957), p. 781.

[16] Hellerstein and Hellerstein (2001), p. 576.

[17] Multistate Tax Compact Article I(2).

[18] Section 16(b) of UDITPA provides that sales made to a state where the taxpayer is not taxable are attributed to the state of origin. If this "throwback" rule were universally applied to foreign exports, it is less likely that sales-only apportionment would violate international trade rules, because the reduction of taxes on export income would occur only in circumstances when another jurisdiction had nexus with the taxpayer and thus a legitimate claim to tax at least a portion of that income. In any event, the wholesale adoption of the throwback rule would undercut the economic development objective of sales-only apportionment. It is worth pointing out, moreover, that many states (including, in particular those with single-factor or heavily-weighted sales formulas (e.g., Connecticut, Iowa, and Minnesota) do not employ the "throwback" rule.

[19] See McLure (1980). The effective tax rate on each factor depends on the profitability of the corporation, relative to the factor nationwide, as well as the statutory tax rate.

[20] The tax is, however, more like a multiple-stage tax on gross receipts than a single-stage retail sales tax. Again, we remind readers that our concern in this note is only with income derived from the manufacture and sale of tangible personal property.

[21] If, instead of the domestic manufacturer making foreign sales ("exports") in Table 1 we were to look at a foreign manufacturer making in-state sales ("imports"), then the fraction of income associated with in-state sales that is taxable in-state would be 1/3, 1/2, 100% under the same three formulas. We again assume that the domestic manufacturer has all of its property and payroll in the taxing state and ignore domestic payroll and property of the foreign manufacturer. It would, of course, be relatively simple for the foreign manufacturer to avoid nexus or make sales into a state without sales-only apportionment.

Fraction of income that is taxable in-state, assuming all output is sold in-state or is exported

	Domestic manufacturer making in-state sales	Domestic manufacturer making foreign sales ("exports")
Equally-weighted three-factor formula	100 percent	2/3
Double-weighted sales formula	100 percent	1/2
Sales-only apportionment	100 percent	0

Why sales-only apportionment violates international trade rules

In the case of sales-only apportionment the corporation in the foregoing example pays no tax in the state if it exports all its output, but pays tax on all its income if it exports none of its output. Thus sales-only apportionment falls squarely within the description of BTAs quoted earlier, *"fiscal measures which put into effect, in whole or in part, the destination principle* (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market ...)"[22] (emphasis added). Since corporate income taxes are direct taxes, sales-only apportionment constitutes an export subsidy of the type prohibited by the long-established understanding of GATT 1947[23] – an understanding that should command no less respect under GATT 1994. Indeed, Article XVI(1) of the WTO Agreement provides that "[e]xcept as otherwise provided …, the WTO shall be guided by the decisions, procedures, and customary practices followed by the CONTRACTING PARTIES to GATT 1947 and the bodies established in the framework of GATT 1947."[24] Moreover, Annex I(e) of the SCM Agreement lists among the "illustrative list of export subsidies," which are generally prohibited by Article 3.1[25], "[t]he full or partial exemption, remission, or deferral specifically related to exports, of direct taxes … paid or payable by industrial or commercial enterprises."[26] In short, sales-only apportionment violates international trade rules because it produces a destination-based income tax, which constitutes a prohibited export subsidy.[27]

Is there a persuasive case for sales-only apportionment?

To overcome the prima facie case that sales-only apportionment is a prohibited export subsidy, it would be necessary to argue persuasively that sales-only apportionment accurately reflects where income originates. After all, there is nothing wrong with an income tax that attributes income to the place where sales occur, provided that income originates where sales occur. Defenders of sales-only apportionment against the prima facie case advanced above would presumably base their position on the SCM's definition of a subsidy:

[22] The same thing occurs on the import side. Sales-only apportionment falls within the prohibited class of "fiscal measures which put into effect, in whole or in part, the destination principle (i.e. ... which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)" (emphasis added).
[23] See supra Part II.
[24] WTO Agreement, Article XVI(1).
[25] See supra Part II.
[26] SCM Agreement, Annex I(e).

[27] Despite the apparent subsidy for exports created by sales-only apportionment, we recognize that one may nevertheless argue that it does not constitute an export subsidy because such apportionment favors "interstate" as well as "foreign" exports. For example, if Corporation A and Corporation B, conduct all of their manufacturing operations in State X, which has adopted sales-only apportionment, and Corporation A sells all of its output to State Y while Corporation B sells all of its output to Country Z, one may contend that there is no violation of international trade rules because foreign sales are subsidized no more than domestic sales. Although this is plainly an issue that will require further exploration to determine whether the "prima facie" case set forth in this article will survive more extended scrutiny, we offer several preliminary observations at this juncture.
First, in the context of "national treatment" allegations against subnational legislation, the appropriate comparison is between treatment of in-state and foreign goods. See Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies, GATT Doc. No. DS17/R (18 February 1992) (report of the panel); United States – Measures Affecting Alcoholic and Malt Beverages, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). The fact that out-of-state goods are treated no better than foreign goods does not save the state legislation from condemnation under GATT. One might advance an analogous argument with regard to the treatment of interstate and foreign exports.
Second, as noted above, see supra Part II, the SCM Agreement defines a "prohibited subsidy" to include "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance," SCM Agreement, Article 3.1(a), and GATT 1947 imposes general restraints on "any subsidy … which operates directly or indirectly to increase exports ..." GATT 1947, Article XVI(1 Whether or not sales-only apportionment constitutes a "subsidy" that is "contingent, in law or in fact … upon export performance" or one that "operates directly or indirectly to increase exports" will depend, in the end, on a definitive interpretation by the WTO of the meaning of those phrases in the context of subnational measures and, in particular, whether "foreign" in that context should be construed to embrace all out-of-state sales.
Third, even if one were to conclude that (1) the "national treatment" analogy is inapposite because it deals with indirect taxes on goods rather than subsidies for direct taxes and (2) the language of Article 3.1 of the SCM Agreement and Article XVI of GATT 1947 requires a comparison between a state's treatment of all domestic sales and all foreign sales rather than between in-state and out-of-state sales, the more that the states adopt sales-only apportionment, the stronger the case becomes for establishing a violation of international trade rules. Indeed, if every state adopted sales-only apportionment, the subsidy "to increase exports" or "contingent … upon export performance" would be self-evident, however one defined exports. Consider the case of a federal tax with sales-only apportionment and the case in which all states had corporate income taxes and sales-only apportionment and assume, crucially, that nexus is not an issue. The first would clearly violate international trade rules, so the second, which is equivalent, also should.

[A] subsidy shall be deemed to exist if (a) (i) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e., where … (ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits) …; and (b) a benefit is thereby conferred.[28]

In substance, the defenders of sales-only apportionment would contend that it is not a "subsidy" at all within the meaning of the SCM Agreement, because it does not constitute revenue "otherwise due" but rather is a reasonable method of exempting income from foreign economic processes.[29] This seems to be a daunting task.

In adopting formula apportionment as the methodology for attributing income, one must accept that there is no objective standard for what is the correct apportionment formula. But one can appeal to common sense, economic analysis, judicial precedent, standard practice, the legislative history of sales-only apportionment, and federal law. None of these supports sales-only apportionment.

Common sense. The notion that only sales reflect where income is earned – that labor and capital make no contribution – is far-fetched.

Economic analysis. The common sense view that labor and capital contribute to the creation of income reflects – indeed, is probably grounded in – economic analysis. Income is the return to capital and labor. Sales are essential to the realization of income, but they are not enough, by themselves.[30]

Judicial precedent. The U.S. Supreme Court has opined that income "may be defined as the gain derived from capital, from labor, or from both combined."[31] While this statement is now regarded as an unduly narrow view of income, the notion that capital and labor should be ignored completely in determining the source of income flies in the face of the Court's observation that "the standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates."[32] We recognize, of course, as we observed at the outset of this note, that single-factor sales apportionment has survived scrutiny as a matter of federal constitutional law. But that was no ringing endorsement of single-factor sales apportionment as a method for apportioning income. To the contrary, the Court permitted a deviation from the "benchmark"[33] three-factor formula in *Moorman* only because to do otherwise would require "extensive judicial lawmaking"[34] and because Congress rather than the Court was the appropriate body to fashion such rules.

Standard practice. As noted earlier, until recently the equally weighted three-factor formula was the standard formula. "The three-factor formula … has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated"[35], and thus where income originates. Even now only a few states have shifted to sales-only apportionment. Canada uses payroll and sales, equally weighted, to apportion corporate income.

Legislative history. The states that have made the shift to sales-only apportionment have almost certainly done so only to improve their competitive position.[36] As a key economic advisor to the Governor of Georgia observed in explaining the state's adoption of a double-weighted sales factor, the legislation "offer[s] economic incentives for business expansions and locations here ... By promoting the activities of firms that have a physical presence – property and labor – in Georgia, [the legislation] should clearly have a stimulative

[28] SCM, Article 1 (emphasis supplied).
[29] See United States – Tax Treatment for "Foreign Sales Corporations," AB-2001-8, WT/DS108/AB/RW (14 January 2002) (Report of the Appellate Body).
[30] Indeed, some economists have argued that sales should be dropped altogether from the apportionment formula; see Harriss (1959); Studenski (1960), pp. 1131–32. We cite these authorities not because we necessarily agree with them but only to demonstrate the absurdity, from an economic standpoint, of the position that capital and labor may be ignored altogether in an income apportionment formula. Musgrave (1984) considered both "supply" and "supply-demand" based formulas. Although the former approach considers using only labor and capital as apportionment factors, the latter includes sales. Musgrave does not consider using only sales to apportion income.
[31] Eisner v. Macomber, 252 U.S. 189, 207 (1920) (quoting Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918) and Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913)).
[32] General Motors Corp. v. District of Columbia, 380 U.S. 553, 561 (1965).
[33] Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 170 (1963).
[34] Moorman Mfg. Co. v. Bair, 437 U.S. 267, 278 (1978).
[35] Container, 463 U.S. at 183.
[36] The following argument is typical of this line of reasoning: "[U]nder current tax policy, a company with multi-state operations faces a higher tax bill in New York if it locates jobs and investment here. For tax purposes, New York now allocates a company's income to this state based on three factors: in-state sales (which is counted twice), in-state payroll, and in-state property. By basing corporate taxation solely on in-state sales, New York can reward, rather than punish, employers that create jobs here ..." The Wire, newsletter of the Business Council of New York State., Inc., November 24, 2000, quoted in Mazerov (2001).

effect."[37] It seems unlikely that any state has made the shift because it thought sales-only apportionment accurately reflects where income is earned.

Federal law. Under the Internal Revenue Code, when a taxpayer manufactures goods within the United States and sells them outside the United States or manufactures goods outside the United States and sells them within the United States, the income "shall be treated as derived partly from sources within and partly from sources without the United States."[38] The implementing regulations describe two methods that may be used for dividing the income from these transactions between foreign and domestic sources. Under the so-called "50-50" method, one half of the income from these transactions is allocated to production activities and one half is allocated to the sales function – essentially a two-factor apportionment formula of property and sales.[39] Under the independent factory price (IFP) method, the taxpayer may elect to allocate income between foreign and domestic sources on the basis of an independent factory price that is "fairly established" by sales to unrelated third parties.[40] These rules are significant because they provide yet another piece of evidence as to what constitutes a reasonable standard for determining the source of income derived from manufacturing in one jurisdiction and selling in another. Whatever room for debate there may be about whether the formulary "50-50" method is superior to the "arm's-length" IFP method, one thing is clear: Under no circumstances, under federal law, can a taxpayer who manufactures in one jurisdiction and sells in another assign *all* of the income to the jurisdiction of the sale, which is exactly what sales-only apportionment does.

Do international trade rules constrain state tax policy?

International trade rules derived from GATT 1947 generally have been regarded as applicable to subnational governments. GATT 1947, Article XXIV:12 provides that "[e]ach contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories." As an eminent American authority on GATT has observed, "Article XXIV:12 obligates the United States to compel state adherence to [GATT] …".[41] Indeed, over the years a number of disputes involving subnational measures have arisen under GATT, including an American challenge to the practices of Canadian provinces regarding imports of beer *("Beer I")*[42] and a Canadian challenge to various U.S. national and subnational taxes and regulations applicable to alcoholic beverages *("Beer II")*.[43]

It was precisely because the international trade rules embodied in GATT and related agreements applied to subnational taxing measures that the American states expressed considerable misgivings about the impact on their taxing authority of the agreements reached during the Uruguay Round of multilateral trade negotiations.[44] While the preexisting understanding under the language and practice of GATT was that its rules applied to subnational measures, the new rules developed during the Uruguay Round for services (the General Agreement on Trade in Services (GATS)) were explicitly made applicable to subnational measures.[45] The states, speaking through the Multistate Tax Commission (MTC)[46] and the Federation of Tax Administrators (FTA)[47], objected both to the

[37] Georgia Department of Revenue, Georgia Revenue Quarterly, Vol. 17, No. 1, at 1 (1995) (quoting Dr. Henry Thomassen, economic advisor to Governor Zell Miller). Politicians and business groups in other states have expressed similar sentiments in supporting legislation to change their three-factor formulas with a double-weighted sales factor to a single-factor sales formula. See, e.g., Pratt and Goldberg (2002); (California) Plattner (2002) (New York)..

[38] I.R.C. § 863(b).

[39] Reg. § 1.863-3(b).The property factor is determined by reference to the location of the taxpayer's "production assets" within and without the United States. Reg. § 1.863-3(c)(1). The sales factor is determined by reference to the location of sales within and without the United States based on where rights, title, and interest of the seller are transferred to the buyer. Reg. §§ 1.863-3(c)(2), 1.861-7(c).

[40] Reg. § 1.863-3(b)(2)(i). Under a third approach, the taxpayer may apportion income from § 863 sales by the method it uses in keeping its books and records if it has received advance permission from the Internal Revenue Service to do so. Reg. § 1.863-3(b)(3).

[41] Hudec (1986), p. 221. see also Schaefer (2001), p. 630. Whether the trading partners of the United States can convince it to enforce their complaints against sales-only apportionment does not affect the basic issue of whether that method contravenes international trade rules.

[42] Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies, GATT Doc. No. DS17/R (18 February 1992) (report of the panel).

[43] United States – Measures Affecting Alcoholic and Malt Beverages, GATT Doc. No. DS23/R (Feb. 7, 1992) (report of the panel). See also Territory of Hawaii v. Ho, 41 Haw. 565 (1957) (GATT has same effect as treaty and therefore Hawaii law in violation of GATT is preempted under Supremacy Clause).

[44] See Aune (2002); Hellerstein (1995).

[45] See GATS Art. I:3(a) (defining "measures by Members" as meaning "measures taken by … central, regional or local governments and authorities").

[46] The MTC is the administrative arm of the Multistate Tax Compact. The Compact seeks to facilitate proper determinations of state and local tax liability of multistate taxpayers, promote uniformity or compatibility of state tax systems, facilitate taxpayer convenience and compliance, and avoid duplicative taxation. The MTC frequently supports the states' interests before judicial and legislative bodies. There are 20 state members and 19 state associate members of the Multistate Tax Compact.

[47] The FTA frequently represents the interests of states and state tax administrators before legislative bodies.

restrictions imposed by the GATT/GATS on their traditional taxing powers and to the impact of the new dispute settlement procedures under the WTO Agreement.[48] Whatever the merits of those objections, the crucial point for present purposes is the simple fact that the states made them, for it constitutes powerful evidence, if any were needed, that states are subject to the substantive discipline of contemporary international trade rules.[49]

What now?

Our purpose has been to stimulate debate, by suggesting that sales-only apportionment constitutes a prima facie violation of international trade rules. If that suggestion stands up to further analysis, one would expect the European Union and perhaps other trading partners of the United States to complain to the World Trade Organization that sales-only apportionment constitutes a prohibited export subsidy. If those contentions are sustained, sales only apportionment will have reached its high-water mark. If states want to improve their competitive position, they will need to do it honestly and transparently, by reducing corporate tax rates, perhaps replacing lost revenues with revenues from taxes levied explicitly – rather than implicitly – on payroll, property, or sales.[50]

If sales-only apportionment is proscribed, what formula would be allowable under international trade rules? This question is difficult to answer; as we noted above, the decision is, to some extent, arbitrary. It seems, however, that a formula that double-weights sales would be found acceptable; as noted above, Canada uses a two-factor formula that places half the weight on sales, as does the United States, at least in the context of goods manufactured by the seller.

[48] MTC and FTA spokesmen have expressed these concerns formally and informally to the Executive Branch, to Congress, and to the tax community through oral and written submissions. Their views are summarized in MTC and FTA (1994) and FTA (1994).

[49] The United States submitted a number of reservations to the new GATS rules (as distinguished from the preexisting GATT rules), including reservations relating to the states' use of formulary apportionment. See supra note 1. In addition, in enacting the Uruguay Round Agreements, Congress provided a number of procedural protections from GATT/GATS-based attacks on state laws, including a provision barring any "private" right of action challenging a state law under GATT or GATS. See 19 U.S.C. § 3512. Only the United States may bring such an action for the purpose of declaring a state law invalid under the Uruguay Round Agreements.

[50] Of course, those that levy sales taxes could also eliminate tax on sales to business; see McLure (2001).

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