Formulary Apportionment—Myths and Prospects

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Structure of the Presentation

- Introduction
- Explaining and distinguishing our proposal
- Assessing the proposal
- Concluding remarks, Q&A, and real-world examples for Discussion

Introduction

Main Argument: Taking the Middle Path

- A radical reform to a unitary tax system is not the only way to deal with the shortcomings of the arm’s length standard’s (ALS).

- Policymakers could *internalize* formulary alternatives into current tax arrangements and generate *better* (though not perfect) international tax policies if the tradeoffs of formulary arrangements were better understood.

Essence of the Proposal

- There is a need to distinguish formulary alternatives from unitary regime alternatives.

- Setting a hybrid regime in which:
  - ALS is applied when there are adequate market comparables (including comparable profit methods)
  - formulary solutions are applied when the ALS does not provide satisfactory results (primarily with respect to intangible assets).

Main Points

- While every unitary setting requires an allocation formula, formulary arrangements *do not necessitate a consolidated unitary framework*.

- Formulary arrangements have certain key advantages:
  - they constrain income shifting
  - they promote transparent and consistent treatment of intra-group transactions

- Many of the problems associated with adopting formulary arrangements have been misunderstood and exaggerated.

- The baseline to evaluating the merits of the proposal is the current ALS transfer pricing regime, which is highly dysfunctional (at least with respect to intangibles).

Part I: Explaining and Distinguishing the Proposal

Current Methods & Proposals

- Current transfer pricing methods are based on separate accounting of each entity and:
  - focus on transactions and activities
  - use market indicators to allocate profits
  - apply separate accounting conventions
- Unitary Proposals
  - focus on unity of multinational enterprises (MNEs)
  - require income consolidation
  - use formula to allocate income
- Formulary Arrangements?

Formulary v. Unitary

- Formulary Arrangements:
  - focus on transactions and activities
  - use formula to allocate income generated (only) by *certain* transactions and activities
  - apply separate accounting conventions

- When compared to unitary arrangements, formulary solutions:
  - do not provide MNEs with consolidation benefits
  - require substantially less international cooperation and coordination because they can be applied unilaterally (e.g., U.S. interest allocation rules)

Using Formulary Solutions

- They could be applied *selectively* (almost as if they were just another transfer pricing method) instead of to all income generated by MNEs.

- They should be used *alongside current* transfer pricing arrangements and applied only when these traditional methods are unsatisfactory.

- They should be seen as a default arrangements, leaving tax authorities with the discretion to allow taxpayers to come up with advanced pricing arrangements (APAs) in unique cases.

First Tier: Ordinary ALS Transfer Pricing Rules

Applied in (the majority of) transactions where there is an easy-to-observe market price indicator

Second Tier: Formulary Arrangements for the hard to source/price income sources

Applied namely with respect to income generated from intangibles where there is no easy to observe market price (namely: intangibles

Third Tier: Unique pre-negotiated arrangements

Benefits of FAs

- Reduce MNEs' ability to engage in income shifting (primarily with respect to intangibles).
- Reduce administrative and compliance costs associated with documenting and monitoring intra-group transactions that lack easy-to-observe market comparables.
- Promote transparency and consistency with respect to sensitive issues in tax administration.

Part II: Assessing the proposal

Key Arguments Against Integrating FAs

- (1) Associating FAs with unitary solutions and, as a result, exaggerating the difficulties
- (2) Requiring an unrealistically high standard:
  - FAs cannot provide perfect solutions
  - however, they may *provide incrementally better solutions than those currently in place*

1. Are FAs arbitrary?

- Myth: The FA is a crude averaging device because the formulas used are alienated to market realities about how MNEs generate their incomes.

- Answer (2): The FA is not fundamentally different from the ALS:
  - Market prices, like formulary factors, are both reasonable proxies that lack any inherent "correctness."
  - <u>Market prices do not try to determine the firm-specific sources of profitability.</u>

- Conclusion: As *proxies* both FA and ALS are means to an end, as long as they promote sensible policies.

2. Do FAs require unattainable tax harmonization?

- Myth: FAs could only be applied after fundamental aspects of existing tax regimes have been harmonized.

- Answer (1):
  - This confuses FAs with unitary arrangements.
  - As mentioned, FAs:
    - should be applied *only towards hard-to-source* (primarily intangibles-related) transactions and activities
    - require *no consolidation*
    - could be *applied unilaterally*

2. Do FAs require unattainable tax harmonization? (cont.)

- Myth: FAs require harmonization. Without it, categorization and valuation problems would render the arrangements impractical.

- Answer (2):
  - Problems of categorization and valuation with respect to intangibles *exist today* in the ALS separate accounting systems; *the shift toward FAs would not aggravate them*.
  - The FA concept *<u>detaches questions of valuation from questions of location</u>* and:
    - provides improvement with respect to the latter
    - aligns we with the proposal’s goal of incremental improvement

3. Are FAs alienated to business practices?

- Myth: FAs do not reflect how MNEs structure their business affairs and would lead to inefficiencies.

- Answer: FAs would not prohibit practices—they just deny some of their tax benefits.

- Answer (2): Even if at some point a FA averaging-allocation reaches unintuitive results:
  - it would reduce shifting and, therefore, arbitrariness of current ALS practices
  - it would still have (limited) APA options that would provide flexibility

4. Would FAs be easy to plan against?

- Myth: MNEs can easily adjust their behavior to allocate formulary factors in low tax jurisdictions.

- Answer (1): MNEs may not respond to tax planning incentives because of:
  - high (constant) non-tax costs of shifting
  - relatively low profits for shifting in a hybrid regime
  - relatively low profits in a multi-factored FA

- Answer (2): In terms of income shifting, FAs would likely provide a significant improvement when compared to current ALS arrangements.

5. Do FAs require new international conventions?

- Myth: FAs are inconsistent with current international tax arrangements.

- Answer (2): Today there is not just one method, but 180+ methods that adhere to the same name but may have little substantive content in common.

- Answer (1+2): FAs are not fundamentally different from current transfer pricing profit methods.
  – Both do not rely on market prices, apply separate accounting and focus on transactions and activities.
  – This suggests they could be under the OECD framework.

5. Do FAs require new international conventions? (cont.)

- Myth: FAs require excessive coordination to avoid problems of double taxation. Experience shows this type of coordination is unrealistic.

- Answer (1):
  - There is no need for unanimous agreement, FAs could be applied unilaterally.
  - It is unrealistic and unnecessary to try to buy out tax havens’ agreement to any FAs.
- Answer (2):
  - As in the ALS framework, coordination between major economies could help smooth double-taxation problems
  - Today, because of low-tax-haven jurisdictions, the problem if of double-non-taxation

6. Would FAs increase effective tax rates on MNEs?

- Myth: FAs would allocate more income to high-tax jurisdictions and, as a result, shift investments to low-tax jurisdictions.

- Answer:
  - FAs would allocate more income to high-tax jurisdictions, but have no necessary impact on the average or marginal tax rates of MNEs.
  - Countries could (and probably should) provide (tax or non-tax) direct subsidies to MNEs that conduct otherwise underprovided activities.
  - Income shifting has only negative externalities; countries should therefore avoid subsidizing MNEs engaging in the practice.

Concluding Remarks, Q&A, and Real World Examples for Discussion