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Taxation of Multinational Financial Institutions

Using Formulary Apportionment to Reflect Economic Reality

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The Proposition

One type of multinational entity – the multinational financial institution – poses particularly significant challenges to the international tax regime in terms of its current profit allocation rules.

MNFIs are a unique subset of multinational entities, and as a consequence of their unique traits, the traditional international tax regime does not yield an optimal inter-jurisdictional allocation of taxing rights.

Tax minimisation, achievable because of the unique traits, and realised through exploitation of the traditional source and transfer pricing regime, results in a jurisdictional distribution of taxing rights which does not reflect economic reality.

Recognition of the problem

1984: OECD, Transfer Pricing and Multinational Entities – Three Taxation Issues.

1998: OECD, The Taxation of Global Trading of Financial Instruments.

2001: OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments. Parts I & II

2003: Revised Part II and new Part III

2004: Revised Part I (General).

2006: Revised Parts I – III.

2008: Final Report

2010: Updated Report

1984 Report of the OECD

The transactions between the various part of an international banking organisation are so frequent and so complex that the problem of deciding to which particular part of the organisation an particular element of the total profit should be related for tax purposes often becomes one of considerable difficulty.

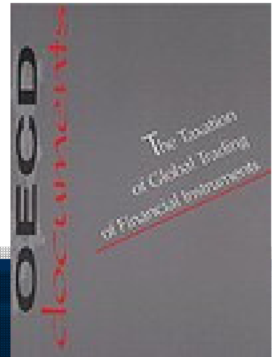
TRANSFER PRICING AND MULTINATIONAL ENTERPRISES

THREE TAXATION ISSUES

1998 Report of the OECD

Technological change, the communications revolution, and the spread of financial deregulation and liberalisation have had a dramatic effect in globalising financial markets. Financial firms have developed innovative financial instruments, such as derivatives, to meet the global demand to finance trade and investment and to reconcile the often different demands of borrowers and investors.

Such innovation challenges traditional tax systems both as regards the taxation of the end users of innovative products and the providers of such instruments. A second challenge arises because financial firms have increasingly organised their activities on a global basis so as to be able to meet the demands of investors for global financial products, 24 hours a day.



2010 Report of the OECD (Part II)

There have been considerable changes in the global economy since 1984, which have affected the way multinational banks carry on business. There also have been changes in thinking about the application of the arm‘s length principle, reflected most notably in the revision of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations started in 1995

This Report is therefore intended not only to update the issues and situations described in the 1984 Report but also to deal with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets which have been such a feature of the global economy since the late 20th century.

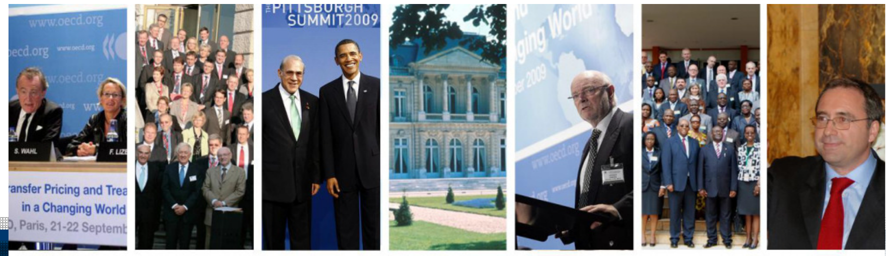
2010 Report of the OECD (Part III)

This Part of the Report (Part III) looks at the global trading of financial instruments (global trading), an activity that is commonly carried out by banks but also by financial institutions other than banks. Particular attention is paid to how the authorised OECD approach applies to a number of factual situations commonly found in enterprises carrying on a global trading business through a PE. The starting point for this analysis is naturally the 1998 OECD document: —The Taxation of Global Trading of Financial Instruments.

[T]here have been changes in global financial markets that affect the global trading of financial instruments since the publication of the Global Trading Report (for example increasing use of credit derivatives).

2010 Report of the OECD

The authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.



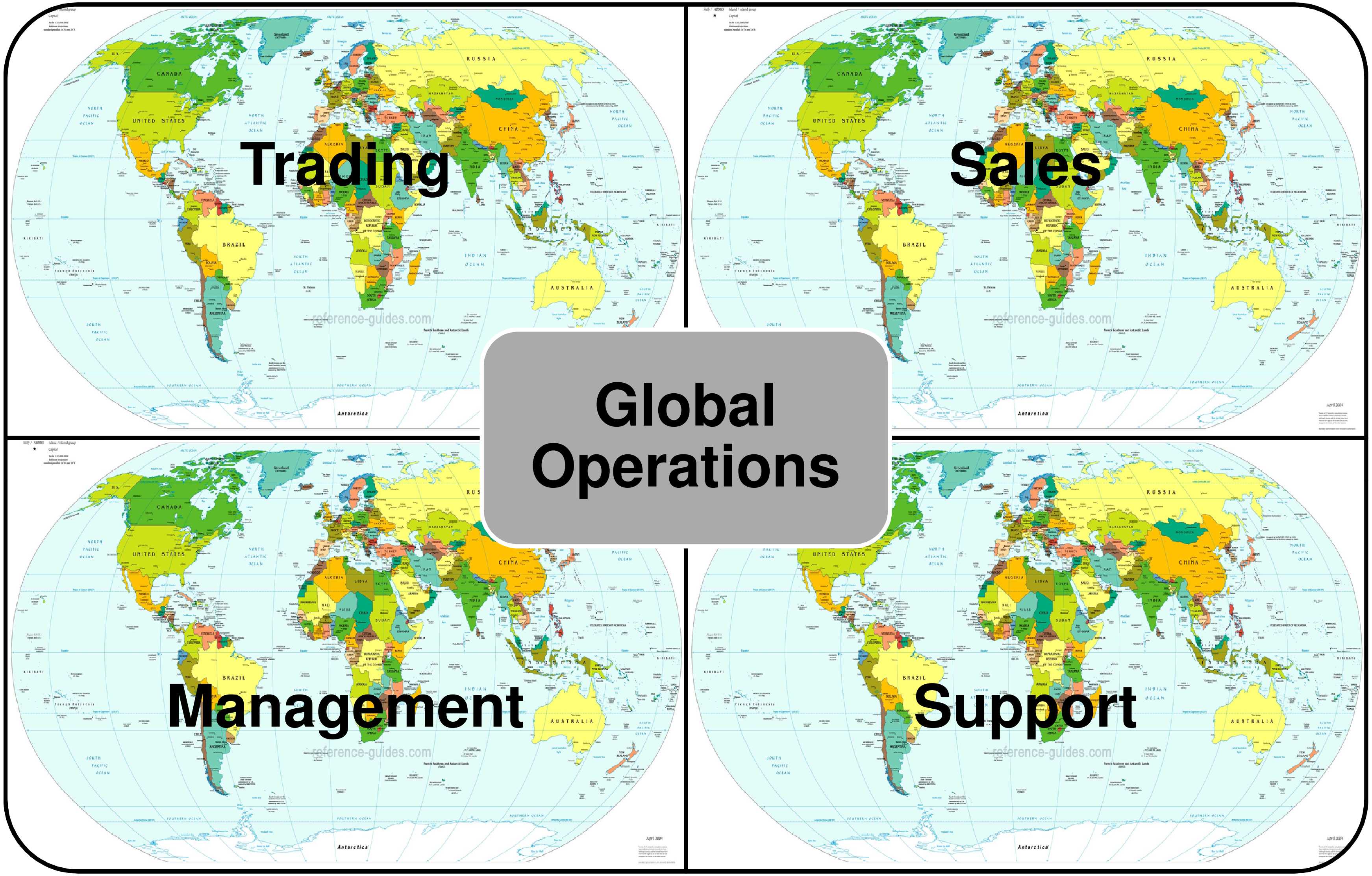
Are MNFIs a unique subset of MNEs?

- Unique nature of the services and consequent products they supply
  - MNFIs undertake an intermediary role in the marketplace
  - There are synergistic gains because MNFIs expand internationally to meet the needs of existing clients
  - Monopolistic advantages and network linkages

- Non-traditional organisational structure adopted
  - Explained by the theory of internalisation of the firm
  - Trading models
  - Service time zones

Trading Models

Separate enterprise model → Centralised product management model → Integrated trading model


Trading
Sales
Global Operations
Management
Support

5 Theoretical benefits of the unitary tax model for MNFIs

"As in 'Alice in Wonderland,' [separate accounting] turns reality into fancy, and then pretends it is in the real world."

Jerome R Hellerstein

'Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment'

(1993) 60 *Tax Notes* 1131, 1136.

1: Reflecting the economic reality of MNFIs

- Formulary apportionment looks to the economic activity rather than the enterprise

- MNFIs are so highly integrated that the entity cannot be divided into any smaller component parts with any degree of accuracy

- The multinational entity is “an indivisible whole rather than a mere sum of its separate parts”

2: Reflecting integration

- By ignoring the separate parts of the multinational entity, the formulary apportionment model also ignores the entity's legal structure, making the structure adopted meaningless for tax purposes, just as it is meaningless for purposes of management decisions.
- The formulary apportionment model looks to the economic substance of the multinational entity and, in this sense, adopts a substance-over-form approach.
- The fundamental nature of this model is not to distinguish between a head office with affiliated branches and a parent company with multiple subsidiaries as the traditional model does.

3: Reflecting internalization

- Internalization theory also supports the use of global formulary apportionment for MNFIs as a theoretically superior model.
- Internalization theory means that the arm's-length standard does not accurately represent why an entity becomes multinational.
- This same theory may be used to demonstrate that the unitary tax model is consistent with economic reality.
- Formulary apportionment recognizes not only the highly integrated nature of MNFIs, but also the advantages gained by operating via foreign direct investment.

4: Consistent with the aim of efficient operations

- Unitary taxation conforms to the aim of efficient operations within MNFIs by providing the advantage of consistency between financial institution management policy and tax policy.

- Not only are the business decisions within the MNFI reflected in the formulary apportionment model, but also the decision to become multinational.

5: Distributes rights through an equitable model

- A jurisdiction will receive its fair share when the tax model reflects the economic activity undertaken in a jurisdiction.
- The economic activity undertaken in a jurisdiction is reflected under a formulary apportionment model via the specific factors in the formula, along with the relative weighting.
- It is only the income or loss of the individual MNFI that is relevant to determine the income or loss to be attributed to each jurisdiction in which that entity operates. The industry in which the MNFI operates does not determine the profit or loss of the individual financial institution.
- The formulary apportionment model accepts that the market does not dictate the profits of individual MNFIs, and seeks "a 'fair' or 'proper' division of the overall profits regardless of how the marketplace would operate."