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TOWARDS UNITARY TAXATION OF TRANSNATIONAL CORPORATIONS

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SUMMARY

This paper puts forward proposals for a reform of taxation of transnational corporations (TNCs). Although it would involve a new approach to this issue, it builds on long experience and analysis of the actual practice of tax administrations, and the paper discusses transitional arrangements for the changeover. It has become increasingly clear that a fresh look is needed at the international tax system, the basic structures of which were devised a century ago.

The foundations for the current international tax system were laid early in the 20th century, when TNCs were in their infancy, and most international investment flows consisted of private and public loans. Experts understood that TNCs posed a different problem, since they generally operate as integrated businesses under central direction, although they consist of groups often of very many companies. It was agreed that national taxes should apply to the business profits of the members of such a group operating within each jurisdiction, but tax administrations could adjust the accounts if necessary to prevent `diversion' of profits. The aim was to ensure that they reflected `the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions'. This became known as the arm's length principle (ALP). However, tax administrations could also adjust the accounts based on comparisons with the profits made by local firms with similar business, or considering the proportion of profits declared locally in relation to those of the TNC as a whole.

By the second half of the century TNCs became increasingly dominant in the world economy, managing operations in different countries. They also developed increasingly complex techniques for reducing their overall taxes, exploiting the loopholes in the loosely coordinated international tax system.

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International tax avoidance involves two main methods. First, TNCs can create intermediary entities in convenient countries, usually those with no or low income tax (known as tax havens), to carry out activities (e.g. financial transactions, transportation, providing advice or other services), or to act as ``holding companies' owning assets (e.g. intellectual property rights, bonds, shares). By attributing profits to them the group's overall taxes can be reduced, even though they usually exist only on paper, perhaps with a name-plate on an office building.

Secondly, a TNC can adjust the prices of transfers between members of the TNC group, to shift profits from high-tax to low-tax countries. This is known as `transfer pricing'. However, it is not always easy to judge whether the aim is tax avoidance, as the prices set between related entities within a unitary group are generally decided administratively and not competitively, so they may reflect various strategic concerns of the TNC (e.g. management incentives, currency exposure).

Concerns about tax avoidance by TNCs resurfaced in the 1960s, especially in the USA, the home state of very many of them. To combat the use of tax havens, in 1962 US enacted measures to include in the profits of a US parent company the income of its affiliates formed in low-tax countries, if they fall within the definition of a `controlled foreign corporation' (CFC) Many other OECD countries later introduced similar rules. To try to deal with transfer pricing, the US introduced detailed regulations in 1968, elaborating how such prices should be determined.

Unfortunately, this dual policy response lacked coherence. Indeed, the transfer pricing regulations made it more difficult to deal with profit-shifting through intermediary companies, since they cemented into place the ALP, requiring affiliates to be treated as separate entities. In particular, the US regulations specified that where possible the pricing of specific transactions should be based on those for similar transactions between unrelated firms, or `comparable uncontrolled prices' (CUP). However, as a fall-back where these were not available, they did allow estimation of the actual profit on the basis of profit-rates for similar firms, either for a pattern of transactions or for the overall profit (`profit-split').

Despite its flaws, this US approach was adopted by the OECD in a report issued in 1979, subsequently revised as the Transfer Pricing Guidelines. Meantime, its application by the US itself was challenged as ineffective. Studies showed that comparables could be found for only a minority of cases, and a report for the US Congress found that applying the regulations was time-consuming, burdensome and created uncertainty. In 1988 the US Treasury announced a new approach, which would restrict the CUP to where an exact comparable could be found, and proposed a new method for calculating an `arm's length return', attributing to the affiliate a profit based on analysing its functions and applying an industry average rate (the `comparable profit method', or CPM). This caused considerable conflict within the OECD, but was eventually adopted as the `transactional net margin method' (TNMM) in the revised Transfer Pricing Guidelines of 1995.

With this experience, pressures mounted for a new approach to TNC taxation. Such an approach was already available, and had indeed been considered in the 1930s. It consists of treating a TNC engaged in a unified business as a single entity, requiring it to submit a single set of worldwide combined or consolidated accounts in each country where it has a business presence, and apportioning the overall profit according to a weighted formula reflecting the proportion of its actual presence in each country. The experts who considered the issue in the 1930s considered that this system could not be adopted internationally, due to the political difficulties of reaching agreement on the definition of the taxable base and on the apportionment formula. However, they also recognised that in practice national authorities would have regard to the firm's overall accounts and the proportion of the total profits attributed to affiliates. Indeed, the increased use of profit-split methods since the 1980s showed that this was necessary and inevitable. It is not a very big step to move from profit-split methods to a full unitary taxation approach, although it does require a reorientation of approach. The main advantage, however, is that it would deal not only with transfer pricing, but also with the tax avoidance by TNCs through the tax haven system.

The unitary approach is based on the economic reality that TNCs exist because of the advantages and synergies of combining economic activities on a large scale and in different locations. They also generally are oligopolies based on distinctive or unique technology or know-how. Hence, treating a TNC affiliate for tax purposes as a separate entity, and insisting that intra-firm transactions should be based on comparables, is both impractical and senseless.

The unitary approach had already been applied since the 1930s, especially within federal systems, particularly in the USA. Notably, it was applied by California, for example to prevent Hollywood film companies from siphoning profits through distribution affiliates set up in neighbouring Nevada. US state taxation based on combined reporting and formulary apportionment became regularised and coordinated during the 1960s, with a 3-factor formula using assets, payroll and sales. However, it became resented by non-US TNCs which found that businesses they acquired or set up in the US, which in their early stages incurred great costs and so made losses, could be taxed by states on a proportion of their worldwide profit. A strong business-led campaign failed to abolish the system, but did succeed in having it limited to the `water's edge', excluding non-US affiliates. Many tax authorities had also become wedded to the ALP, which of course is also strongly supported by the professional advisors of the tax avoidance industry. Hence firm statements excluding the unitary approach were included in the OECD Transfer Pricing Guidelines, even while they increasingly accepted profit-split methods.

The OECD approach is now being exported to developing countries, which are adopting and applying transfer pricing rules. However, only the largest, such as Brazil, India and China, have the capacity even to attempt to administer them. They pay lip service to the OECD Guidelines, but these authorise a wide range of methods, and the approaches adopted by different tax administrations are in practice very diverse and contradictory. TNCs are therefore likely to become increasingly embroiled in conflicts over divergent transfer price adjustments, which can only be dealt with by a slow, discretionary and secretive international administrative procedure between tax authorities. Within the EU the European Commission has, after over a decade of careful work and consultation, published a proposal for a unitary system known as the Common Consolidated Corporate Tax Base (CCCTB). It has significant flaws, particularly being restricted to the parts of TNC groups within the EU, and hence failing to deal with tax havens. Nevertheless, it represents the first formal international proposal for a unitary tax system.

The time is now right to prepare for a change to the unitary tax approach. Although this would entail overcoming some problems, it would establish a much stronger basis for international tax coordination than the present system. A transition should involve three elements. First, there should be expert studies exploring the economic and legal aspects of the change. Secondly, a unitary approach could be adopted by groups of countries, such as within the EU, or other regional groups such as MERCOSUR or ASEAN. Thirdly, countries could immediately require the submission of a combined report by any TNC with a business presence within their jurisdiction. The information so provided could be used to apply the profit split methods already accepted by the OECD Guidelines, or to apply a formulary apportionment to specific sectors such as financial services. Most importantly, a combined report would provide a true overall view of the firm, eliminating profit shifting both by transfer pricing and the use of tax havens. Complemented also by a requirement for country-by-country reporting of the taxes actually paid, this would be a giant step towards setting the international tax system on a basis of transparency and effectiveness, and hence restoring the legitimacy of taxation in all countries.

INTRODUCTION

A central issue of international taxation today is how to deal with transnational corporations (TNCs). Although taxes are national, taxation is coordinated internationally through various legal and administrative arrangements, managed by tax specialists. On the other hand, TNCs' operations are internationally dispersed but centrally coordinated. At the heart of many of the failings of the international tax system is the mismatch between the weak international coordination of taxation and the power of TNCs to organise their affairs so as to minimise their tax liabilities.

The international tax system was devised in first half of the 20th century, when TNCs were in their infancy, and international economic transactions consisted mainly of trade and lending between different entities in more than one country. TNCs are different, in that they consist of a single firm which directly controls and coordinates business activities located in different countries. Operating under unified direction, a TNC is a single firm in economic terms, although legally it consists of many (sometimes thousands) of affiliates, forming a corporate group. Transfers between these affiliates, involving the supply of goods, services or finance, are internal to the firm, but from the viewpoint of states appear as international transactions of trade or investment. Provisions were included in tax treaties to deal with TNCs as a special case, which were further adapted as such enterprises came to dominate international business in the second half of the 20th century. These traditional provisions rely on treating the component parts of a TNC in each country as if they are separate enterprises, dealing at `arm's length' with each other. However, when this principle was first devised, it was understood that this was a fiction, and that various methods could be used to ensure a fair allocation of profits.

Many of the specialists who constructed and have worked with the system have understood that the separate-enterprise arm's-length approach was an unsatisfactory expedient, because it runs counter to the economic reality of TNCs, which generally operate as coordinated firms under central control. The difficulties it created came increasingly to the fore as TNCs became dominant in the international economy in the second half of the 20th century. It caused increasing problems also because TNCs became adept at using affiliates artificially created in tax havens to reduce their overall tax liability. In order to patch it up, increasingly diverse and complex rules have been elaborated, but the system has become ever more arbitrary and opaque.

Hence, many have argued that a different approach is needed for taxation of TNCs, which should start from a recognition that they operate as an integrated business, under central direction. This approach is known as Unitary Taxation. This assesses the firm on the basis of a single set of consolidated accounts for its business as a whole, and allocates the taxable profit between its activities in different states according to a formula which reflects the geographical location of those activities. Adoption of this approach would greatly reduce the opportunities for international tax avoidance due to shifting of profits to lower-tax countries, especially tax havens. It would also greatly simplify tax administration, which would especially benefit poor developing countries, as well as reducing the costs of compliance for firms. Above all, by aligning tax rules more closely to the economic reality of international business, it would improve the fairness and transparency of taxation and help create a level playing field for business.

This paper will first explain the basic principles of the present system and the problems with it; it will then discuss the Unitary Taxation alternative; and finally it will consider how to move towards a unitary system.

1. The Present System and How we Got Here

The problem of taxation of TNCs has been recognised since the earliest days of international tax coordination, nearly a century ago. The formal legal structures of this coordination are the bilateral treaties for the avoidance of double taxation and prevention of fiscal evasion, usually referred to as double tax treaties (DTTs), which are based on treaty `models'. The first model DTTs were drawn up at a conference organised by the League of Nations in 1928.[*] At that time, most businesses and corporations were national, and international economic flows mainly consisted of trade and *portfolio* investment. This involves lending, by banks and by investors in bonds or shares, to business ventures abroad, and is very different from foreign *direct* investment, in which the investor controls the foreign business. This generally takes place through companies based in one country which set up or take over businesses in other countries, and hence are referred to as trans-national corporations, TNCs.

Most international financial flows before 1914 were of portfolio investment, but there had been some growth of foreign direct investment by TNCs since the late 19th century. In addition to many mining and other raw materials extraction ventures, some manufacturing companies became transnational. For example, an early pioneer was the Singer Sewing Machine company based in the USA, which in 1867 set up a plant in Scotland. Dealings such as the supply of component parts or of finance from one affiliate to another, which were considered international transactions by states, were internal to such firms. Hence, TNCs were recognised to pose a special problem for taxation.

1.1 The Origins of the Tax Treaty Principles[†]

The model tax treaty aimed to allocate the right to tax income from international activities between the `home' state (from which the exports or investments originated) and the `host' or recipient state. For international lending capital-exporting countries argued that, while the host state could tax the profits of the actual business, payments to a foreign investor (e.g. of interest or dividends) should be taxed by the home state, as part of the income of the investor, resident in that state.

Provisions were included also to deal with the special case of TNCs. If the TNC operated in a host state through a separately incorporated subsidiary company or other legal entity, the subsidiary should be treated as a separate enterprise. This meant that the business profits of the subsidiary itself should be taxed by the host state. Where a company operated abroad through an office or branch which was not separately incorporated, the model treaty used the concept of the `Permanent Establishment' (PE). The host state was allowed also to tax profits attributable to a PE. Payments made to the parent company (dividends, interest, fees or royalties) could be taxed by the home state, although this might require negotiations with the host state to ensure that it did not also apply withholding taxes at source to such payments.

However, national tax authorities were very aware of the problem of `diversion' of income by TNCs, which could take advantage of their centralised decision-making to shift profits to lower-tax states in order to reduce their overall taxes payable. This called for special rules. The various methods which were used to deal with the special case of TNCs were examined by a

[*] This treaty, as well as the main succeeding model tax treaties, have been helpfully made available by Prof. Michael McIntyre, at http://faculty.law.wayne.edu/tad/treaties-historical.html. Additional very useful historical documentation has been provided by Prof. Richard Vann at http://setis.library.usyd.edu.au/oztexts/parsons.html.

[†] For more detailed discussion, and citation of sources, see Picciotto 1992, especially pp. 18-35.

study carried out for the League of Nations Fiscal Committee in 1932-33 by a US lawyer, Mitchell B. Carroll (Carroll 1933).

Carroll found that in the case of a branch or subsidiary of a TNC, most national tax authorities tried as far as possible to assess the income of the local entity on the basis of its own accounts. However, they generally also insisted on checking whether such accounts were a true reflection of the entity's activities. This verification usually relied on comparing the accounts with those of similar but independent local firms, as well as examining the accounts of the parent or related business to ascertain the breakdown of income and costs with the affiliate.

If these methods proved inadequate, they fell back on what the report described as `empirical methods'. This entailed assuming that the local affiliate made the same percentage profit as the enterprise as a whole, or as others in a similar line of business, and assessing its taxable profit by applying this percentage either to its turnover, or to some other factor such as capital employed. The UK report to Carroll's inquiry estimated that in some 55% of cases an assessment could be done on the basis of the affiliate's own accounts, although with careful checks on the pricing of internal transfers, and often with adjustments negotiated with the taxpayer. In a further 20% of cases, a percentage of turnover would be used, and in the final 25% a percentage of another factor (e.g. assets for banks, train-mileage for railways). The UK report stressed that the `fact that the revenue authorities have the alternative of basing profits on a percentage of turnover prevents the taxpayer taking up an unreasonable attitude' (league of Nations 1932, p. 191).

Carroll also reported that some systems used an alternative method, which he described as fractional apportionment.[‡] In particular the report from Spain stated that it had in 1920 abandoned assessment on the basis of the accounts of the local entity, since many branches of foreign companies showed little or no profit. It argued strongly that the only way to ensure that no enterprise was taxed at more than 100% of its total profits was to start from the accounts of the firm as a whole. Under the Spanish system any branch or affiliate forming a unity with a foreign company was assessed on the basis of a proportion of the unitary firm's total profits. The appropriate allocation percentage was fixed for each firm by a committee of experts, having regard to the accounts of the affiliate (if they existed), and with a right of appeal. The Spanish report argued that this method also entailed the least interference with the enterprise, since it did not require the checking of hundreds of internal prices, which would result in the substitution of often arbitrary figures, and taxation on the basis of largely imaginary accounts.

Fractional apportionment was also used in some other systems: for example, the French tax on revenue from securities (interest on bonds and dividends on shares) was applied to such payments by foreign companies with affiliates in France, based on the proportion of assets in France. The fractional approach was also used in federal systems, in particular by Swiss cantons, and a number of states in the USA, and in a few international treaties, such as those of Austria with Hungary and Czechoslovakia.

1.2 International Apportionment and the Arm's Length Principle

The Carroll report recommended that the international system should be based on separate accounts, but they could be adjusted as appropriate using specific apportionment rules. Accounts should be based on what became known as the Arm's Length Principle (ALP): i.e. attributing to the entity `the net business income which it might be expected to derive if it were

[‡] I use the term fractional or formulary apportionment in contexts in which has been commonly used, for example in the Carroll report, to describe any approach which allocates profit by proportion or by formula. I prefer the term Unitary Taxation, as described and analysed below, both because I think it is clearer, and also because it requires submission of combined or consolidated accounts as well as allocation by formula.

an independent enterprise engaged in the same or similar activities under the same or similar conditions'. This was adopted as the basis for treaties based on the League of Nations model, and with some rewording remains the principle laid down in model treaties today.

The report recognised that various methods would need to be used to adjust accounts to ensure a fair apportionment, especially because within a single business entity not all items of income and expenditure can be allocated to a single specific source. General overhead expenses, such as the costs of the centre of management, and the financing of capital items benefiting the enterprise as a whole, were commonly allocated by tax authorities using some kind of formula. Carroll considered that this was different from a general formula apportionment of profits, and compatible with the ALP. Allowance was also made for states to continue to use fractional apportionment if they had customarily done so, although only for Permanent Establishments. This provision is still included in article 7 of the UN model DTT (subject to the proviso that such an apportionment must comply with the ALP), but it was dropped from the OECD Model at the last revision in 2010. In the case of separately incorporated affiliates of a TNC, the starting point should be their own accounts, but if these diverge from the ALP, an appropriate adjustment may be made to the profits and taxed accordingly, under article 9 of the OECD model treaty.

It was clear that the ALP did not establish a clear or precise measure, but at best a general principle. Indeed, the German report accepted that fractional apportionment was not only the ideal method, but would in practice be used in the many cases where separate assessment was not feasible. Although superior in principle, the unitary approach would be difficult if not impossible to adopt, for political reasons, since it should be based on international agreement on (i) tax accounting principles for assessment, and (ii) a common allocation formula. The ALP was obviously much easier to incorporate into international treaties. However, its adoption merely converted the problem, from a decision on general apportionment by formula (with adjustments if necessary), to negotiation of specific ad hoc apportionments. The German report stressed that this would in practice require close cooperation between tax authorities, from which more general principles could perhaps emerge.

Carroll reported not only that some firms manipulated internal transfer prices to reduce their tax bill, but also that others found that despite their meticulous efforts to allocate profits fairly, tax authorities of different countries took different views, which could result in assessments on much more than 100% of the total profits. However, the report did not recommend giving the taxpayer any remedy for the latter. The model treaties provided only for discussions to resolve disputes between the states, with the possibility of an advisory opinion by a technical body of the League of Nations. The post-war model DTTs did give the taxpayer the right to present a claim to its national tax authority, but such a claim should be resolved by consultation between the authorities concerned, with no guarantee that conflicting adjustments must be resolved. In recent years tax treaties have begun to include provisions for arbitration as a fall-back to resolve such conflicts, and a multilateral system for such arbitration has been in place in the EU since 1990. Regrettably, however, these procedures are highly opaque, as the outcomes are rarely published, so they remain known only to the participants.

Thus, the approach adopted attempted to reconcile the specific case of TNCs to the general principles of tax treaties, being based on the ALP but subject to adjustments reallocating profits as necessary, including formula apportionment of specific items of general expenditures. From the 1930s, however, international lending dried up, and from the 1950s foreign direct investment by TNCs became the dominant form of international capital flows.

1.3 The Tax Treaty System and International Avoidance

Although model DTTs were formulated early, it took longer to negotiate actual treaties. This occurred in the second half of the 20th century mainly through the OECD (Organisation for Economic Cooperation and Development), whose members were both exporters and importers of capital, so found it easier to agree on principles for allocating tax jurisdiction.[§] Nevertheless, it took over 20 years from the establishment of its Fiscal Affairs Committee in 1955 for the OECD countries to negotiate a network of DTTs among themselves, as well as some with other countries.[**]

In the meantime, TNCs became adept at exploiting the many loopholes in the interaction of national tax laws in order to minimise their tax exposure. From their perspective, many of the devices to which they resorted were necessary and reasonable, to counter the inadequacies of international coordination. Two main techniques were devised. One, dealt with in the Carroll report, was profit-shifting by the adjustment of internal transfer prices, which came to be known as transfer-pricing. The second, which became much more important, was the creation of intermediary entities in convenient jurisdictions or `tax havens'.[††] This had already been pioneered early in the 20th century by wealthy individuals and families for tax evasion (illegal tax-dodging). The further development and systematisation by TNCs of the facilities and techniques of the tax haven system had much more far-reaching and serious consequences. Like dangerous drugs, the facilities offered by the offshore system became addictive both to TNCs and many other users, while the suppliers of these facilities came to think there was no other way they could earn a living.

The basic principles of tax avoidance through tax havens can be summarised quite simply, although many of the techniques became extremely complex. Essentially, it consists of channelling payment flows through entities (a company, partnership, trust or other legal person) formed in jurisdictions where such receipts would be subject to low or no taxes. This can be done by using such intermediary entities to carry out activities (e.g. financial transactions, transportation, providing advice or other services), or to act as ``holding companies' owning assets (e.g. intellectual property rights, bonds, shares). These entities usually exist only on paper, perhaps with a name-plate on an office building, but diverting payments to them by well-designed routes can greatly reduce taxes on the corporate group of which they form a part.

[§] The work of the League of Nations was taken up by a Financial and Fiscal Commission established by the United Nations, but it quickly became deadlocked by east-west and north-south splits, and ceased to meet after 1954. In 1956 a Fiscal Committee was set up under the Organisation for European Economic Cooperation (which administered the Marshall Plan), renamed the OECD in 1961, allowing its expansion to other parts of the world. In 1967 the Secretary-General of the UN set up an Ad Hoc Group of Experts on International Cooperation in Tax Matters, which focused on the adaptation of the OECD model DTT to the needs of developing countries, in a UN model. It was slightly upgraded to a Committee of Experts in 2004, although it still has minimal resources (only 1.5 professional staff), especially compared to the OECD. The OECD continues to try to marginalise the UN, by admitting Observer states to the work of the Fiscal Committee, and establishing a Global Forum in 2003, initially described as a Global Forum on Taxation, and then as the Global Forum on Transparency and Exchange of Information for Tax Purposes.

[**] Some OECD countries (e.g. the Netherlands and the UK) extended their tax treaties to their colonies and dependencies, which continued them after independence.

[††] Whether a country can be used as a haven depends both on its laws and their interaction with those of other countries. Hence, any country might be a haven: for example Canada's Newfoundland was used as such in the 1920s and 30s. Over time, some countries have refined their laws, usually at the behest and with the help of advisers specialising in avoidance, and these are recognised as the main havens. Some specialise in particular activities (e.g. hedge fund formation, captive insurance, brass-plate companies); what they have in common is a high level of secrecy, especially in relation to enforcement of other countries' taxes: see Tax Justice Network 2007.

This is not the place to examine this problem in detail. What is relevant here is to note that such techniques are only viable if international taxation continues to treat affiliates of a TNC as separate entities. Under a unitary taxation approach, the problem disappears, since all internal transactions and transfers are eliminated, and the TNC is assessed on the basis of consolidated accounts.

The rapid growth of TNCs since the 1950s led to the systematisation of these techniques of avoidance. Indeed, such growth was partly due to the ability of TNCs to reduce their cost of capital by using such avoidance techniques to reduce their effective tax rates overall. The use of tax havens was also linked to the growth of the offshore finance system, which offered facilities, above all secrecy, which could be used for both avoidance and evasion, as well as money-laundering.

Anti-avoidance techniques have also been devised, coordinated mainly by the OECD, since the 1970s. However, they have tackled the problems with separate solutions, rather than a holistic approach. In particular transfer pricing has been dealt with only by continued elaborations of the ALP. Unfortunately, this has further entrenched the separate enterprise approach, which enables the use of avoidance through tax haven intermediaries, while succeeding only in showing the unworkability of the ALP.

1.4 Problems with the ALP[‡‡]

As it became elaborated and refined, the ALP has increasingly been been shown in practice to be impossible to apply effectively or consistently, and demanding of a very high level of resources. The US introduced formal regulations to apply the ALP in 1968: instead of treating it as a general principle for ensuring broad fairness in allocating costs and profits within a TNC, they attempted to define rules for the pricing of specific transactions. Recognising that these had international implications, the issue was taken up through the OECD, and then also by the UN Group of Experts. This was also spurred by growing concerns about the power of TNCs, including some high-profile publicised cases involving transfer pricing, notably the Swiss pharmaceutical firm Hoffman-LaRoche.[§§]

The OECD finally produced a report in 1979 *Transfer Pricing and Multinational Enterprises*, which confirmed a consensus around the ALP, and generally following the approach in the US regulations. Significantly however, it did not propose any revisions to the model treaty, nor even to the commentary on its provisions, but merely set out guidelines to be taken into account by states.[***] National tax administrations have each developed their own methods, sometimes stated in regulations and sometimes only as guidelines for tax officials. Yet the apparent consensus on the ALP has contrasted sharply with lack of agreement on clear rules to apply it. Even the OECD Transfer Pricing Guidelines, as successively revised, only put forward a variety of methods, which are each extensively discussed. All of these purport to constitute implementations of the ALP, although many of them are in fact indirect methods of apportioning profits. The Guidelines are now both complex and extensive, covering some 370 pages.[†††]

[‡‡] For reasons of space I will not provide a detailed analysis here, but only an outline of the main issues which have arisen, and attempts to deal with them.

[§§] Publicised in the report by the UK Monopolies Commission (1973) *Chlordiazepoxide and Diazepam*.

[***] The original 1979 Report was renamed Guidelines when a revised version was issued in 1995; the most recent revised edition was in 2010. In 2012 proposals were released for revisions of sections of the Guidelines on Safe Harbours, and Intangibles.

[†††] Available from http://www.oecd.org/ctp/, unfortunately only on payment or for subscribers.

The Guidelines stress that the ALP should as far as possible be applied to the pricing of specific transactions, and also wherever possible on the basis of a comparison between the TNC's internal (`controlled') price and comparable prices charged between independent enterprises (`comparable uncontrolled prices': CUPs). But this rests on the fundamental flaw of the ALP: in economic reality TNCs exist because of their competitive advantages, foremost of which is their control of unique technology or know-how. Hence, as studies have repeatedly shown, it is not only extremely complex and time-consuming to try to identify comparables, in the large majority of cases true comparables do not exist. For example, no other cellphone is a true comparable for an Apple iPhone. The Guidelines therefore offer two alternatives: the resale price minus a profit-mark-up, or the cost price plus a mark-up. Although these are described as transactional pricing methods, in reality they aim to identify the appropriate profit level of the affiliate compared with other firms in the same line of business, so again tend to overlook the competitive advantages of TNCs. They are in any case inappropriate for TNCs with internationally integrated activities.

In fact, even as the ALP became enshrined in the OECD Guidelines, criticisms of this approach had mounted in the USA, fuelled by several studies showing its limitations, including one for the Congress by the General Accounting Office in 1981.[‡‡‡] In 1988 the US Treasury announced a new approach (US Treasury & IRS 1988), which would severely restrict transactional pricing methods to cases where an `exact comparable' could be found, and put forward a new method to calculate an `arm's length return'. This entailed an analysis of the `functions' carried out by affiliates, to which a `market' rate of return would be attributed, leaving the remaining `residual' profits for the parent company. A major motivation for this was the concern that US TNCs had been shifting profits by setting up manufacturing plants abroad, often in low-tax countries such as Ireland, where they could show high profits due to the unique technology embodied in their products. The US Internal Revenue Service (IRS) preferred to treat such affiliates as `contract manufacturers', which would deny them any profits attributable to intellectual property rights (IPRs) such as patents, transferred to them from the parent company.

This new US view led to sharp conflicts within the OECD for several years, with big business lobbies joining other tax administrations in attacking the US line. The disputes were patched up with the issuing of the 1995 Guidelines, which reformulated the new US approach, to try to assimilate it to the ALP under the rubric of `transactional profit methods'. These are `profit split methods' and the `transactional net margin method' (TNMM), which the guidelines stress are the only ones compatible with the ALP. This affirmation was linked to a strong rejection of any use of `global formulary apportionment'. The OECD's opposition to unitary taxation had also been cemented by another campaign by big business lobbies, against its use by US states, especially California (see further section 3.2.1 below). Yet in practice profit split and the TNMM are methods for apportioning profits, by applying an analysis of economic factors, and hence close to formulary apportionment.

The 1995 Guidelines also attempted to deal with the difficulties posed by `intangibles', which go to the heart of the increasing problems of applying the ALP. As already pointed out, these are rooted in the inability of the ALP in to deal with the basic characteristics which give TNCs their competitive advantages, especially their control of know-how, in the broadest sense. This

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[‡‡‡] The GAO Report concluded `Because of the structure of the modern business world, 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. ... We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under s.482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations' (US GAO 1981 p.52-3).

has become increasingly important with the transition to the `knowledge economy', in which TNCs are at the forefront. In their 1995 version (still current in the 2010 edition) the Guidelines approached this very narrowly, in terms of transfers of Intangible Property. Due to its inadequacies, a complete rewrite has now been undertaken, culminating in a draft issued in June 2012.[§§§] This now attempts to deal with Intangibles more broadly; but it is still hampered by the focus on transactions, which is inevitable under the ALP. The inadequacies of this approach were shown in a news report by Reuters in October 2012 that Starbucks had shown no taxable profits in the UK for 10 years, although it had regularly trumpeted to its shareholders the profitability of its UK operations. Commentators suggested that this was probably due to intra-firm pricing, especially the payment of royalties of 6% to the parent company for use of the brand name and related IPRs, which is at the top end of permissible rates based on comparables.[****]

Various means have been used to try to deal with the vast administrative problems of applying the ALP in practice. These are broadly of two kinds: (i) the time and special expertise needed to carry out the checks on transaction prices, and (ii) the difficulty of achieving consistency due to the complex and often subjective nature of the judgments involved. One means of dealing with these is to adopt `safe harbours' or `bright line' rules. These can greatly economise on the resources needed by tax administrations, and simplify compliance by taxpayers, but they can be easily avoided, and may make international coordination more difficult. Hence, the 1995 Guidelines discouraged their use; but the revisions proposed in 2012 now look on them much more positively, at least in relation to smaller taxpayers.

Another method, more appropriate for large TNCs, is the adoption of Advanced Pricing Agreements (APAs). An APA gives the TNC prior approval of its pricing scheme, but requires submission of detailed documentation and negotiation with the tax authorities, often of several countries. The time and expense involved means that they are mainly useful for large firms, although they are strongly promoted by the large accountancy firms, for whom they provide a good business.

1.5 Advantages and Limits of the ALP

It is easy to understand why the ALP was first adopted, as a means of accommodating TNCs as a special case within the international system. But once established, it has become hard to dislodge, indeed it has become even more deeply embedded as it has become increasingly elaborated. Practitioners are comfortable with the system they know, both as tax administrators and as tax advisers earning large fees.

For a national tax administration, it seems natural to start from the accounts of the entities within its jurisdiction, even if they form part of a larger TNC. The adjustments to the accounts which this inevitably entails can be done according to the specific circumstances of the company, using any of the wide range of methods now approved as acceptable under the ALP according to the OECD. The OECD Guidelines recognise that `transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer' (OECD 2010, para. 1.13). Generally, the aim is to ensure an allocation of profit to the local entity which seems a reasonable split, taking account of its functions within the group. Achieving this by adjustment of internal prices seems a legitimate approach. Most such adjustments take place as part of the confidential and informal negotiations with the firm, which may frequently be able to adjust its related company accounts accordingly without the need for further negotiation with the other tax administration. If this is not possible, the firm

[§§§] See http://www.oecd.org/ctp/transferpricing/transferpricingaspectsofintangibles.htm.

[****] T. Bergin, `Special Report: How Starbucks avoids UK taxes', Reuters, 15th October 2012.

must request a `corresponding adjustment', which may lead to negotiations between tax authorities under the `mutual agreement procedure'. Today, these conflicts may involve millions of dollars, and taxpayers complain of long delays. Nevertheless, both tax authorities and TNCs prefer to sort out these disputes under a shroud of confidentiality, and have strongly resisted pressures for publication of such settlements.[††††]

Despite the high costs of separate accounting, most TNCs seem to prefer it. The main reason undoubtedly is that it allows them freedom to organise their internal structure, and generally to deal with national tax administrations one-on-one, unless they request resolution of a conflict. No single authority necessarily sees the complete tax accounts of the TNC as a whole.[‡‡‡‡] Hence, they have to rely on bilateral exchange of information, which is authorised under tax treaties, but secrecy jurisdictions such as tax havens do not generally provide such information.[§§§§] TNCs are generally unwilling to reveal even to their shareholders how much tax they pay in each country where they do business, as shown by their reluctance to accept country-by-country reporting (Murphy 2012, PwC 2012). There are some disadvantages for business: in particular separate accounting does not automatically allow the offsetting of losses in one country against profits in another. But for most TNCs these are outweighed by the ability to exploit the opportunities for international tax avoidance, especially through the tax haven and offshore secrecy system. This has now become the biggest single obstacle to tax fairness, as well as the biggest facilitator of corruption and crime. Hence, although TNCs are facing increasing problems in dealing with the heightened scrutiny of their transfer prices by tax administrations, many of them strongly resist any possibility of a shift to unitary taxation, because it would threaten tax avoidance using tax havens, on which a significant number of them have become dependent.

TNCs are now the dominant element in the world economy. Their tax liabilities run into hundreds of millions of dollars, and have major implications both for their competitiveness and for national tax revenues. It no longer seems acceptable that the determination and allocation of these taxes between states should be done on the basis of methods which are impossible to administer in ways which can be seen to be effective, consistent and fair.

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†††† In one notable case, the pharmaceutical company GlaxoSmithKline was assessed for US$5.2 billion in back taxes and interest by the US Internal Revenue Service in 2004 related to profits from its anti-ulcer drug Zantac. Glaxo claimed that this was arbitrary and appealed, arguing for a refund of US$1 billion. The dispute was finally settled for US$3.4 billion. Glaxo's complaint was based on a comparison with the treatment given by the US tax authorities in an APA with its then rival SmithKline, which Glaxo discovered only after its merger with SmithKline in 2001.

‡‡‡‡ The UN Practical Manual on Transfer Pricing for Developing Countries, revised in 2012, advises that among the documentation which a tax administration should request for a Transfer Pricing audit should be the `Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years' (UN 2012, para. 8.6.9.12). Interestingly, comments on the draft sent to the UN Tax Committee by the US Council for International Business objected to this provision, although it accepted that such consolidated accounts are readily available for publicly quoted companies, and did not object to the requirement to provide segmented accounts, which are necessary for evaluation of transaction prices under the ALP, and which are time-consuming and therefore costly to prepare. The objections were not accepted by the Committee, but the US expert member suggested that the matter could be raised again.

§§§§ The information exchange provision in the traditional tax treaties was until recently very limited: notably, the requested state had no obligation to obtain information which it did already have for its own tax purposes. Successive revisions of the tax treaty models since 2000 have greatly extended this, although it takes time to implement the model provisions in actual tax treaties. Tax havens are not usually party to such treaties, but since 2007 the OECD efforts against evasion and avoidance have resulted in negotiation of some bilateral treaties for the exchange of tax information. However, these provide only for information on the basis of a specific and targeted request, and their limitations mean that they are not much used. In any case, few developing countries have the resources either to negotiate or to utilise such treaties.

2. The Unitary Taxation Approach

A shift towards assessing TNCs on a unitary basis, coupled with a principled basis for apportioning their tax liability, would bring the international tax system into closer alignment with economic reality, and hence greatly improve its effectiveness and legitimacy. Although not without its own difficulties, these are minor compared to the problems it would eliminate. The unitary approach is based on the assumption that the income of a firm is earned by that firm as a whole, and it does not attempt to identify or quantify how much of it could be said to have been earned by any of the component parts. Instead, income is *apportioned* by a formula using factors which quantify the actual geographical location of its activities. Thus, the unitary approach is based on the principle that tax should be paid according to where the activities generating the income take place, because taxes help to make those activities possible (providing education, infrastructure, etc).[*****]

A unitary approach would replace three major elements which create fundamental problems for taxation of TNCs under the ALP: (i) the need for detailed scrutiny of internal accounts and pricing and for the negotiation of adjustments based on the ALP; (ii) the need to deal with profit-shifting within the firm, especially using tax havens, by complex anti-avoidance measures, such as rules against thin capitalisation, controlled foreign corporations, and abuse of treaty benefits; and (iii) source and residence attribution rules.[†††††] It would therefore greatly simplify the international tax system, to the benefit of both taxpayers and tax administrations.

It should be said at the outset that, although it is desirable that all states applying this approach to a TNC should do so as far as possible in a harmonious and coordinated manner, this does not mean agreement on every aspect, or on uniform rules. Taxation is not an exact science, and as we have seen in the previous section, the present system operates with a very loose system of coordination, and no clear agreement on common rules. As we have seen in the previous section, even the guidelines for the ALP which have been formulated allow a wide range of approaches and much room for interpretation. Similarly, states could apply somewhat different versions of the unitary approach, provided that there is reasonable coordination, including procedures to deal with conflicts, as already exist under tax treaties.

2.1 The Combined Report

The basis of applying the Unitary method is that each TNC must prepare a Combined Report covering the whole of the corporate group engaged in a unitary business. Any state applying the unitary approach to any entity subject to tax in that state which is part of a TNC would require it to submit a combined report covering the whole group of which it forms a part. Thus, instead of seeing only the separate accounts of the local affiliate, each tax authority obtains accounts for the firm as a whole. Since these are consolidated accounts, they will disregard all internal transfers, so they automatically eliminate any profit shifting or other avoidance arrangements involving intermediary entities. Hence, the requirement of a combined report is the key element of the unitary approach, as it would deal a major blow to the use of secrecy and tax havens.

This report should include (i) details of all the related entities engaged in a common or unitary business with the taxpayer, (ii) a set of consolidated accounts for that group, eliminating all

[*****] A frequent criticism is that formula apportionment is `arbitrary', and this seems to be accepted even by some who support it as more effective (e.g. Avi-Yonah and Benshalom 2010, p. 14). This seems based on the misunderstanding that the factors in the formula are `proxies' which (imperfectly, but adequately) quantify the factors that produce profits. Abandoning this futile task, and basing the allocation of tax claims on more legitimate criteria, is one of the strong advantages of the unitary approach.

[†††††] For further discussion of this point see McIntyre 2003.

internal transactions within it, and (iii) a calculation of the proportion of the group's taxable income attributable to the taxing state according to its apportionment formula, specifying the totals of each element in the formula for the group as a whole and the amounts and proportion of those totals for the taxpayer.

Let us consider these components in turn.

2.2 Defining the Unitary Business

Unitary taxation should be applied to all legal entities (companies, partnerships, trusts, etc) which are (i) under common control or direction, and (ii) engaged in the same or related business activities. The first criterion should be based on legal ownership (e.g. direct or indirect ownership of over 50% of shares), but also with a wider test of `control', to prevent avoidance. Thus, it would not cover firms which are closely tied together if they are separately owned, such as franchisees (for example fast-food outlets, unless there is an ownership link), or manufacturers under a long-term contract (for example, Foxconn, which manufactures iPads and iPhones, would not be treated as unitary with Apple). However, it would cover entities in which there is less than a majority ownership stake, if they are effectively under the direction or control of the firm with that stake.

The second test, which must be satisfied separately, is also important. It is neither necessary nor desirable to include within a unitary group all entities which are under common ownership or control, if they do not engage in related activities. It is unnecessary because there would be few related transactions to eliminate. It is not desirable, because to do so might enable avoidance: (i) by profit-shifting, e.g. if a capital-intensive firm acquires a highly labour-intensive business in a low-tax state; or (ii) by profit-dilution, e.g. if a profitable firm acquires a loss-making business to reduce its tax liability.

In many cases, TNCs may argue that they operate distinct activities under independent divisions or profit-centres. However, if they come under common control, there should be a presumption that they are part of a unitary business if there are a significant number of transfers between them, or if they share common resources or services. A distinction should be drawn between a firm which acts like a private equity investor with stakes in many different businesses, and one which operates businesses which may be somewhat diversified but operate under a management which is centrally directed.

2.3 Defining the Tax Base

Each of the affiliates of a TNC in any country applying the unitary approach would be required to include in the Combined Report a set of consolidated accounts for the TNC as a whole. It is clearly desirable that these should be the same, and therefore that those countries should adopt a common set of rules for those accounts, defining the tax base. This would simplify the preparation of accounts for the firm, and give the tax authorities a clear view of its overall activities. There would be an enormous saving of administrative effort for those countries which currently struggle to disentangle the complex internal links of TNCs, and make it possible for those, especially developing countries, who lack the resources even to attempt to do so.

The Combined Report should cover the whole corporate group, and not only those parts of it which operate in the country or countries applying the unitary system. It is of course highly unlikely that classic tax havens would join a unitary taxation system, especially as many of them do not tax income or profits. This does not prevent countries which do shift to a unitary approach from requiring a worldwide combined report, indeed such a report is essential. This would merely extend the principle already applied under the current system to `controlled foreign corporations' (defined in elaborate and complex ways), the income of which is simply `deemed' to belong to their owners.

Although desirable, a common tax base is not essential for a unitary approach. As Michael McIntyre has pointed out, the formula apportionment system operated by many US states works adequately well without such a harmonised tax base (McIntyre 2004). Also, many countries accept accounts for tax purposes based on corporate accounting principles, for which international standards now exist.

A major advantage of adopting an internationally harmonised tax base is that it would make it easier to agree straightforward principles and exclude the special allowances and tax privileges which often bedevil national tax rules. These generally result from business lobbying, either to protect favoured domestic industries or to attract foreign investment. Unitary taxation would remove the temptation to offer such advantages, and thus deal with the problem of tax competition between states to attract investment by TNCs. A broader tax base, excluding such allowances, would reduce such tax competition, and enable reduction of tax rates.

2.4 Determining the Allocation Formula

At the heart of the unitary approach is the allocation of the total profit according to a formula. As with the rules defining the tax base, it is clearly desirable that the allocation formula should be agreed among states applying the unitary approach to affiliates of the same TNCs. However, here also an agreed formula is not essential. A state unilaterally adopting the unitary approach should not adopt a formula which it would not find acceptable if applied by others. Indeed, there would be a disincentive to adopt a formula which TNCs might consider inappropriate, as they could relocate activities or disinvest altogether. For example, a state which is used as a manufacturing location because it can offer a high-quality labour supply at reasonable wage-rates might be tempted to adopt a formula weighted towards the number of employees; but this could encourage firms to adopt labour-saving technologies, or to relocate production.

The allocation formula does not aim to *attribute* the income generated by the TNC to its different affiliates, as does the ALP. The unitary approach assumes that the income is generated by the combined activities of the group. Hence, the factors in the formula simply provide a measure of the extent of the activities of the TNC in each country where it does business, in order to *allocate* the income. The aim is to allocate income according to factors which can easily and accurately quantify the extent of the TNC's activities actually taking place within each country. Hence, an important element in choosing and defining the factors in the formula is that they should be relatively easy to assign to a geographical location. Allocation of income should, therefore, also be based on the geographical location of the factor, and not for example on where its owner is located.

The usual factors generally employed in formula apportionment are assets, labour, and sales. These will be discussed here, briefly, in turn.

2.4.1 Assets:

This should consist of all fixed, tangible property. Assets should be allocated according to where they are physically located or actually used, and not to the entity which owns them, to prevent avoidance. It is preferable to include assets which are leased and not only those directly owned, if only to prevent avoidance by sale-and-leaseback. However, some assets could be excluded, for example inventory (which is sales-related).

It is also preferable to exclude intangible assets, such as IPRs. One reason for this is the difficulty of assigning non-tangibles to a specific geographical location. More importantly, inclusion of intangibles would run counter to the basic principles of unitary taxation. The unitary approach does not attempt to evaluate the contributions to total income made by the different parts of the TNC, it assumes that the income results from the combined efforts and synergy of the firm as a whole. It therefore avoids the increasingly intractable problems faced by the ALP in determining the allocation of income to intangibles, which are clear symptoms of the unsuitability of the ALP, especially in the `knowledge economy'.

Typically, a TNC will operate facilities for research and development (R&D) in one or a few locations; the know-how and IPRs which result will be used in its production facilities in various other locations; and the resulting products will be sold all over the world. Often, an attempt will be made to reduce taxes by transferring ownership of the IPRs to a holding company in a suitable jurisdiction (a haven). Even if this avoidance device is blocked, how is the income from the intangibles to be attributed? Should it be considered as earned entirely by the affiliate where the research was conducted? The manufacturing affiliates might also have contributed, by adapting the know-how in the course of production. Furthermore, IPRs are generally granted protection under national laws which therefore help to generate the TNC's monopoly profits. Also, the income could be partially attributable to the willingness of the consumers to pay for the products embodying that R&D. The OECD Guidelines have long wrestled with these difficulties. The latest draft issued for discussion in 2012 proposes that the attribution should take account of the `functions, risks, and costs' borne by the different affiliates involved. This is no more than sophistry, and it is not surprising that intangibles are central to the vast majority of transfer pricing disputes. The unitary approach simply avoids these problems, because it does not seek to *attribute* income according to the nature of the various activities, but to *apportion* it according to factors linking the activities to each state. Hence, intangibles should be excluded from the assets weighting in the formula.

2.4.2 Labour

This factor covers all employees, as well as any persons working under the direction of the firm. This includes employees of sub-contractors providing labour services, if the firm controls or directs their work and not just its outputs. As with assets, employees should be allocated according to their actual place of work, rather than to the entity which happens to employ them. Those who work at different locations could be allocated according to the number of days spent in each. If this is thought to be difficult to administer, they could be allocated to their primary place of work.

The main difficulty posed by this factor is whether it should be quantified by headcount (number of employees) or payroll costs. Under the system adopted by US states, payroll costs are used, and there are some arguments in favour of this. However, it would be inappropriate to apply internationally, in view of the wide international disparities in wage-rates. The system proposed for the EU (discussed below) would weight the labour factor 50% by headcount and 50% by payroll costs. This seems a reasonable and acceptable compromise.

2.4.3 Sales

This should include all revenue or receipts from the sale of anything outside the firm. These should be allocated according to the destination (the country of the recipient, customer or client), which would prevent profit-shifting through distribution affiliates. It should be noted that this does not mean that a country can tax the business profits of a foreign firm which only sells into that country, unless that firm itself carries on business within the country. That could be done by sales taxes. However, firms with substantial sales in a country generally have a business presence there, to supervise distribution, handle marketing and advertising etc. Even internet-based distribution companies such as Amazon have national websites in the local language, and this should be considered a sufficient business presence. A broader definition should therefore be adopted for what constitutes doing business within a country than is used under the present system for a permanent establishment, which does generally require a more than temporary physical presence.

The issue sometimes arises whether some sales by an affiliate should be excluded if they are incidental and not part of its normal business. It should be remembered that the combined report should include only affiliates and branches which are engaged in a unitary business, as discussed above. Thus, provided the entity concerned is part of such a unitary business, the simplest approach is to include all its sales in the sales factor.

2.5 Weighting the Factors in the Formula

The weighting of the factors in the formula would be the most difficult issue for the international adoption of a unitary approach. The three-factor formula evolved, especially in the practice of US states, to balance out the claims of taxing jurisdictions with different kinds of involvement in business. Assets and labour quantify claims to tax based on production, while sales provides a weighting for those based on large consumer markets.

Historically, the factors have normally been weighted one-third each. In recent years, US states have tended to double-weight the sales factor. This has the effect of splitting income roughly half each according to sales and production (since both assets and labour quantify production). On the other hand, the European Parliament in 2012 amended the proposal drafted by the Commission, from one-third each to 10% for sales and 45% each for assets and labour.

Provided that the factors are defined so as to have a clear geographical location, notably by excluding intangibles, there would be little opportunity for artificial avoidance. Apportionment based on these factors would allocate a minuscule proportion of the tax base to the main tax havens where the only real activity is servicing the avoidance and evasion industry. Critics suggest that TNCs would respond to whatever formula is applied by relocating their activities. However, this is very different from artificial avoidance. In the absence of wide differences in corporate tax rates (between countries with significant economic activity), there would be relatively little scope to reduce a firm's *global* tax liability by relocating production. Certainly, a shift towards unitary taxation, without any coordination of tax rates, could increase the temptation for some states to try to attract investment by offering low tax rates. On the other hand, the improved coordination of taxation provided by the unitary approach would make it easier to phase out the existing tax incentives and holidays offered by many states. Competition on tax rates is considered beneficial by many economists, and is certainly much preferable to competition on special exemptions and incentives. In any case, tax savings would generally be unlikely to outweigh the main factors which determine corporate decisions on the location of investment: the quality and cost of labour, provision of suitable infrastructure, etc. Furthermore, the gains from elimination of profit-shifting and tax avoidance through havens, as well as the substantial savings in enforcement and compliance costs, would make it easier for all states to lower corporate tax rates, thus reducing the differentials between them. There would in effect be a redistribution of the tax burden, by removing the advantages gained by those firms which have exploited the opportunities for international avoidance, creating a much more level playing field which in the long run will benefit all.

International agreement on the weighting of the formula factors would be facilitated by the considerable scope for trade-offs. Countries where wage-rates are higher, which would favour payroll rather than headcount in the labour factor, would tend to benefit from the inclusion of the assets factor with an equal weighting, so might concede that labour should be based on headcount. Similarly, countries with more developed economies and hence larger markets would benefit from the sales factor, so might concede that labour could be weighted according to headcount. Conversely, although countries which have attracted large-scale manufacturing would benefit in terms of tax revenues from use of the labour factor, they should be willing to accept a significant weighting for other factors, for fear of the disincentive effects on inward investment. Apportionment by formula depends on acceptance of the general principles, for long-term application, and should not be decided by short-term and evanescent calculations, which may be unreliable.

An issue which has been debated since the unitary approach was first considered in the 1930s is whether apportionment by a general formula applicable to all firms in all industries is appropriate. Some types of business do have special characteristics which may entail a special formula.[‡‡‡‡‡] Transportation industries pose a special problem because their physical assets are mobile, so they could be taxed based on the value of traffic between contact points. In the case of extractive industries, the tax on extraction of a depleting natural resource should be treated as a rent, and not a tax on business profits. Indeed, historically states used royalties, and the redesign of these systems as income taxes was instigated by the firms themselves, to enable them to satisfy countries of extraction by paying higher taxes, while crediting these payments against their income tax liabilities in their home states (which was not possible with a royalty). It would make more sense today to revert to more sophisticated royalty systems, perhaps combined with production-sharing.

This indicates why a general apportionment formula would be appropriate for allocating a general tax on income or profits. The basis of legitimacy of the income tax lies indeed in its generality and uniformity of application. It is not the only type of tax in the armoury of states, many kinds of special levy or duty are available and applied to specific activities or economic factors: on alcoholic beverages, fuel, airport departures, insurance premiums, etc. Indeed, businesses are fond of referring to their `total tax contribution', especially when accused of avoidance of tax on their profits. General income taxes are considered fair because they are applied equally to everyone, both individuals and legal persons such as companies, proportionately to their income.

This same principle of fairness should extend to the allocation of the tax base between countries by means of a general formula. This would not preclude allowing some form of dispute resolution to deal with problematic cases, whether between countries, or at the instigation of the firm. As already mentioned, such arrangements are already available under tax treaties, the so-called `mutual agreement procedure', and indeed are now mainly used to resolve conflicts over application of the ALP.

3. The Transition To Unitary Taxation

As already explained, unitary taxation is not a new idea, indeed it was identified as a superior approach in principle when international tax rules were first devised. It has also been applied in practice, and there is considerable experience of it, especially in the USA. Finally, as we have also seen in section 1 above, the existing system based on the ALP in practice uses special apportionments, especially under profit split methods and the TNMM. Hence, there is already considerable experience on which to base a unitary system.

Although the ground is prepared for adoption of a unitary approach, rebuilding the international tax system on what would be sounder foundations would still pose some problems. In principle, two strategies are possible: complete replacement of the ALP with a unitary system, or a gradual transition. Replacement has some significant advantages: since unitary taxation is a principled system, it rests on the prior acceptance by the states involved that it will produce a fair and reasonable allocation of taxes in the long run. It is also more

[‡‡‡‡‡] In the US special formulae have been applied to industries such as transportation and banking, negotiated by the Multistate Tax Commission in consultation with those industries (McIntyre 2012, 5).

effective if applied by a significant number of countries, especially if they are closely tied through foreign direct investment.

However, adoption of a unitary approach depends on a political impetus, to resolve the issues of principle involved. Indeed, a major reason it has not been adopted before now, despite its evident strengths, is that tax authorities considered that such a political basis would be lacking. To help resolve this impasse, it is worth considering appropriate transitional arrangements, which might help convince doubters, by a step-by-step movement towards unitary taxation.

The three main components of this transition would be (i) conducting careful studies, (ii) adoption of a unitary system between groups of countries and for specific sectors, and (iii) introduction of combined reporting alongside the ALP. It is essential, however, that these components are formulated with the aim of moving towards a comprehensive adoption of the unitary approach. A clear strategy particularly important in order to achieve both of the main advantages of the unitary approach: (i) to end tax avoidance through profit-shifting and the use of the tax haven system, and (ii) to establish a system of allocation of the tax base of TNCs which is effective, fair and transparent, and hence accepted as legitimate.

3.1 Conducting Studies

No official international tax organisation has conducted a serious study since 1935 of whether the unitary approach would provide a better basis than the ALP. The OECD's Committee on Fiscal Affairs, which has generally taken a leading role, has stubbornly refused even to consider the viability of the approach for over 30 years. It was strongly influenced by the determined lobbying campaign by TNCs in the early 1980s against the application of formulary apportionment on a worldwide basis by US states, especially California (see below). Then in the early 1990s the sharp conflicts over the use of profit-split methods and the TNMM were resolved only on condition that the Guidelines on Transfer Pricing should reaffirm that they constitute an application of the ALP, and should explicitly reject formula apportionment. This obstinate position continues to be maintained, notably in the 2012 consultation on Intangibles.

The OECD position that the ALP expresses an international consensus as the only way to combat transfer pricing has been deployed to close down debate elsewhere, especially in the UN Tax Committee. In recent years many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the vast majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach. Even the largest among them, such as Brazil, China, India, and South Africa have experienced serious difficulties in applying the ALP, especially in finding suitable comparables. Although their regulations pay lip-service to it, they often also emphasise the need for a `holistic approach'. In practice, the methods they prefer are very different from each other, and from those of OECD countries.[§§§§§] Thus, Brazil does not allow profit-split methods, but as the alternative to the CUP method (due to lack of comparables) relies on cost-plus or retail-minus but using specified fixed margins. This is a significant departure from the OECD Guidelines, leading to criticisms in the OECD Committee. In contrast China, which also finds it hard or impossible to find comparables, prefers profit-split methods, but takes account of distinctive factors, notably `location-specific advantages' which it considers justify allocation of higher profits to Chinese members of TNC groups. India also employs this criterion for adjustments. However, this approach also is likely to produce results which diverge from those acceptable to

[§§§§§] The UN Manual includes helpful outlines of the difficulties faced and approaches adopted by Brazil, China, India and South Africa (UN 2012, ch. 10).

OECD countries.[******] So even as the OECD approach is extended to some other countries, it is likely to create increasing problems due to divergent approaches, while most countries will lack the capacity to apply it effectively.

A serious study of the unitary approach would enable them to review their overall approach, and consider whether a new perspective would be more effective and appropriate. This might be best commissioned by the UN Tax Committee, though it would require additional resources.[††††††] Studies should comprehensively explore all aspects of the introduction of a unitary system, including (i) principles for definition of the tax base, (ii) requirements of the combined report, (iii) factors which could be used for the apportionment formula and their weighting, and (iv) consideration of the changes that might be needed to existing instruments, especially model tax treaties, both for a transitional period and for replacement of the ALP.

3.2 Adoption of Unitary Taxation by Groups of Countries

3.2.1 Combined Reporting with Formulary Apportionment by US States

As already mentioned, the unitary approach has been applied by US states since the 1920s. It was initially used as a fall-back, to deal with situations where the local accounts did not seem to fairly reflect profitability, especially profit-shifting. A pioneer was California, which was particularly concerned to prevent motion picture companies siphoning off profits to their distribution subsidiaries in low-tax jurisdictions, especially in neighbouring Nevada. California's Franchise Tax Board for many decades applied the unitary approach only when it considered it necessary, but court decisions in the 1960s gave taxpayers the right to demand it, benefiting companies such as oil producers, which could offset losses or high costs elsewhere against their high California profits. This led to a more uniform application of the unitary system to all companies. However, it also resulted in complaints especially by foreign TNCs moving into the state, which found that despite high start-up costs meaning low initial profitability of the California operations, they would be taxed on a proportion of their global profits. Their resulting campaign, focusing in particular on the new US-UK tax treaty signed in 1975, did not succeed in having the unitary approach held unconstitutional, but it did result in allowing TNCs to choose to exclude most of their non-US affiliates, referred to as the `water's edge' election.[‡‡‡‡‡‡]

The application of the unitary approach by US states is only loosely coordinated, but still works quite effectively. The 3-factor apportionment formula of property-payroll-sales was formulated in 1957 in the Uniform Division of Income for Tax Purposes Act (UDITPA), drafted by the National Conference of Commissioners on Uniform State Laws. It was adopted as Article IV of a Multistate Tax Compact in 1966, which established the Multistate Tax Commission with the power to formulate regulations and develop practice to ensure optimal harmonization in the application of UDITPA. Despite some unilateral moves by states, in particular adopting a double weighting for the sales factor in the formula, the system seems to have worked well, with few complaints by firms since the 1980s (McIntyre 2012).

[******] The OECD Guidelines (paras. 9.148-153) do discuss the issue of `location savings' in the context of the restructuring of a TNC's operations to relocate activities to a lower-cost country, in terms of how such savings should be allocated among the parties. China and India appear to have broadened out this concept considerably and, not surprisingly, stress their own locational advantages as factors that justify a higher allocation of profit.

[††††††] This could be along the lines of the recent project to revise the UN Manual on Transfer Pricing, which involved the largest sub-committee in this body's history, and meetings in India, China and South Africa.

[‡‡‡‡‡‡] This has added a new layer of complexity, which there is no space to discuss here. California's Franchise Tax Board provides an extensive online Manual, accessible at https://www.ftb.ca.gov/aboutFTB/manuals/audit/water/index.shtml .

3.2.2 The CCCTB in the EU

An important step forward has been taken by the formulation of a proposal for unitary taxation within the EU, by the European Commission. The Commission has been searching for a more effective basis for corporate taxation in the EU since it commissioned the Ruding Report in 1992; in 2001 it proposed a move towards taxation within the EU on a consolidated basis, and detailed work was carried out from 2004 especially through a working group, including national tax officials, business representatives and tax experts, which met 2005-8. This careful preparation meant that when in February 2011, responding to the Euro crisis, the Franco-German `competitiveness pact' called *inter alia* for the `creation of a common assessment basis for corporate income tax', the Commission was able to publish its draft in March 2011.[§§§§§§] After careful study, the European Parliament approved this draft, although with some significant proposed amendments, by a large majority in April 2012.[*******]

The proposal is for a Common Consolidated Corporate Tax Base (CCCTB) to apply to all companies within the EU. This would establish a common set of rules for all participating member states for calculation of the corporate tax base, on a consolidated basis for all members of the corporate group (and hence eliminating internal transactions among them), and apportionment of the taxes to be paid between the participating states. It also includes common rules for tax interactions with third states, including rules to combat the use of tax havens, and a general anti-avoidance rule. The general apportionment formula proposed by the Commission is one-third for assets (excluding intangibles), one-third for sales, and one-third for labour (split 50-50 between payroll and headcount). However, as mentioned in section 2 above, the Parliament proposed a weighting of 10% for sales and 45% each for the other factors.

The proposal has been criticised for several shortcomings. First, the Commission proposal would allow firms to choose whether to come under the system or stick with existing national rules. This would mean countries continuing to run two parallel systems, with firms able to choose between the two. To restrict opportunistic choices, an election once made would be binding for five years in the first instance, and then for 3-year periods. This provision was no doubt intended to make the proposal more acceptable to reluctant firms and states. However, the Parliament proposed an amendment which would make it binding within two years on companies and cooperatives formed under the EU statute, and on all qualifying companies within five years (small and medium enterprises could opt out). Secondly, no harmonisation is proposed of tax rates. Indeed, the Commission even argued that the resulting tax competition would be desirable. However, an economic analysis done for the Commission suggested that there could be significant imbalances in the costs/benefits between states without some degree of harmonisation of rates, and this would also improve the overall welfare impact (Bettendorf et al 2009).

The proposal would have advantages which should make it attractive to many TNCs. In particular, existing rules make it hard or impossible to set off gains and losses in different countries, which is a significant problem for TNCs. Unitary taxation would automatically pool losses and gains, thus facilitating cross-border business. A Commission survey showed that this would immediately benefit some 50% of non-financial and 17% of financial firms. Some might regard this as a disadvantage, but it can be seen as a necessary concomitant of the single European market. Similarly, it would remove tax impediments to intra-group reorganisations. Most significantly, it would reduce tax compliance costs: the Commission estimated a 7%

[§§§§§§] Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) COM(2011) 121/4, See http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

[*******] European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2012-135

reduction in recurring tax-compliance costs, and over 60% for opening a subsidiary in another member state. National tax administrations would also reduce their enforcement costs, although to a lesser extent because of the need to operate two systems in parallel.

The main limitation of the proposal is that the consolidated accounts to be filed need only include the members of the corporate group resident in participating states. This deprives the CCCTB of a key advantage of the unitary approach, since it allows TNCs to exclude intermediary entities which they use for tax avoidance, including those located in havens. This problem would continue to have to be dealt with by the usual range of anti-avoidance measures, which are included in the CCCTB rules, including rules on transfer pricing, controlled foreign corporations, and a general anti-avoidance principle.

The proposal is currently under consideration by the European Council, in a working party on tax questions.[†††††††] In the context of the euro crisis there is now considerable political support for closer economic policy and fiscal coordination, perhaps in the form of a `euro-plus pact' to support the Euro, although this was not the initial rationale for the CCCTB (Ruding 2012). Clearly, not all the EU member states would be willing to adopt the proposal: indeed, objections were expressed during the earlier stages by several.[‡‡‡‡‡‡‡] Nevertheless, it is possible for such a proposal to proceed under the `enhanced cooperation' procedure. Once the Council decides that the proposal could not be adopted by unanimity (which under EU rules is required for taxation measures), a smaller group of states, at least nine, could decide to use that procedure. Although proceeding with a smaller group of states would obviously reduce the scope of applicability, it might allow amendments which could strengthen the provisions. A similar decision has already been taken in respect of the separate proposal for a financial transaction tax (FTT), which was also given an impetus by the financial crisis.

It is important to understand that the CCCTB could, if modified, play a major role in the fight against international tax avoidance, as well as helping resolve the problems of transfer pricing. The key to this would be to require all companies doing business in the states operating a CCCTB to submit a worldwide Combined Report.

3.2.3 Extending and Deepening Unitary Taxation

The CCCTB is important, despite its limitations, as it provides a fully worked out proposal for a unitary system to be applied internationally between a significant group of states. This belies the insistence of the OECD that the ALP is the `only game in town'. In conjunction with the fact that there is considerable support in the US for a unitary approach, as well as the experience over nearly a century of combined reporting for state taxation, it helps to open the way for a transition from the ALP to unitary taxation.

As with the EU, other regional groupings could formulate proposals for unitary taxation. These could include the Association of South-East Asian Nations (ASEAN), the East African Community, the Andean Pact, etc.

As we have seen, the main limitation of existing systems and proposals (combined reporting in the US, and the CCCTB), is that they are limited to the `water's edge'. Yet there is nothing to prevent a unitary system, even if introduced by one or a few countries, to be based on a worldwide combined report (see section 2.1 above). Indeed, this is essential to achieve one of

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[†††††††] See `Report by Finance Ministers on Tax issues in the framework of the Euro Plus Pact', 25th June 2012, ECOFIN 640, available from http://register.consilium.europa.eu/pdf/en/12/st11/st11803.en12.pdf, and Working Party on Tax Questions, agenda for meeting of 24th October 2012, http://register.consilium.europa.eu/pdf/en/12/cm04/cm04821.en12.pdf, both accessed 31st October 2012.

[‡‡‡‡‡‡‡] Bulgaria, Ireland, Malta, Poland, Romania, Slovakia, Sweden, the Netherlands, and the UK: see Preamble to the European Parliament Resolution on the CCCTB, http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A7-2012-0080+0+DOC+XML+V0//EN.

the main aims of the unitary approach, to defeat international avoidance through the tax haven system. Thus, adoption of the approach by regions or groups of states should be on the basis of a worldwide combined report. It is also obviously desirable that some coordination should be developed, especially of the three main elements of the combined report (discussed in section 2).

3.3 Introduction of Unitary within the Present System

Some commentators have proposed that formula apportionment could be introduced alongside the ALP. This could be done either in general, or for particular sectors.

Current suggestions for a parallel introduction rest on the understanding of the defects in the ALP, mainly the unavailability of comparables, and the appreciation that the `other' methods considered acceptable (profit split and the TNMM) entail a type of formulaic apportionment of profits. The arguments for this strategy are that it would enable tax administrations to `cautiously and gradually' shift to a new system (Avi-Yonah and Benshalom 2010, p. 13). It would entail the abandonment of the view (or pretence) that the `other' methods which have been accepted as alternatives to finding comparables are incompatible with formula apportionment. Instead, the ALP should be interpreted (as these authors suggest was always intended) as simply authorising a fair or appropriate allocation of profits. However, this is not a unitary approach, nor does it claim to provide one. It would perhaps apply some sticking-plaster to the gaping wounds caused by the inadequacies of the ALP.

A transitional strategy to help accustom tax administrations to operating a unitary approach could nevertheless have some merits. The key to it however, as the analysis put forward here suggests, is the introduction of a requirement for TNCs to submit a Combined Report in each country where they are subject to tax. This would have immediate benefits for tax administrations, by providing them with a single overview of the entire consolidated accounts of the firm, eliminating all profit-shifting and profit-stripping. Tax officials in individual countries are often faced with the enormous tax of trying to penetrate the elaborate and complex maze of intermediary entities used by TNCs to channel transactions and profits, usually to avoid tax. They may resort to cumbersome procedures for exchange of information with colleagues in other countries to try to get a fuller picture. All these problems would fall away if a requirement were introduced by the major states for submission of a combined report.

If introduced in parallel, the combined report could be used in two ways. First, it could be used directly as the basis for unitary taxation with formula apportionment for firms in industries where this is particularly appropriate. An important example is multinational banking (Sadiq 2011-12). It is no accident that banks and other financial firms are the main users of the tax haven system, and indeed their systematic tax avoidance, by reducing their cost of capital, significantly contributed to the liquidity that fuelled the speculative bubble which resulted in the financial crash. Countries everywhere are now eager to find a more effective way of taxing the profits of financial firms, and a unitary system would provide it.

Secondly, tax administrations could begin to apply a unitary approach in parallel to the present system, as a check. As pointed out above (section 1) this tactic has indeed long been used, although on a rudimentary basis, lacking a true overall view of the firm which a combined report would provide. Submission of a combined report should also also complemented by a requirement for country-by-country reporting of the taxes actually paid (Murphy 2012). This would be a giant step towards setting the international tax system on a basis of transparency and effectiveness, and hence restoring the legitimacy of taxation in all countries.

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