tax justice network

Reforming Corporate Taxation in a Global Economy: A Proposed to Adopt Formulary Apportionment
By Reuven Avi-Yonah and Kimberly Clausing.

In a June 2007 discussion paper sponsored by The Bookings Institution, Reuven Avi-Yonah and Kimberly A. Clausing argue for a formulary apportionment method based on the destination of sales or services.

The authors first describe the conceptual and practical problems with the current system of U.S. corporate taxation of multinational enterprises:

(1) The current system is not suited to the global nature of international business: International production processes make the separate accounting system of assigning profit to specific geographic locations inherently arbitrary. Also, the nature of operations of multinational enterprises generates additional profit over what would occur with strictly arm's length transactions between unaffiliated entities. With firms that are truly integrated across borders, holding related entities to an arm's length standard for the pricing of intracompany transactions does not make sense, nor does allocating income and expenses on a country-by-country basis.

(2) The U.S. system of international taxation creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic activities in such countries, and by shifting profits to lower tax countries.

(3) The current system based on the arm's length standard is too complex, with heavy compliance burdens and the impracticality of coherent enforcement. Avi-Yonah and Clausing state that "The (OECD's) arm's length standard has become administratively unworkable in its complexity."

(4) The current system raises little tax revenue in the United States due to the shifting of income outside the U.S. tax base.

Avi-Yonah and Clausing discuss the advantages of a Formulary Apportionment method, and how this would resolve the four forementioned problems with the current system. They propose a simple FA method based only on sales (rather than a three-factor formula of property, payroll and sales.) Sales would be determined by the location of the customers (the destination of sales of goods and services), but they also discuss alternative formulas.

They also discuss the definition of a unitary business

- Control: the subsidiary operates under the legal and economic control of the parent corporation.
- Unitary business activity: an integrated multinational enterprise.

The authors discuss potential problems with a formulary apportionment method:

(a) determining which businesses are unitary
(b) the need for a "global accounting system."
(c) determining the destination of sales and the issue of the "mobility of customers"
(d) the need for international cooperation and consensus regarding both the adoption of FA and the choice of a formula.
(e) Interaction with income tax treaties.

Some have argued that if formulary apportionment is adopted, then U.S. tax treaties will need to be modified -- because Article 9 of the treaties, which currently govern transfer pricing issues, assumes the Arm's Length/SA method. Modifying tax treaties would require a major effort of international co-operation and negotiating.

However, it seems that existing US tax treaties will not have to be renegotiated. This is because if FA were adopted to replace the arm's length method, Article 9 would not apply; instead, transfer pricing would be covered by Article 7 of U.S. income tax treaties, which covers transactions within the same enterprise.

Even though adopting FA would not require renegotiating any US treaties, however, it would be a good idea for the US to explicitly sanction the use of FA in future treaty negotiations. This can be done by inserting into future US treaties the language of OECD Model Article 7(4):

> *"Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from*

determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article."

The authors also discuss possible WTO issues.