NEWS ANALYSIS

Is Transfer Pricing Worth Salvaging?

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This article is an expanded version of remarks to the International Tax Institute in New York on July 18.

What is competitiveness?

Stated another way, would anyone buy American products if the United States did not have a global network of naval bases and exclusive power to protect shipping lanes all over the world?

In the great historical sweep of things, the United States is a commercial power because it is a naval power. If that sounds like Great Britain in the 19th century, that is because the parallels only begin with naval power. No one can import or export anything using water transport without the permission of the U.S. Navy.

If we look at the role of the United States in the world in terms of military power, we understand that U.S. multinationals aren't the first ones into a foreign country. Therefore, they should not conduct their own foreign policies and ought to be picking up the tab for naval protection.

Military spending is about 20 percent of the U.S. budget. Are multinational corporations paying anything like that in taxes? No. Individual taxpayers are subsidizing these large enterprises through the tax system, while the latter whinge about what little tax they do pay and expect the citizens to be grateful for the jobs that are retained in the United States.

What is the tax problem? In a nutshell, developments in law and planning have enabled U.S. multinationals to deprive the United States of tax revenue, as though it were any other source country.

The main way multinationals avoid U.S. corporate income tax, and the corporate income taxes of all the other countries in which they operate, is transfer pricing. Transfer pricing has become a newspaper pejorative for abuse of separate company accounting and fictitious corporations.

Defenders describe it as ''the arm's-length principle'' — as though attaining perfection in pricing between fictitious entities would resolve the question of who should pay how much tax where. Transfer pricing is the leading edge of what is wrong with international taxation. It raises all of the other issues.

The question that needs to be answered is what base Congress wants to tax, now that the international corporate income tax base is largely gone and the U.S. corporate income tax base is seriously at risk. Proposals for territorial taxation would essentially concede what little is left of the international base, while putting the U.S. base at risk.

Visible Opposition

The purpose of the OECD model treaty was to make life comfortable for American, British, German, and French multinationals by ensuring that the taxation of their operations by host countries is limited by separate company accounting and the permanent establishment concept. Treaties accomplish this task very well — so well, in fact, that many multinationals pay tax nowhere.

Our American readers tend to believe that the OECD model treaty and the transfer pricing guidelines are immutable and permanent fixtures of the tax landscape, rather than clumsy tools that affluent developed countries have used among themselves, to their collective detriment, and seek to impose on developing countries.

The former head of the OECD Centre for Tax Policy and Administration liked to refer to the transfer pricing guidelines as the Bible. There are similarities. Both require a great deal of faith. And the Bible is about as practical a document for tax administrators as the guidelines. Readers, the arm's-length method did not come down on stone tablets. There is nothing sacrosanct about it.

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The OECD Centre for Tax Policy and Administration has lost control of the debate. The transfer pricing guidelines are a sorry vestige of a system that will be gone in 10 years.

The OECD cannot justify the results that the current system permits. More rules and more document requirements will send our readers' kids to private colleges, but continued tinkering will not change the outcomes. More rules will not shore up the corporate tax base in developing countries so their kids can go to school. The problems have reached the public, and opponents ranging from protest groups to governments are saying no.

Brazil, Russia, India, and China (the BRICs). The polite Western fiction is that the BRICs will be brought along to the OECD view when they have their own multinationals stomping around the world. Ain't happened, ain't gonna happen. The BRICs sign the treaties and then do what they want.

India is actively undermining PE limitations on tax jurisdiction. It was influential in prodding the OECD to accept services PE in the commentary on the model treaty. India likes to withhold on outflows, and it imputes income from intangibles to the place they are used.

India is only an observer at the OECD, but its influence on the development and interpretation of treaties cannot be underestimated. India regards the OECD model commentary as a mere recommendation and the 1995 OECD transfer pricing guidelines as a document that takes care of the interests of developed (read capital-exporting) countries at the expense of the taxing rights of developing countries. India has lobbied the U.N. Financing and Development Office to devalue the guidelines as guidance for article 9 of the U.N. model treaty.

China, which has become the developed world's manufacturing plantation, is starting to flex its economic muscle. China signs the treaties, offers advance pricing agreements, and then lets local tax officials make their own decisions.

Here it is important to understand that China is not a low-tax country. It is a country where all kinds of production costs are low. Wages and shipping costs are low. There are no rules on pollution. Workers need not be provided pensions or medical care. The ''China price'' is a function of all these factors.

But Chinese taxes are not low. It's a big deal when China unilaterally decided to reduce withholding taxes on repatriated profits and dividends to qualified investors. The government made this change without going through the treaty mechanism, but it only applies to treaty countries (and only has practical utility for territorial regimes). (For prior coverage, see *Doc 2011-26025*.)

So when multinationals complain that home country taxes are making them uncompetitive, they should be reminded that they were permitted to move production, undercutting wages and benefits in their home countries, for the sake of their competitiveness, which relies more on cost factors than it does on the level of taxation.

Brazil is not going to be brought around to the transfer pricing nonsense. Brazilian law imputes industry-specific fixed margins unless the taxpayer can prove otherwise. The transactional net margin method, beloved by multinationals, is barely distinguishable from imputation of fixed margins. The former, which is in wide use, arrives at related-company margins by looking at the margins of other companies in the same business.

Brazil has no U.S. tax treaty, for a variety of reasons. It has an investment protection treaty with the United States. U.S. multinationals do a lot of business in Brazil, because it is a huge market and a major commodities producer. So the trope that a bilateral tax treaty is necessary for American companies to do business in a country is just not true. An investment protection treaty is necessary. A tax treaty is not.

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The proposed common consolidated corporate tax base (CCCTB) would establish formulary apportionment and elective consolidated filing for Europe. Some larger members will adopt it among themselves, while transactions with outside countries will continue to be governed by transfer pricing. Ireland agreed not to fight the CCCTB in last year's bailout document.

The CCCTB is for real. European multinationals do not want to build internal law firms to comply with American-style transfer pricing rules. They support the CCCTB, which has been made elective as a condition of their support. Of course they will run the numbers and elect adversely to the fisc, but it is not as though their current tax planning is especially kind to tax collection.

A multinational group would file a single consolidated return for the entire EU, measured on a broader tax base defined by EU rules, with its parent's country of residence (an EU holding company of a U.S. parented group could file). The CCCTB will facilitate cross-border use of losses. A close reading of the draft directive shows that the Europeans are addressing problems beyond separate company accounting. (For the draft directive, see *Doc 2011-5547*.)

There would be an all-in rule for affiliates. Every affiliate of which the group owns 50 percent of the voting rights and 75 percent of the value would be required to join the return. PEs in third countries would also join. Income from passthrough entities (regardless of the group's equity holding) would be proportionally included in income.

The CCCTB would combine and net the taxable incomes of each group member, after intragroup transactions (measured at the lower of cost or value) were stripped out. An antiabuse rule would allow artificial transactions to be ignored. Europe has a high standard of artificiality (*Cadbury Schweppes plc and CSO Ltd. v. Commissioners of Inland Revenue*, C-196/04, *Doc 2006-19082*).

Transfer pricing would continue to govern the group's relationship with affiliates in non-EU (and EU nonparticipating) countries and entities and transactions between group members and controlled entities that do not fall within the criteria for inclusion in the return.

Interest paid to residents of tax havens (countries lacking both real tax systems and tax information sharing agreements) would be nondeductible. Controlled foreign corporation rules would claw back passive income booked in low-tax countries (which would exclude Ireland).

The consolidated taxable income would be allocated among group members in participating countries according to the three-factor formula — property, payroll, and sales, equally weighted — formerly used by U.S. states. A consolidated net loss would be carried forward, not allocated.

Occupy Wall Street. These are your kids. These are bright, energetic, self-starting young people who you would like to have as employees. They are the same class of educated people who protested and stopped the Vietnam War. This is serious.

The young and educated are also the class that sets fashion trends. Consumer products companies, like Apple, are vulnerable if they zero out their corporate income taxes. Boycotts work. These kids can turn consumers against a product. The Occupy kids love Apple products, but that didn't stop them from simultaneously picketing Apple stores all over the country. Zeroing out now poses a risk to sales for a consumer products business, not just a reputational risk.

Tax Justice Network (TJN). The TJN is an organization that has been fighting tax havens, which are integral to the operation of multinational tax planning. Its latest research report, using Bank of International Settlements numbers, shows that $21 trillion has been stashed in tax havens. (For the report, see *Doc 2012-15576* or *2012 TNT 142-44*.)

The TJN supports a concept called country-by-country reporting, which would require multinationals to publish a balance sheet and income statement for each jurisdiction in which they operate.

Country-by-country reporting is best suited to extractive industries. Mineral-producing countries suffer from bizarre planning that somehow minimizes the proceeds of the sale of easily priced minerals removed from their soil. This idea suffers from the same fallacy as separate company accounting — the idea that every affiliate, however flimsy, behaves according to its tax-planned contractual and legal arrangements.

Country-by-country reporting would prevent multinationals from telling different stories to different governments. Presumably we could enforce the unenforceable 1995 OECD transfer pricing guidelines, which unduly respect those tax-planned contracts.

Well, gee, shouldn't the OECD support country-by-country reporting if it would help sort out the maze of tax-planned hollow entities in a typical multinational group? The OECD does not endorse country-by-country reporting.

Country-by-country reporting appeared in the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) as an amendment to the Securities Act of 1934. The new subsection requires publicly traded mineral extraction companies to disclose in their annual reports all taxes, royalties, fees, and other payments made to foreign governments. The SEC will make some of the information public (15 U.S.C. section 78m(q)). The SEC proposed amendments to regulation S-K in December 2010 (75 *Fed. Reg.* 80978).

Country-by-country reporting also shows up in the Cut Unjustified Tax Loopholes Act, S. 2075, sponsored by Sen. Carl Levin, D-Mich., the chair of the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations. It would amend the securities law to require all publicly traded companies to provide this information in interactive format. The bill would also require per-member breakouts of sales, pretax income, taxes paid, and intragroup loans (*Doc 2012-2605*, *2012 TNT 27-19*).

Naming and shaming. The Bloomberg article about Google and the *New York Times* article about Apple are the latest in the general interest media's efforts to convey in plain English and graphics why household names pay no tax. The articles show multinationals whose fortunes are based on valuable unique intangibles siphoning income out of market countries and into tax havens. (See *The New York Times*, Mar. 24, 2011 (General Electric), and Apr. 28, 2012 (Apple); Bloomberg, Oct. 21, 2012 (Google).)

Newspapers love names and faces. The problem with this method is that while it provides a layman's description of transfer pricing abuses, it contributes to the impression that the problem is just a few bad apples, when every multinational is stripping income out of market countries and into tax haven intangibles holding companies.

Indeed, income shifting is so easy that the business in question need not be exotic or complex. The *Guardian* investigation of bananas and the ActionAid investigation of SAB Miller beer show that transfer pricing rules fail to produce a fair result even in relatively simple cases of low-technology physical products. This puts the lie to the argument that tax rules have simply failed to keep pace with a high-tech globalized world.

Intangibles Migration

Most of the valuable U.S. intangibles have already gone out the door. Cost sharing, which until recently was governed by loose rules, allowed the transfer of existing intangibles as well as prospective winners. So even established companies became able to book their future growth in international earnings in tax havens.

The *Veritas* decision exemplifies the common practice of migrating the intangibles while they are inchoate. The transfer of low-valued inchoate technology plus depreciating existing technology to develop it holds down the affiliate's costs under a cost-sharing agreement. The court decision holds that the IRS cannot use hindsight to re-price the deal. (For the decision, see *Veritas Software Corp. v. Commissioner,* 133 T.C. 297 (2009), *Doc 2009-27116, 2009 TNT 236-17*, *nonacq.* AOD 2010-05, *Doc 2010-24215*, *2010 TNT 218-15.*)

Better pricing of royalties is not going to solve this problem. The ''commensurate with income'' clause was effectively read out of the law in *Xilinx Inc. v. Commissioner,* 598 F.3d 1191 (9th Cir. 2010), *Doc 2010-6163, 2010 TNT 55-12.* The Ninth Circuit, reversing itself, held that the IRS could not impose cost-sharing conditions that the parties themselves would not use in their own agreements and that all transfer pricing guidance must be faithful to the arm's-length method.

Moreover, charging a price for a transfer of a business opportunity will not adequately compensate for all the future profits growth that will be booked offshore. The OECD does not recognize the transfer of a business opportunity as a transfer of an asset that can be priced, despite German importuning, because the United States does not want this type of transfer recognized.

What is the solution? The ultimate, most desirable solution is formulary apportionment to countries where intangibles are used — that is, the location of the ultimate consumer. But some new thinking focuses on incremental fixes to the current system, including clawback of excess profits or re-sourcing of the income from intangibles.

Contract Manufacturing

The person on the street already knows that manufacturing jobs and even machinery have been shipped off to China. She would be offended that multinational affiliates that are not even engaged in manufacturing are allowed to avoid U.S. tax by being deemed to be engaged in manufacturing (reg. section 1.954-3(a)(4)(iv)).

The popular image is of third-party contract manufacturers, but many of them are controlled foreign corporations. Existing manufacturing operations are converted into contract manufacturers to limit the income attributable to these operations. The idea is to restrict the manufacturer's local income to costs plus a markup, stripping out the profit from sales of the product.

Nothing changes except the contracts between the group and its manufacturing affiliates. The principal company, which is usually located in a tax haven, assumes ownership of the raw materials and responsibility for quality, credit, and marketing risks. The manufacturer retains only the risk that it failed to follow instructions. If the manufacturer does not own the product it is working on, it has essentially been reduced to getting a fee for services.

The principal company is charged with supervision of the manufacturing, so it can say that its income is active income for subpart F purposes. Yes, the IRS is prepared to believe that a Swiss principal company can effectively supervise manufacturing at a Chinese contract manufacturer. It is deemed to make a ''substantial contribution'' to the manufacturing by supervising, in return for which the group gets to defer tax on the income.

The Chinese are not interested in these fine contractual distinctions. Their auditors strive to impute some of the profit on the sale of the product right back to the Chinese manufacturer.

China wants to reclaim some of the advantages of the China price as taxes. It uses its own apportionment factors, like compensation for labor advantages and access to market, to increase allocation of income to Chinese affiliates. China also uses profit-split methods.

The frightening thing about the shifting of income from relatively simple manufacturing operations to tax haven principal companies is how cheap it is. Contracts are redrafted, lawyers babysit, and a few people are assigned to mind things in Switzerland. The OECD transfer pricing guidelines tell tax examiners to respect these self-serving contracts. (For JCX-37-10, see *Doc 2010-16144* or *2010 TNT 139-13*.)

Stripped-Risk Distribution

Restructuring for stripped-risk distribution is another easy contractual income-shifting fix that does not change the facts on the ground. The former distributor contractually relinquishes inventory risk and customer credit risk to the principal company. The latter may also be handling product quality risk and raw materials for a contract manufacturer that is on a cost-plus contract. The former distributor, now dubbed a commissionaire or something similar, is contractually limited to a commission.

Tax planners base their case for limited income attribution to stripped-risk distributors on the argument that they cannot conclude contracts ''in the name of'' the principal. Nonetheless, these affiliates function as exclusive local representatives. Planners argue that an affiliate working exclusively for its owners could be an independent agent under the exception provided in article 5, paragraph 6 of the OECD model treaty.

This planning has not been thoroughly tested in court, but it recently failed in Spain in *Roche Vitamins Europe Ltd.*, No. 1626/2008 (Jan. 11, 2012). The Spanish Supreme Court held that the Swiss drug company had a PE in Spain that took the form of its stripped-risk distribution subsidiary, which was also a contract manufacturer. (For discussion, see *Tax Notes*, Apr. 23, 2012, p. 393, *Doc 2012-8280*, or *2012 TNT 78-4*.)

Roche stands for the proposition that there is no such thing as a related-party independent agent, even when the planners carefully prevent the agent from having the power to conclude contracts, and no non-PE netherworld between dependent and independent agents. The decision also states that risk cannot be separated from the business activity to which it relates. This reasoning has been criticized as force of attraction.

The case was also a loser for the taxpayer on the profit attribution point. The Court looked at the totality of the circumstances and concluded that a Spanish PE should have been earning far more than the limited income attributed to the Spanish affiliate. So planners cannot take comfort that even if a PE is deemed to exist, no further income than planned will be attributed to it.

Formulary Apportionment

Transfer pricing rules do not apportion income. They decide prices in hypothetical transactions between affiliates. Then the source rules have to act to determine where the income was earned, the residence rules have to determine where the earner is taxed, and, if the earner is a PE, special rules apply to decide how much of the income the host country gets to tax. At no point in the process is the multinational group's total worldwide taxable income discoverable.

The result of all this complexity is rarely fair to the host country, but it is justified on the quasi-religious belief that market prices can be derived for an enterprise that does not transact internally at those prices. That is a feature, not a bug. The point of the treaty-based international consensus was to make it comfortable for multinationals to romp around the world while paying minimal tax.

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A pernicious fiction propagated by the OECD is that the arm's-length method produces precise results, while all other methods of allocating income are sloppy. The arm's-length method is illusory.

Indeed, the OECD-authorized approach for allocating profits is fiction piled on top of fiction. It starts with the idea that a member of a multinational group is a separate economic actor, with its own separate capital and capabilities. It imagines that this separate economic actor transacts with its parent and sisters the way unrelated parties transact with each other. Then it attempts to derive a price. (For the OECD's ''Report on the Attribution of Profits to Permanent Establishments,'' see *Doc 2006-25440*.)

The whole point of being a multinational group is so that different components of the empire do not have to transact with each other at unrelated, market prices. That is the source of synergy and operating efficiencies. The arm's-length method essentially denies that these efficiencies exist — which is ironic for a method that provides gainful employment for many economists.

There is no way to impute market prices to controlled transactions. Even if synergy savings could be identified and quantified, there is no way to allocate them among group members.

Formulary apportionment is criticized as imprecise because its goal is fairness to the stakeholders — the host countries whose citizens bought the multinationals' products and services. If a huge oil company's gasoline is in every car, truck, motorcycle, and lawn mower in a particular jurisdiction, it is hard to believe that the group earned no income there. Multinational corporations are not eleemosynary institutions.

Formulary apportionment has been in use in the United States for 100 years and was in use in Europe until then-Assistant Treasury Secretary Stanley Surrey's export campaign convinced the Europeans to use the arm's-length method. (For the history, see *Tax Notes,* Feb. 17, 1986, p. 625.)

Europe will return to formulary apportionment when EU members adopt the CCCTB. You read that right. The Europeans were using formulary apportionment until Surrey arrived in the 1960s with new transfer pricing rules.

Formulary apportionment is cheap to administer, which explains its initial appeal to states that could field few professionals to fight the armies of advisers deployed by multinationals.

Most states now use a sales-based formula or double-weighted sales. Roughly half the states have forced combination. The states do not have a common tax base, but so many of them use a base derived from the federal base and a sales-based allocation formula that double taxation is not a serious problem.

Would the federal government be constrained by the unitary business requirement? No. The unitary business requirement is a due process restriction on the tax jurisdiction of the states. The criteria are functional integration (by which the Court meant non-arm's-length internal transactions), centralization of management, and economies of scale. This requirement does not restrict the United States in taxing its residents on income earned outside its borders. (See *Container Corp. v. Franchise Tax Board,* 463 U.S. 159 (1983); *Barclays Bank v. Franchise Tax Board,* 512 U.S. 298 (1994).)

Moreover, there are few conglomerates left, and they are not long-lived. They tend to be dismantled when investors figure out that variety does not foster sound management. Would multinationals purchase companies in other businesses to lower their tax bills if formulary apportionment were adopted without a unitary business restriction? That is a stretch. Usually the purchase of an unfamiliar business is attributable to managerial vanity.

Would the federal government be constrained by the nonbusiness-income differentiation? No. This differentiation is the flip side of the unitary business restriction. The theory says that only income earned in a unitary business can be apportioned and that investment-type income cannot be apportioned.

Indeed, it can be argued that the seminal Supreme Court case on nonbusiness income was wrongly decided. The taxpayer was a conglomerate, and its business was buying and selling portfolio companies. The dispute was whether short-term capital gain on the sale of an affiliate in a different business than the taxpayer's New Jersey operations could be apportioned to the state (*Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *Doc 92-5269*, *92 TNT 124-2*).

How do we deal with intangibles? Is ignoring intangibles as property a benefit of formulary apportionment?

It has been suggested that a sales-based formula, or double-weighted sales, may be a useful proxy for intangibles and avoid adverse employment effects. A formulary apportionment system would need a destination-based sales rule, instead of the federal rule of title passage.

Under the CCCTB, property will include R&D and marketing costs as a proxy for intangibles. Property will be included according to economic ownership and use, so that leased property will be included in the allocation factor. Sales will be based on destination.

Can the United States unilaterally adopt formulary apportionment and expect others to follow? This is the big bogeyman about formulary apportionment. Yet Surrey himself admitted that the arm's-length method requires no lesser degree of international agreement.

Oh, other countries would never agree! The chief countries that would have to agree — those in Europe — have already agreed to reinstitute formulary apportionment among themselves. The other important countries — the BRICs — have already rejected the arm's-length method, implicitly in the case of China and explicitly in the case of Brazil.

To say that international coordination is impossible is to ignore the way the OECD works. The OECD, a European organization, operates by consensus. The current system requires a great deal more consensus than is generally imagined. OECD member countries and observers have to agree to OECD interpretations.

The treaty commentary is a consensus document — sort of an agreed best practices. That is why there is no commentary on best practices for thin capitalization rules, even though every European country has them (the United States has weak ones).

OECD model commentary on article 9 permits thin cap rules because so many countries have them (paragraph 3 of the commentary on article 9). But there is no agreement on what thin cap rules should look like, even though they risk violating the nondiscrimination clause in OECD model treaties. (See *Square D Co. v. Commissioner,* 438 F.3d 739 (7th Cir. 2006), *Doc 2006-2877*, *2006 TNT 30-9*.)

The usual, top-down operation of the OECD sees the United States (and secondarily the United Kingdom) imposing its views and interpretations of the vaguely worded OECD model treaty on other members. The United States converted Europe, which was using formulary apportionment, to separate company accounting in the 1960s. Europeans became believers while their national champions benefited.

The top-down approach is most recently illustrated by the United States foisting partnership look-through on OECD members. Some of them didn't want it, and their local laws said that while a partnership is not an entity, there is no looking through to investors to find a suitable treaty beneficiary. Yet they all capitulated in the end. (See OECD, "The Application of the OECD Model Tax Convention on Partnerships" (1999).)

The services PE represents an unusual kind of bottom-up consensus from OECD members and the most important observer, India. The model commentary on article 5 now permits a services PE (paragraphs 42.11 through 42.48 of the commentary on article 5).

The official U.S. position is opposition to a services PE clause. The real position is what diplomats might euphemistically call nuanced. The United States has signed 15 treaties providing for services PE, including the recent protocol with its most important trading partner, Canada (*Doc 2007-21595*, *2007 TNT 185-82*).

Article 9 of the OECD model accommodates combined filing. It has been misread. It does not command separate company accounting. It does not command arm's-length pricing — it simply allows income allocation when this pricing is absent, as it is in every multinational group. Indeed, it accommodated formulary apportionment that was in place when the treaty was drafted.

It could be reinterpreted or changed to accommodate forced combination. The United States and the United Kingdom, as common law countries, are fond of leaving the treaty language intact while changing the interpretation through the commentary. Huge swings in interpretation have been accommodated through changes to the commentary.

It is often wrongly assumed that OECD model treaties would need to be changed to accommodate formulary apportionment. The CCCTB draft directive implicitly assumes that articles 7 and 9 would permit income allocation by formula.

The CCCTB draft directive uses the article 5 concept of PE, because third-country PEs would be part of the filing group. Article 5, which delineates PE, is the significant treaty obstacle to an effective formulary apportionment regime.

Certainly formulary apportionment would work better without the PE restrictions on tax jurisdiction, which European countries have adopted in their OECD model treaties. PE is a physical presence test, and it is obsolete and unfair to host countries. Economic nexus, which is asserted by some states, does not require physical presence. (See *Geoffrey Inc. v. South Carolina Tax Commissioner,* 437 S.E.2d 13 (S.C. 1993), *cert. denied,* 114 S. Ct. 550.)

The states use an aggressive assertion of tax jurisdiction in conjunction with formulary apportionment and forced combination. Modern communications make the expansive jurisdiction imperative, especially in the face of restrictive federal law on sales agents and Supreme Court precedent sanctifying physical presence for tax jurisdiction (P.L. 86-272; *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), *Doc 92-4595*, *92 TNT 110-2*).

Formulary apportionment by itself does not cure the problem of nowhere income. Some states and some countries don't have income taxes. Throwout rules and throwback rules are used to reallocate income that will not be taxed. The point is that income is allocated to jurisdictions that will tax it. Countries may want to beef up withholding and stop conceding it in treaties. They may also want to repeal the revenue rule, which is dying anyway (*Pasquantino v. United States*, 544 U.S. 349 (2005), *Doc 2005-8734*, *2005 TNT 80-9*).

Would there be manipulation of the factors? This is a bogeyman often raised by opponents of formulary apportionment. Making tax-advantaged contracts among controlled entities and baby-sitting board meetings are cheap. Moving people, plant, and equipment is expensive. Sales cannot be moved if the rule requires that the location be that of the final consumer. The CCCTB would restrict interest deductions and would have an antiabuse rule.

Another advantage of formulary apportionment is that corporate residence would not matter. No income would be allocated to tax haven intangibles holding companies under a formula based largely on sales, because there is no market in tax havens.

The United States has backward residence rules that are very convenient for tax planners in a separate company accounting system. No other developed country is as foolish about residence. The United States should adopt the principal place of operational management test used in the 2004 protocol to its Dutch treaty (*Doc 2004-4882*, *2004 TNT 46-23*) and the International Tax Competitiveness Act of 2011, H.R. 62, *Doc 2011-576*, *2011 TNT 7-32*, introduced by House Ways and Means Committee member Lloyd Doggett, D-Texas.

Incremental Action: Formulae

Although the United States is the last defender of transfer pricing, it is also the chief sponsor of the formulary methods that have crept into the transfer pricing rules. We have enough experience to know that formulae can be overlaid onto separate company accounting for income measurement purposes. The OECD blesses formulary methods when the United States wants them.

Many formulae are in regular use, with the assent or even encouragement of the affected taxpayers, simply because there is no other good way to allocate the income in question. These include:

- transactional net margin method (comparable profits method in reg. section 1.482-5);
- profit-split method (reg. section 1.482-6);

- OECD recommendations for the taxation of global trading operations (http://www.oecd.org/dataoecd/10/1/2090324.pdf); and
- allocation of expenses to foreign income (reg. section 1.861-8 and 1.861-9).

Separate company accounting and transfer pricing do not have to depend on the mythical arm's-length price. Yes, of course it's stupid to treat affiliated entities as economic actors. But it's even stupider to imagine that they might transact with each other at any price that does not primarily serve the interests of the parent and its tax planning.

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If the income of separate entities is formulaically allocated so that each country where the group does business gets a fair cut, then the sin of treating affiliates as separate entities is ameliorated. That being said, no formula should respect nonsensical legal moves like transfer of ownership of intangibles to a tax haven. Formulae should be an acceptable attempt to achieve a fair result for host countries.

Ilan Benshalom of Hebrew University believes that governments are too institutionally wedded to separate company accounting and transfer pricing to give them up any time soon, so policymakers should strive for incremental improvements that recognize the unreality of transactions between affiliates. He argued that the arm's-length standard gives too much credence to tax-planned intragroup contracts.

Benshalom and Reuven Avi-Yonah of the University of Michigan Law School argue for greater use of formulae within the current separate company accounting system, specifically for income from intangibles and mobile financial income. They recognize that these two residual items could account for the bulk of a group's income. (See Benshalom and Avi-Yonah, ''Formulary Apportionment — Myths and Prospects,'' Univ. of Mich. Law School Working Paper No. 221 (Oct. 2010).)

The pair argue that no one member of a multinational group can be assigned economic ownership of these shared assets, from which the whole group benefits. So income from intangibles should be allocated to where they are used for manufacturing and distribution, with proportions determined by formula. Income from financial assets would be treated as though it were earned by the group as a whole and be allocated to countries where the group operates under a formula.

Formulary apportionment of intangible income according to a destination sales formula would mean that the countries where the ultimate consumers reside would tax the income. India is asserting jurisdiction over intangibles income at the place of use already. China would argue for some intangibles income to be allocated to intermediate users of intangibles.

The residence countries of the parents of multinational groups that depend heavily on intangibles might not like the idea that the income from these intangibles would be taxed in market countries, while R&D expenses are deducted in the parent's residence country. Packing R&D expense into the United States is a common practice. The solution would have to be apportionment of R&D expense along with the income from the intangibles.

A sales-based formula with corresponding apportionment of R&D expenses would be the fairest way to allocate income from intangibles. The United States, however, has historically followed a pattern of clawing back income from U.S.-developed intangibles (T.D. 9568, *Doc 2011-26562*, *2011 TNT 243-16*). The United States has also created new intangibles when foreign-developed intangibles were being exploited within the country, as epitomized by the Glaxo Zantac settlement.

Incremental Action: Subpart F

If the United States wants to continue in the clawback vein, then subpart F is the vehicle of choice, especially given the government's lack of success in fighting the outbound transfers of intangibles at the front end.

The impact of the check-the-box rules on subpart F cannot be overstated. Those rules' treatment of single-member entities as tax nothings restored the earnings stripping gambits that inspired subpart F in the first place. As former Joint Committee on Taxation staff member Paul Oosterhuis of Skadden, Arps, Slate, Meagher & Flom LLP noted in his Woodworth Memorial Lecture some years back (*Doc 2006-11895*, *2006 TNT 128-19*):

> U.S. multinationals, however, had set up structures in which a foreign affiliate company located in a low-tax jurisdiction would lend, license or otherwise do business with operating company affiliates in high-tax foreign jurisdictions. Interest, royalties or other deductible intercompany payments were made by the high-taxed foreign affiliates, reducing income tax liability in those foreign jurisdictions and creating income for the low-taxed foreign affiliate. Due to deferral, that income could generally avoid U.S.-level tax until repatriation. Prior to subpart F, these

simple "earnings stripping" arrangements represented the heart of U.S. corporate international tax planning.

Subpart F was effectively repealed for stripped earnings, because checking the box for the entity meant that U.S. law saw none of its transactions with its sisters, who may also be disregarded entities. The Clinton administration's effort to restore subpart F and the vehement business reaction was not a pretty episode. (See Notice 98-11, 1998-1 C.B. 433, *Doc 98-2983*, *98 TNT 12-8*; and Notice 98-35, 1998-2 C.B. 34, *Doc 98-20115*, *98 TNT 119-6*. See also section 3713 of the Internal Revenue Reform and Restructuring Act of 1998, H.R. 2676, *Doc 98-20437*.)

The business argument that won the day was that the multinationals were only depriving foreign governments of revenue, with the implication being that those were high-tax European countries that Congress disdained. Many of the victims are poorer countries. Moreover, there might have been an implicit assumption in the congressional response that the United States would not be a victim of check-the-box planning.

But we are still using separate company accounting. So the United States should arguably be allowed to tax the intragroup passive income items that were created in check-the-box planning and were recognized by other countries. Check-the-box allows multinationals to have the best of both worlds. And in the last decade, the United States has become just another source country out of which income can be stripped, in the eyes of U.S. multinationals.

Subpart F is a re-sourcing rule. It is an antiabuse rule that makes up for some colossally stupid source rules, like a rule that permits sales to be booked in the country of title passage.

Source rules should be called allocation or assignment rules. Source is arbitrary. When we understand that certain types of income have no readily identifiable source, we will stop assigning foreign source to highly manipulated types of income.

Recent proposals to lower the U.S. corporate income tax rate contain clawback provisions. The Obama administration and House Ways and Means Chair Dave Camp, R-Mich., both have suggested making excess profits from migrated intangibles an item of subpart F income. (For the Camp discussion draft, see *Doc 2011-22576* or *2011 TNT 208-27*. For Treasury's 2013 budget green book, see *Doc 2012-2947* or *2012 TNT 30-32*.)

The Camp plan also includes an alternative proposal that would include income from intangibles in subpart F income, subject to a high-tax kickout rule. But a forced patent box would tax foreign-source income from intangibles at a lower rate if they were repatriated. Although a patent box alone cannot offer a low enough rate to prompt repatriation, this alternative is regarded as politically palatable. (For discussion, see *Tax Notes*, Dec. 12, 2011, p. 1327, *Doc 2011-25293*, or *2011 TNT 233-8*.)

In an unpublished paper presented at the recent TJN conference on transfer pricing in Helsinki, Benshalom suggests treating CFC equity as long-term subordinated debt for the purpose of imputing a yield to the parent. (See Benshalom, "Rethinking the Source of the Arm's Length Transfer Pricing Problem.")

Why impute debt when intragroup debt is wholly phony? Benshalom likes the idea of using the market-determined interest rate as a measurement of the cost of capital. Thus his proposal would require an analysis of the CFC's balance sheet and determination of a solo borrowing cost — but this is easy and relatively precise compared to transfer pricing. (See *General Electric Capital Canada Inc. v. The Queen* (2009 TCC 563), 2006-1385(IT)G, 2006-1386(IT)G, *Doc 2009-26729*.)

Benshalom assumed that thin cap rules would make the deemed payment nondeductible on the CFC end, while the parent would be taxed on the interest even in a dividend exemption regime. A parent, he noted, can cause a subsidiary to pay a dividend any time it wants — something a noncontrolling shareholder cannot do.

What's this got to do with source rules? Benshalom sees imputed debt as a proxy for source of income. What does it cost the parent to deploy its capital in risky ventures in various countries? Market-determined interest rates will provide an acceptable price and impute a reasonable amount of deemed-repatriated income.

There's nothing new about the problems discussed in this article. They have been festering for years. What is new is that Europe has turned on the international consensus, and the former voices in the wilderness have entered the mainstream. Public disgust at multinationals being excused from their civic resposibilities is real.

Inside the unreality of the Washington Beltway, however, the discussion is focused on how to reduce taxes for multinationals by enacting a territorial system. Perceptive policymakers understand that layering territorial rules on top of the current system would be a disaster, but multinationals will fight hard for a territorial system without restraints. That would allow them to keep all the benefits of shifting income, with no repatriation tax.

Arguments for territorial taxation, capital export neutrality, capital import neutrality, and the neutrality flavor of the week all assume that host countries have real tax systems that can reach income earned within their borders. These arguments also assume foreign direct investment. When the truth is revealed that multinationals are permitted to shift profits, without investment, to countries that don't tax them and don't have real tax systems, then the argument for any neutral approach breaks down.

> ***Tax competition for foreign direct investment is honest competition. Tax competition for booking income is not.***

Booking income from an intangible in a tax haven is not a fit subject for tax competition. Tax competition for foreign direct investment is honest competition. Tax competition for booking income is not. Poor little Ireland is still poor, despite the billions of dollars of multinationals' income booked there. It was only booked there. It sloshed through Ireland on the way to somewhere else, and did not pave the dirt roads on its way out. ■

ECONOMIC ANALYSIS

An Automatic Brake on Profit Shifting in a Territorial System

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One often overlooked benefit of including an interest allocation rule in a territorial system is that it would obviate the need for separate, base-preserving thin capitalization rules. An interest allocation rule takes the debt of a multinational group held by third parties and assigns it to different jurisdictions in proportion to some measurable factors, most often assets.

Related-party debt — ''a principal tool of the tax planner'' — could not be used to strip income out of the United States and other high-tax countries. Cross-border intracompany interest — ''the big enchilada of easily manufactured income and expense'' — would no longer enter the calculation of taxable profits. (The quotes are from H. David Rosenbloom, ''Banes of an Income Tax: Legal Fiction, Elections, Hypothetical Determinations, and Related-Party Debt,'' *Doc 2003-26323*; and Lee A. Sheppard, ''What Hath Britain Wrought?'' *Doc 2010-27246*. For more discussion of the relationship between interest allocation and thin capitalization rules, see ''Should the Camp Territorial Plan Include a 5 Percent Haircut?'' *Tax Notes*, July 23, 2012, p. 359, *Doc 2012-15299*, or *2012 TNT 141-3*.)

This article is about allocating worldwide interest using gross profits as the allocation factor. The term ''gross profits'' means profits before interest or taxes. In addition to the salutary effects on artificial profit shifting that it shares with other interest allocation methods — in particular, allocation of interest by assets — interest allocation using gross profits would reduce the incentive to shift profits by adjusting transfer prices. It does this by narrowing the difference between domestic and foreign effective tax rates.

Incentive to Adjust Transfer Prices

Under normal circumstances, any multinational that shifts profits out of the United States reduces its worldwide taxes by:

$$(t_{us} - t_f)*X$$

where X is the shifted amount, t_{us} is the U.S. statutory tax rate, and t_f is the foreign statutory rate. Call this amount ''Shift Incentive 1.'' A cut in the U.S. tax rate or an increase in the foreign rate will reduce Shift Incentive 1. The expression still holds if interest is allocated by assets.

Unlike current law or a system whereby interest is allocated by assets, under rules in which interest