

Under Strict Embargo until
00h01 Sunday 9 December 2012

TOWARDS UNITARY TAXATION OF TRANSNATIONAL CORPORATIONS

Sol Picciotto



Contents

Overview	1
Introduction	2
1. How We Got Here	2
1.1 Brief Historical Summary	2
1.2 Tax Treaties and International Tax Coordination	4
1.3 Origins of the Tax Treaty Principles	4
1.4 International Apportionment and the Arm's Length Principle	5
1.5 The Tax Treaty System and International Avoidance	5
1.6 Problems with the ALP	7
1.7 Advantages and Limits of the ALP	8
2. The Unitary Taxation Approach	9
2.1 The Combined Report	9
2.2 Defining the Unitary Business	9
2.3 Defining the Tax Base	10
2.4 Determining the Allocation Formula	10
2.4.1 Assets	10
2.4.2 Labour	12
2.4.3 Sales	12
2.5 Weighting the Factors in the Formula	12
3. A Managed Transition	14
3.1 Conducting Studies	14
3.2 Adoption of Unitary Taxation by Groups of Countries	14
3.2.1 Combined Reporting with Formulary Apportionment by US States	14
3.2.2 The CCCTB in the EU	15
3.2.3 Extending and Deepening Unitary Taxation	16
3.3 Introduction of Unitary within the Present System	16
Sources	17
Boxes	
Box 1: Tax treaties in the international tax system	3
Box 2: Controlled Foreign Corporations (CFCs)	6
Box 3: Accepted Methods for Transfer Price Adjustment under the ALP	7
Box 4: Transfer Price Adjustments	9
Box 5: The Example of Amazon	9

TOWARDS UNITARY TAXATION OF TRANSNATIONAL CORPORATIONS

Sol Picciotto¹

Overview

The problem

It has become clear that we need to take a fresh look at how transnational corporations (TNCs) are taxed. This paper, building on long experience and analysis of the actual practice of tax administrations around the world, proposes a thorough reform of the system towards a fresh approach: Unitary Taxation. This would help place the international tax system on a foundation fit for the 21st century.

Currently, multinationals are taxed under an international system whose basic structures were devised a century ago. Under unitary taxation, they would be taxed not according to the legal forms that their tax advisers create for them, as is currently the case, but according to the genuine economic substance of what they do and where they do it. This would be far more legitimate and simpler to implement than the current system.

The present international tax system treats TNCs as if they were loose collections of separate entities operating in different countries. There is currently only weak coordination between tax authorities, and this 'separate entity' approach gives TNCs tremendous scope to shift profits around the globe to suit their tax affairs.

This tax avoidance mainly involves two related methods. First, TNCs create subsidiary companies or entities in convenient countries, usually those with no or low income tax (tax havens), either to carry out activities (such as financial transactions, transport, providing advice or other services); or to act as "holding companies" to own assets such as intellectual property rights, bonds, or shares. By attributing profits to them, the group's overall taxes can be reduced, even though they often exist only on paper, perhaps with a name-plate on an office building.

Second, 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'.²

A solution

Unitary Taxation directly addresses both problems. It does not allow the TNC to be taxed as if it were collection of separate entities in different jurisdictions, but instead treats a TNC engaged in a unified business as a single entity, requiring it to submit a single set of worldwide consolidated accounts in each country where it has a business presence, then apportioning the overall global profit to the various countries according to a weighted formula reflecting its genuine economic presence in each country. Each country involved sees the combined report and can then tax its portion of the global profits at its own rate.

This fits the economic reality that TNCs are usually oligopolies based on distinctive or unique technology or know-how: they exist because of the advantages and synergies that come from combining economic activities on a large scale and in different locations. These advantages cannot be attributed to a single location, but to the whole global entity. Treating each affiliate as a separate entity for tax purposes is impractical and does not correspond to economic reality.

Unitary taxation would greatly reduce opportunities for international tax avoidance due to profit-shifting and the use of tax havens. By simplifying tax administration, it would cut the costs of compliance for firms and would benefit poor developing countries especially. TNCs also provide powerful political cover for many tax havens: by curbing their use unitary taxation would make it politically far easier to tackle tax havens on financial secrecy and many other issues. And by aligning tax rules more closely to economic reality it would improve the fairness and transparency of international tax and help create a level playing field for business.

Tax experts have long known that this unitary approach makes more sense. Even in the 1930s when the "separate entity" approach was first agreed internationally to deal with transfer pricing it was recognised that in practice national authorities should look at the firm's overall accounts in order to ensure a fair split of the total profits attributed to affiliates. Techniques increasingly used since the 1990s already go a long way towards unitary taxation:³ indeed some jurisdictions – notably a rising number of U.S. states – already successfully implement it, and the European Union has prepared proposals for adopting it.⁴

With increased globalisation in recent years there has been a trend towards a more 'territorial' basis for taxing TNCs, as states which are their 'home' countries are giving up their claims to tax their foreign profits. Unitary taxation would place this on a sounder foundation, as TNCs would be taxed according to their genuine economic presence in the countries where they operate. This would ensure that they make a fair contribution as corporate citizens towards the costs of the public services provided by the states where they do business.

The path to reform

The time is now right for reform. To get there, some problems will need to be overcome, but they are by no means insurmountable. Although many experts do oppose unitary taxation, typically this is for reasons that do not withstand serious scrutiny, and which are largely due to vested interests in the present system.

This paper proposes a managed transition to unitary taxation, building on existing methods and prior experience. Although the history and details of the present system are complex, the fundamentals can easily be understood in a common sense way by political representatives, campaigners and others, especially in light of all the evidence that General Electric, Starbucks, Amazon, Google and many other TNCs have been able to avoid taxes and gain significant competitive advantages as a result.

Complemented by a requirement for country-by-country reporting of the taxes actually paid, unitary taxation would be a giant step towards setting the international tax system on a basis of transparency and effectiveness, and hence restoring the legitimacy of tax in all countries. The path to reform must be prepared now.

¹ Emeritus Professor, Lancaster University, Senior Adviser, Tax Justice Network, and author of *International Business Taxation* (1992), and *Regulating Global Corporate Capitalism* (2011). I am grateful for comments from Michael Durst, Ted van Hees, David Spencer and especially Nicholas Shaxson, Michael McIntyre and Richard Murphy; the responsibility for the paper remains mine.

² It is not always easy to judge whether the aim of transfer pricing is tax avoidance. The prices set between related entities within the TNC are generally decided administratively and not competitively, so the prices may also reflect various non-tax strategic concerns of the TNC such as management incentives, or currency exposures.

³ Since the 1990s, tax authorities have increasingly used so-called "transactional profit" methods (see Box 2.), which are already a significant step towards profit apportionment, a component of unitary taxation.

⁴ Common Consolidated Corporate Tax Base, or CCCTB.

Introduction

The international tax system was devised in the early 20th century when TNCs were in their infancy. The system not kept up with profound changes in the global economy since then.

Taxes are national, and international tax co-ordination happens through various legal and administrative arrangements managed by tax specialists. TNCs' operations, however, are internationally dispersed but centrally coordinated. At the heart of the problems of taxing TNCs is a mismatch between their power to organise their global affairs to minimise their tax liabilities, on the one hand, and the weak international coordination of tax, on the other.

From the outset it was recognised that TNCs posed special problems. Although a TNC in economic terms is a single firm operating under unified direction, legally it consists of many (sometimes thousands) of affiliates forming a corporate group. Cross-border transfers (of goods, services or finance) between these affiliates are internal to the firm but from the viewpoint of states they appear as international transactions of trade or investment.

The formal legal structures of international tax coordination are tax treaties between states (see Box 1 below), which treat TNCs as a special case. Traditional provisions in treaties take the 'separate entity' approach to TNCs described in the Overview, treating them as if their component parts trade with each other at market-based 'arm's length' prices. As the historical section below explains, even when the 'arm's length' principle was first devised it was understood to be a fiction, since TNCs' unique products and services, and their global synergies and advantages, mean that open market independent prices for their internal transfers could not be determined – because no true comparable transfers existed anywhere else.

Many specialists who constructed and have worked with the system have understood that the separate-enterprise arm's-length approach was unsatisfactory. As TNCs became more dominant in the second half of the 20th century, these difficulties came to the fore as TNCs increasingly used affiliates artificially created in tax havens to curb their tax liabilities. Increasingly diverse and complex rules have been elaborated to patch up the system, which has consequently become ever more arbitrary and opaque.

Many argue that a fresh approach is needed for taxing TNCs, starting from a recognition that they operate as integrated businesses under central direction. This approach is known as Unitary Taxation with formula apportionment (a better term is profit apportionment).⁵ It assesses a TNC's tax liability on the basis of a set of consolidated accounts for its worldwide activities, and apportions the profits according to an agreed formula which reflects its real business presence in each country.

The sections below explain the origins and basic principles of the present system and problems with it. Next, unitary taxation is discussed, describing how it would deal with both transfer pricing and tax avoidance through tax havens while also reducing harmful 'competition' between jurisdictions to offer tax exemptions and other advantages. Finally, it considers a pathway of practical steps for moving towards a unitary system.

A transition should involve three elements. First, there should be expert studies exploring the economic and legal aspects of the change. 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. Second, a unitary approach could be adopted by groups of countries such as within the EU, or regional groups such as MERCOSUR, the East African Community or ASEAN. Third, countries could immediately require the submission of a combined report by any TNC with a business presence within their jurisdiction.⁶ The information so provided could be used to improve existing transfer pricing methods, or to support profit apportionment in specific sectors such as financial services. A combined report – which in itself is simply a transparency requirement – would provide a true overall view of the firm, helping eliminate profit shifting by transfer pricing and the use of tax havens.

Some obstacles lie on the path to reform. Specialists who have invested in the present system are understandably reluctant to change to one they regard as untried, and which would be politically difficult to agree upon. In addition, the complexity of the current system is highly lucrative for the large tax advice and tax avoidance industry including the Big Four accounting firms, and they naturally prefer to keep what they have. While TNCs themselves suffer disadvantages from the complexity and frequent arbitrariness of the present system, which obliges them to spend large sums on tax 'planning' advice, these are outweighed by the advantages they gain from reducing their taxes, which gives them significant competitive advantages over their purely local competitors.

Others cite problems with unitary taxation itself as a reason not to act. However, this paper demonstrates that while unitary taxation is not straightforward to implement, it represents a vast improvement on the current system – and there are clear pathways to reform.

What is needed now is political will to begin the change.

I. HOW WE GOT HERE

I.1 Brief Historical Summary

The foundations for the current international tax system were laid early in the 20th century, when most international investment flows consisted of private and public loans. TNCs were in their infancy, but experts already understood that they posed special problems.

It was agreed that national taxes should apply to the business profits of those parts of a firm operating in each jurisdiction, but that tax administrations could take steps to prevent diversion of profits. The aim was to ensure that each part of a TNC was treated in the same way as purely local businesses, although they happened to have foreign investors. This was supposed to be achieved by treating each component part of a TNC as if it were a separate business operating independently of the other parts, at arm's length in the market.⁷ This crystallised into the "separate-entity" approach and the *arm's length principle* (ALP) mentioned above.⁸

Experts already saw the limitations of this approach and by the 1930s unitary taxation was already being applied, especially within domestic federal systems, particularly in the United States. The most notable adherent was California, which used the system to prevent (for example) Hollywood film companies from siphoning profits through

5 This paper uses the term unitary taxation to refer to the taxation of a multinational firm as a single entity. This has two elements: a combined report including its worldwide consolidated accounts, and an apportionment according to a formula of its profits, by and to each country where it operates. Historically, the terms fractional or formula apportionment have also been used, but the term profit apportionment, as used by commentators such as John Kay, seems clearer. However, it is used here to describe any approach which allocates profit by proportion or by formula, while unitary taxation also requires a worldwide combined report.

6 The concept of a combined report comes from US state measures: it includes submission of consolidated accounts for the unitary group (see further s. 2.1 below).

7 The test adopted was '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'.

8 It could be applied either (i) by modifying the terms of transactions between the parts of a TNC, or (ii) by adjusting the accounts based on comparisons with the profits made by local firms with similar business, or (iii) considering the proportion of profits declared locally in relation to those of the TNC as a whole. These three methods were authorised to be applied to branches of the same company; if the TNC operated through separately incorporated subsidiary companies (affiliates), accounts could be adjusted to correct a 'diversion' of profit (Picciotto 1992, 31-2)

9 For a brief account of unitary taxation by U.S. states, see Unitary Method Curbs Tax Shenanigans: An Alternative to Arms-Length by Jonathan Rowe, written in 1980, when unitary was starting to spread more widely

distribution affiliates set up in neighbouring Nevada.⁹ However, the national experts felt it could not be adopted internationally due to the political difficulties of reaching agreement. In the 1970s, indeed, U.S. states such as California were forced to restrict their system, by a strong campaign especially by British businesses led by Barclays Bank, which took a case against California all the way to the Supreme Court (*Barclays v. FTB* 1994).

By the second half of the century TNCs became more dominant in the world economy and increasingly exploited loopholes in the loosely coordinated international tax system.

In 1962 the United States took new countermeasures against the use of tax havens with its rules against what came to be called *Controlled Foreign Corporations* (CFCs). These enabled the United States to tax the profits of affiliates based in tax havens as if they belong to the parent company, in effect disregarding that they are separate entities. This approach of 'merging' entities for tax purposes directly contradicts the 'separate entity' approach, but it is limited to strictly defined circumstances (see Box 2 below). Other OECD states followed suit, but with increased globalisation in recent years CFC rules have become more difficult to apply.

In 1968 the U.S. also decided to begin stricter examination of transfer pricing, and to do so introduced detailed transfer pricing rules elaborating how to determine the prices of cross-border transactions between separate entities inside a multinational. The rules specified that wherever possible the yardstick for setting the prices of transactions was to find

similar transactions between unrelated firms, or 'comparable uncontrolled prices' (CUP). This helped cement into place the separate entity concept and the ALP. However, as a fall-back where comparables 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': see Box 3).

The OECD adopted much of this U.S. approach in a report in 1979, even as studies in the U.S. were revealing that the rules did not work. The U.S. revised its approach in 1988, and after long negotiations in the OECD additional fall-back methods were accepted (see Box 3), but only by claiming that they were supposedly variations of the separate entity, arm's length approach.

Tax authorities became increasingly wedded to the ALP, as did professional advisors of the tax avoidance and compliance industry, which became ever more heavily invested in the complex system and derived increasingly large fees from it. Hence, firm statements excluding the unitary approach were included in the OECD Transfer Pricing Guidelines, even while they increasingly accepted profit-split methods (see Box 3) which go a long way towards unitary taxation.

Developing countries are now adopting and applying their own transfer pricing rules, even though 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 often

BOX I: Tax Treaties in the International Tax System

Countries sign bilateral treaties for the avoidance of international "double taxation" (that is, getting taxed on the same income twice, by two countries) and to prevent fiscal evasion. These are usually referred to as double tax treaties (DTTs) and they are based on treaty 'models'. The first model DTTs were drawn up at a League of Nations conference in 1928, which set up a Fiscal Committee. This Committee continued to meet during the Second World War in the western hemisphere, and issued a new model treaty in Mexico in 1943, influenced by Latin American capital-importing countries, which tended to favour taxation at "source" (that is, where the income is generated), as opposed to "residence" (which refers to the home jurisdiction of the TNC.) A subsequent model issued in London in 1946 shifted towards residence taxation. The League of Nations' work was taken up by the United Nations under a Financial and Fiscal Commission, 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 in 1961 the Organisation for Economic Cooperation and Development (OECD), and allowing its expansion to other parts of the world. The Committee on Fiscal Affairs is now part of the OECD's broader tax work, and consists of member state representatives, serviced by a large staff (the numbers are not publicly available).

In 1967 the UN Secretary-General set up an Ad Hoc Group of Experts on International Cooperation in Tax Matters, which

focused on adapting 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, though it still has minimal resources (only 1.5 professional staff), especially compared to the OECD, which in practice dominates the system. The OECD continues to try to marginalise the UN, by opposing any upgrading of or additional resources for the UN Committee, and confining its work to the model treaty, which it insists should be based on the OECD model with only minor modifications. It has also admitted Observer states to the work of the Fiscal Committee, and established 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, which includes tax haven states.

Tax treaties provide the skeleton of the international tax system, while flesh is put on these bones by the Commentaries to the Model Treaties, which are considered authoritative guides to their interpretation. The OECD in particular has also issued a number of reports discussing specific issues. The Transfer Pricing Guidelines, which began as a Report in 1979, are not part of the Commentaries, but are considered authoritative. They may be incorporated into national laws and subsidiary legislation. The sinews of the international tax system are the experts, who form a specialist community with its own knowledge, language and culture, formed and strengthened through the activities of organisations such as the International Fiscal Association and through contacts in professional practice.

contradictory. TNCs are likely to become increasingly embroiled in conflicts over divergent rules, which can only be dealt with by slow, discretionary and secretive international administrative procedures between tax authorities.

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). Although it has significant flaws, particularly being restricted to the parts of TNC groups within the EU (and hence failing to deal with external tax havens), it represents the first formal international proposal for a unitary tax system.

The remainder of Section I explores this historical evolution in some detail.

1.2 Tax Treaties and International Tax Coordination

The formal legal structures of international tax coordination are the double tax treaties (DTTs), which date back to 1928.¹⁰

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 (FDI), 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 transnational corporations, or TNCs.

Although most international financial flows before 1914 were of portfolio investment, foreign direct investment by TNCs had grown since the late 19th century. Along with many mining and other raw materials extraction ventures, some manufacturing companies became transnational. One early example was the Singer Sewing Machine company based in the USA, which in 1867 set up a plant in Scotland.

1.3 The Origins of the Tax Treaty Principles¹¹

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. In relation to 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 foreign direct investment through 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).¹² The host state was allowed also to tax profits attributable to a PE. The parent company could be treated as an investor, so payments to it (dividends,

interest, fees or royalties) could be taxed by the home state, like returns on portfolio investment. However, this might require negotiations with the host state to ensure that it did not also apply withholding taxes at source to such payments.

Nevertheless, 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 study for the League of Nations Fiscal Committee in 1932-33, coordinated by a US lawyer, Mitchell B. Carroll.¹³

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 would be 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,

¹⁰ See Box 1 below. The main model tax treaties, starting with the first ones of 1928, 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>.

¹¹ For more detailed discussion, and citation of sources, see Picciotto 1992, especially pp. 18-35.

¹² The host country cannot tax income earned within the country unless it is attributable to a PE, so its definition has been a source of disagreement between richer capital-exporting countries, which are generally the home of TNCs, and the poorer capital-importing countries, which are the host states. The PE concept requires a physical presence which is more than temporary: capital-importing countries prefer a shorter time-period for defining permanence (three or six rather than twelve months), and prefer to include e.g. building sites and oil rigs. The PE concept has become increasingly inappropriate with the growth of services and e-commerce, and a shift to unitary taxation should also entail its replacement with a broader definition of what constitutes doing business within a country (see section 2.4.3 below).

¹³ The full study consisted of five volumes, the first three containing reports from 27 states (I: France, Germany, Spain, the United Kingdom and the United States of America; II: Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxembourg, Netherlands, Roumania and Switzerland; III: British India, Canada, Japan, Mexico, Netherlands East Indies, Union of South Africa, states of Massachusetts, of New York and of Wisconsin); the fourth was Carroll's own report (Carroll 1933), and the fifth by a US accounting professor Ralph C. Jones *Allocation accounting for the taxable income of industrial enterprises*.

which would result in the substitution of often arbitrary figures, and taxation on the basis of largely imaginary accounts.

Profit 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.

1.4 International Apportionment and the Arm's Length Principle

The Carroll report (Carroll 1933) recommended that the international system should be based on treating affiliates as separate entities from the parent, but their accounts could be adjusted as appropriate. 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 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 superior in principle, and would in practice be used in the many cases where separate assessment was not feasible (League of Nations 1932, p. 122). However, the consensus was that the unitary approach would be difficult if not impossible to adopt, for political reasons,¹⁴ 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 operate in a network of bilateral treaties. However, its adoption merely converted the problem, from a decision on the principles of general apportionment by formula, to negotiation of specific ad hoc apportionments, by adjustment of

transfer prices to ensure a fair profit split. 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 for treatment of international investment in 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.

1.5 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.¹⁵

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'.¹⁶ 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

¹⁴ This is entirely understandable in view of the political weakness of the League of Nations: the U.S. did not join that body due to a negative vote in the Senate, Russia and Germany were not admitted, and others such as Japan left. In that context international coordination under its auspices of issues such as tax, with the participation of non-member states and indeed in this case with U.S. leadership, was clearly only possible without the involvement of politicians. Since then the technical experts have constructed a system which is now producing outcomes which are equally clearly politically unacceptable.

¹⁵ Some OECD countries (e.g. the Netherlands and the UK) extended their tax treaties to their colonies and dependencies, which continued them after independence.

¹⁶ 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.

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.

This is not the place to examine this problem in detail. What is relevant here is to give a reminder that such techniques are only viable if international taxation continues to treat affiliates of a TNC as separate entities. Under unitary taxation 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. TNCs became the main users of the haven system, lending it some respectability. If this could be removed (and unitary taxation would go a very long way towards achieving this) it would be much easier to deal with these disreputable uses.

Concerns about tax avoidance by TNCs resurfaced in the 1960s, especially in the United States, the home of many of them. To combat the use of tax havens, the U.S. in 1962 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, see Box 2). Other OECD states gradually adopted similar rules in the 1970s and 1980s, harmonised and coordinated through the OECD Fiscal Committee. This was especially to meet objections from Switzerland that they conflicted with tax treaty principles, which would require states introducing CFC rules to reach new agreements with their relevant treaty partners. To deal with this, it was agreed that such anti-avoidance measures should comply with the OECD consensus.

Essentially, CFC rules attempt to strengthen taxation by the ‘home’ country of a TNC of its foreign profits if they have been retained abroad. With increased globalisation, tax systems have become increasingly ‘territorial’, as home states of TNCs have retreated from trying to tax profits earned elsewhere. So for example the UK in 2012 revised its CFC regime, removing the presumption that an activity which could have been carried out in the UK must have been located abroad for tax avoidance reasons. CFC regimes have also become increasingly complex, indeed impenetrable except to the dedicated specialist.

The US also introduced detailed transfer pricing regulations in 1968, elaborating how such prices should be determined.

Unfortunately, this dual policy response was contradictory. The CFC approach effectively allowed jurisdictions to treat separate entities as if they were part of the parent. This was the opposite of the ‘separate entity’ approach at the heart of the transfer pricing regulations, which cemented into place the ALP. In particular, the U.S. regulations specified that where possible the prices of specific transactions should be based on those for similar transactions between unrelated firms, or ‘comparable

17 The profit could be determined either for a pattern of transactions or for the overall profit.

18 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.

19 Publicised in the report by the UK Monopolies Commission (1973) *Chlordiazepoxide and Diazepam*. This showed that the firm’s UK affiliate was paying £922 per kilo to its Swiss parent for the active ingredient of its new wonder-drug valium, whereas the same ingredients could be obtained from small companies in Italy (where Roche’s patents were at that time not protected) for £20 per kilo.

Box 2: Controlled Foreign Corporations (CFCs)

The US rules first introduced in 1962 are known as Subpart F (after the relevant part of the Internal Revenue Code). Germany introduced measures in a decree of 1965 (after a 1964 report on tax havens), and a Foreign Tax Law (*Aussensteuergesetz*) from 1972. Others followed during the 1970s and 1980s.

Although they differ in detail, such measures generally treat the income of a foreign affiliate as part of the income of its parent, even if not remitted (e.g. as dividends), and therefore directly taxable by the home state (parent’s state of residence), provided it meets the definition of a CFC. Generally, this entails three tests, all of which have become more difficult to apply with increased globalisation:

- **Control:** it is owned and/or controlled mainly by one or more companies resident in the home state; the control threshold can be circumvented, and has become harder to apply as TNCs have become more decentralised and regionalised;

- **Passive Income:** the income it earns does not derive from an active business in the place where the CFC is located; but it is hard to define the location of many service functions, especially finance, and management of IPRs, both of which have become increasingly important; heavy lobbying by the financial services industry has ensured that most banking, finance and insurance income is generally considered ‘non-passive’, which explains why financial firms are the biggest users of tax havens;
- **Low-tax:** the CFC is resident in a low-tax jurisdiction, usually designated by issuing a list; as preferential tax regimes have proliferated, it has become more difficult to distinguish outright ‘havens’.

Other tests may also be applied, e.g. a tax reduction motive test.

uncontrolled prices' (CUP). Only as a fall-back, where these were not available, did they allow other methods, including estimation of the actual profit on the basis of profit rates for similar firms (See Box 3, 'profit split' method).¹⁷

While this was taking place at an international level, inside the United States the unitary approach (which had already been applied since the 1930s) became regularised and coordinated by U.S. states during the 1960s, with a 3-factor formula using assets, payroll and sales. However, non-US TNCs resented it, especially because businesses they acquired or set up in the US, which in their early stages incurred great costs and so made losses, could still be taxed by states on a proportion of their worldwide profit even if loss-making. A strong business-led campaign failed to abolish the unitary system but did succeed in having it limited, so that US states now must offer a 'water's edge' alternative, excluding non-US business.

1.6 Problems with the ALP

Hence, anti-avoidance techniques, coordinated mainly by the OECD, 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. Furthermore, the ALP has further entrenched the separate entity approach, which became increasingly unworkable as the international tax system became more complex. As it became more developed and refined, the ALP has increasingly been shown in practice to be impossible to apply effectively or consistently, and demanding of a very high level of resources.¹⁸

The US transfer pricing regulations of 1968 did not treat the ALP as a general principle for ensuring broad fairness in allocating costs and profits within a TNC, but instead attempted to define rules for pricing specific transactions. Recognising that these had international implications, the issue was taken up through the OECD, and then also 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.¹⁹

Despite all these flaws the OECD produced a report in 1979, *Transfer Pricing and Multinational Enterprises* (subsequently revised as the Transfer Pricing Guidelines) that defined a consensus around the ALP, generally following the approach in the US regulations. Meanwhile, 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.²⁰

Significantly, the OECD report 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.²¹ National tax administrations have each developed their own methods, sometimes stated in regulations and sometimes only as guidelines for tax officials.²² 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.²³ They have been familiarly referred to as the 'Bible' (Sheppard 2012), and they do indeed combine authoritative pronouncements with a variety of formulations susceptible of different interpretations.

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

²⁰ 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).

²¹ 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.

²² The UK's transfer pricing rules are now enacted in the Taxation (International and Other Provisions) Act (TIOPA) 2010, s. 164 of which says that they are to be interpreted to ensure consistency with the OECD Guidelines, in so far as double taxation arrangements incorporate the OECD model.

²³ Available from <http://www.oecd.org/ctp/>, unfortunately only on payment or for subscribers.

Box3: Accepted Methods for Transfer Price Adjustment under the ALP

The OECD Guidelines now provide five broad methods for adjusting accounts to conform to the ALP, and state that the 'most appropriate' method should be used in each case, depending on factors such as the nature of the transaction and the availability of information (OECD 2010 para. 2.2). They distinguish between 'traditional transaction methods' (CUP, Resale and Cost-Plus, see below); and 'transactional profit methods' (TNMM and profit-split). The methods are not prioritised but the Guidelines state that the traditional methods provide the 'most direct' means of establishing the ALP, and that profits-based methods must be applied in a way that is compatible with the ALP. Briefly, the five methods are:

- **Comparable Uncontrolled Price (CUP):** the price charged between unrelated firms in transactions which are similar in all respects which could affect open market pricing, or which can be determined by reasonably accurate adjustments to take account of any such differences;
- **Resale Price:** the price at which a product bought from a related party was sold to an unrelated party minus a gross profit margin to cover costs and an appropriate profit;
- **Cost Plus:** the costs incurred in the production of goods or services by a supplier to a related party, plus an appropriate mark-up, based preferably on that charged by the same supplier in comparable transactions with unrelated parties;
- **Transactional Net Margin Method (TNMM):** although this is called a 'transactional' method, it looks at profitability. It establishes the net profit realised from an appropriate base (e.g. costs, sales, assets) in a transaction (or series of transactions that can appropriately be aggregated), ideally by comparison with similar transactions by the same person with unrelated parties, or if not possible the net margin earned in comparable transactions by independent enterprises, based on a functional analysis to determine comparability;
- **Profit-Split:** the total combined profits earned from a transaction or transactions are split between jurisdictions based on the genuine economic activity in different jurisdictions. The split is determined by the geographical division that independent parties would expect to realise from those transactions.

24 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).

25 See <http://www.oecd.org/ctp/transferringpricing/transferringpricingaspectsofintangibles.htm>.

26 T. Bergin, 'Special Report: How Starbucks avoids UK taxes', Reuters, 15th October 2012.

27 As mentioned below (section 3.1), the Brazilian rules go further, and apply the Cost-Plus and Retail methods with fixed profit margins, a method which has been criticised by the OECD.

28 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. The objections were not accepted by the Committee, but the US expert member suggested that the matter could be raised again.

29 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.

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 truly comparable to an Apple iPhone, and a Parker pen is superior to an ordinary ball-point. The Guidelines therefore offered two alternatives: the resale price minus a profit margin, or the cost price plus a mark-up (see Box 3 below). 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 they tend to overlook the competitive advantages of TNCs. They are 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 Government Accountability Office in 1981.²⁴

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 was to be done by attributing to the affiliate a profit based on analysing its functions and applying an industry average rate (the 'comparable profit method', or CPM.)

This entailed analysing the 'functions' carried out by affiliates, to which would be attributed a 'market' rate of return on the capital invested, leaving the remaining 'residual' profits for the parent company. A major motivation for this was the concern that USTNCs 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, see Box 3 above,) 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 to

deal with the basic characteristics which give TNCs their competitive advantages, especially their control of know-how, in the broadest sense. This 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 2012.²⁵ 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.²⁶

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.²⁷ 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.

1.7 Advantages and Limits of the ALP

It is easy to understand why the ALP was first adopted in the early 1930s, when international capital flows were mainly in the form of loans, to provide 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

Box 4: Transfer Price Adjustments

The aim of transfer price adjustments is said to be to ensure that transfer pricing reflects 'market forces', by making adjustments to establish 'the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances' (OECD Guidelines 2010 para. 1.3). When national tax authorities in country A assess the accounts submitted by the relevant local affiliates of the firm, they may require adjustments in the pricing of transactions with its affiliates in country B. The firm may frequently be able to adjust these related company accounts accordingly, if the accounts have not yet been submitted in country B. If this is not possible, the firm must request a 'corresponding adjustment' from the country B authorities. If this is refused, the firm may ask for the conflict to be referred for negotiations between tax authorities under the 'mutual agreement procedure' (MAP). Today, these conflicts may involve millions of dollars, and taxpayers complain of long delays, and arbitrary settlements. As a partial remedy, arbitration has

been introduced as a fall-back under some DTTs, and is available among EU states under a multilateral treaty. 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 either the private MAP settlements or the arbitral decisions.

In one notable case which became public because it had to be litigated, 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 that it should be paid a refund of US\$1 billion. The dispute was finally settled with a payment by Glaxo of 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 (Sullivan 2004).

'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).

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.²⁸ 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.²⁹ 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). The separate entity approach does have 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.³⁰

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. There is considerable evidence that TNCs make extensive use of the opportunities and incentives provided by the international tax system for profit-shifting and reduction of their effective tax rates (Devereux 2006), and that these strategies produce significant distortions in capital allocation, resulting in global economic welfare losses (Keuschnigg and Devereux 2012).

³⁰ It is noteworthy that most TNCs are supporting the EU proposals for a CCCTB, which would apply a formulaic apportionment rather than the ALP, but would not, as currently formulated, require a combined report with worldwide consolidated accounts (see further below).

Box 5: The Example of Amazon

In November 2012, the UK Parliament's Public Accounts Committee quizzed the top executives of Amazon, Google and Starbucks, about their low tax payments in the UK. Amazon explained that all its European sales, including those to UK customers, are made by its Luxembourg affiliates. Its UK affiliate, [Amazon.co.uk](http://www.amazon.co.uk) Ltd, operates the order fulfilment, customer support and logistics services, and 'earns a margin on its operating costs' for those services (Written Evidence to the PAC <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpublic/writev716/m03.htm>).

Not surprisingly, the profits earned and therefore tax paid by Amazon UK are low: order fulfilment and customer support are low-margin businesses. The bulk of the profits are attributable to Amazon Luxembourg Sarl, especially in view of Amazon's large

sales volumes. Yet those sales volumes would not be possible if Amazon did not have the warehouses and other facilities in the UK.

Under current tax rules, it is difficult if not impossible to challenge this attribution of low profits to Amazon UK and high profits to Amazon Luxembourg, since they must be treated as separate entities. A unitary approach would recognise that the profits are due to the synergies of all aspects of Amazon's operations: its websites, order fulfilment, customer support and other services are an integrated whole. The overall profit would be apportioned according to the number of people employed, value of physical assets, and sales to customers, in each country.

TNCs are now the dominant element in the world economy. Their tax liabilities run into billions 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 clearly impossible to administer effectively, consistently or fairly.

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: the real economic activities in each place where they happen.

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).³¹ It would place on a sounder basis the 'territorial' principle, according to which profits are apportioned to the countries where the business activity takes place. However, the apportionment would be done according to factors measuring real physical presence in each territory, rather than accepting the often fictional attribution to entities devised by the fertile minds of lawyers and tax advisers.

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.³² 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. Tax 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, while 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 such 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. 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.

The combined report should include (i) details of all the related entities engaged in a common or unitary business, (ii) a set of consolidated accounts for that group, eliminating all 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 should 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 if a firm acquires an unrelated business in order to achieve: (i) profit-shifting, e.g. if a capital-intensive firm acquires a highly labour-intensive business in a low-tax state; or (ii) 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

³¹ 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.

³² These are rules defining residency, and rules defining where activity takes place, or other criteria for determining jurisdiction to tax business profits. For further discussion of this point see McIntyre 2003, p.259.

many different and unrelated 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 for each country, and therefore that those countries should adopt a common set of rules for those accounts, defining the tax base. Harmonisation of the tax base would simplify the preparation of accounts for the firm, but it is not essential for the adoption of a unitary approach that all states agree on a common tax base definition. The important factor is that the combined report would give the tax authorities a clear view of the firm's overall activities, stripping out internal transactions which are often artificial. There would be an enormous saving of administrative effort for tax authorities which currently struggle to disentangle the complex internal links of TNCs, and this would make fair taxation of TNCs possible for those, especially in 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). Harmonisation of the tax base could be facilitated since 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. A harmonised definition of taxable profits would entail agreement on standard allowances for factors such as research and development and depreciation, and hence ending special and discretionary deductions and allowances. Unitary taxation would remove the temptation to offer such advantages, and thus deal with many aspects of the problem of tax competition between states to attract investment by TNCs. A broader tax base, excluding such allowances, would reduce this type of tax competition, and enable reduction of tax rates. It would still be possible for states to compete by offering lower corporate tax rates, and indeed some would consider this desirable, but there could be pressures also towards tax rate convergence.

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. It should be noted that these kinds of adaptations to the rules would be very different from the avoidance strategies fostered by the present system, which generally entail artificial transactions, existing only on paper. Allocating the tax base according to real economic factors would encourage more efficient decisions on the location of investments.

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. This applies especially to intangible property, particularly intellectual property rights, discussed below. 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. Assets and labour quantify claims to tax based on production, while sales provides a weighting for those based on consumer markets. 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. 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.

An important point is that the unitary approach would both enable and require a fresh look at e-commerce, especially internet sales. Under a unitary approach, sales should be allocated according to the location of the purchaser, and a foreign supplier should be regarded as taxable if it has a business presence within the jurisdiction. This issue was examined by the OECD a decade ago, resulting in several reports and some changes to the Commentary to the Model Treaty (OECD 2000, OECD 2002). This issue is a difficult and controversial one under the traditional approach, largely because under tax treaties states can only tax the business profits of residents, or of a foreign firm if it has a 'permanent establishment' (see section 1.1 above). This generally implies a physical presence. Under this approach, a firm such as Amazon can sell into a country, even through a website in the local language, without needing the kind of physical presence that amounts to a 'permanent establishment'. Although Amazon relies on local distribution centres to ensure fast delivery, relatively low profits can be attributed to these activities, which are a competitive and low-margin business (see Box 5 above). Hence, under current rules Amazon can declare low or no profits in countries where it enjoys very substantial sales, which gives it a very significant advantage over local retailers. Under the unitary approach, a broader definition can and should be adopted of what constitutes doing business within the country, which should extend to any substantial sales involving marketing or a website in the local language, and supervision of distribution. In the case of Amazon, not only a website in the local language, but its control of distribution facilities (even if operated by a different affiliate than the sales), should constitute sufficient business presence to make it subject to tax. The allocation of taxable profits would of course depend on the proportion not only of its sales but also assets and labour in that country. Where such cross-border sales do not involve a significant local presence, sales taxes could be applied.

The same principles can also be applied to cross-border sales of services, for instance financial services, such as banking or insurance, or of advertising (e.g. by Google). A services firm should be regarded as taxable if it has a business presence within the country, and the profits allocated according to the formula including sales, based on the location of the client.

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. As already mentioned, assets and labour quantify claims to tax based on production, while sales provides a weighting for those based on consumer markets.

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 three factors would allocate a very small proportion of the tax base to the main tax havens where the main activity is servicing the avoidance and evasion industry. However, to the extent that real activities have developed in those jurisdictions, they could be taxed, as there would be less incentive to offer zero or low tax rates. A country such as Ireland, for example, has attracted a significant amount of genuine business, due as much to its well-educated workforce and quality of life as to the tax advantages. Countries should and could compete on the basis of real economic factors, and not by offering facilities designed to undermine others' laws.

Critics suggest that TNCs would respond to whatever formula is applied by relocating their activities. However, this is very different from artificial avoidance. As tax commentator Lee Sheppard puts it 'Tax competition for foreign direct investment is honest competition. Tax competition for booking income is not' (Sheppard 2012, p. 476).

In the absence of wide differences in corporate tax rates (between countries with significant economic activity), there would in any case 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 some 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 real 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. 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. 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 of a formula over-weighted towards labour. 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.³³ Transportation industries pose a special problem because their main physical assets (ships, aeroplanes etc) are mobile, so they could be taxed based on the value of traffic between contact points. In the case of extractive industries, the levy on extracting 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). Today, resource rent taxation is regarded by many as a more effective method for production countries, and its interaction with general taxes on corporate income would need special consideration.

Nevertheless, a general apportionment formula applied to most types of business 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, in order to fund the collective services from which all benefit.

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' (see Box 4), and indeed are now mainly used to resolve conflicts over application of the ALP.

³³ 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).

3. A Managed Transition

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 explained in section 1 above, the existing system based on the ALP in practice uses special apportionments, especially under the TNMM and profit split methods (see Box 3 above). 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 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.³⁴ 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 profit 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 (see Historical Summary above) 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.³⁵

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. This is now enormously time-consuming for both tax administrations and taxpayers. Thus, the Indian tax authorities are reported to have made transfer pricing adjustments of close to \$9 billion for fiscal year 2007-2008, and over 3,000 transfer pricing cases are currently pending before the Income Tax Appeals Tribunal, which has now established four special benches to deal specifically with them.³⁶

Although their national 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.³⁷ Thus, Brazil does not allow profit-split methods, but as the alternative to the CUP method (due to lack of comparables) relies on the Resale or Cost-Plus methods, 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 OECD countries.³⁸ 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 would be best commissioned by the UN Tax Committee, which is the most globally representative body, though it would require additional resources.³⁹ 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,

34 Caroline Silberstein, head of the OECD's Transfer Pricing unit until 2011 (when she left to join another former senior OECD colleague Mary Bennett at the international tax practice of the law firm Baker & McKenzie) has been quoted as saying 'The proposals for global formulary apportionment have a number of flaws, including the complexity of getting international consensus on the taxable basis to be shared; the difficulty of dealing with intangibles, which would not be less than under the arm's-length principle; and the political dimension of any discussion on allocation keys' (Stewart 2010).

35 This obstinate position continues to be maintained, notably in the 2012 consultation on Intangibles.

36 (Supekar & Dhadphale 2012). Another practitioner recently concluded 'it is clear that TP itself needs a fundamental re-think and that the arm's length method while good in theory does not pan out well in practice. It is time alternative systems in TP are thought through and brought to the fore.' (Vijayaraghavan 2012, p.9).

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

38 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.

39 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.

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, as mentioned above.⁴⁰

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). Indeed, there has been a growth of US states requiring combined reporting and applying profit apportionment in recent years, 'driven by state budgetary shortfalls and the perceived distortion of taxable income by multistate corporations filing separate company reports' (McCann et al 2010, p. 94).

3.2.2 The CCCTB in the EU

An important step forward was taken when the European Commission tabled a proposal for unitary taxation within the EU. 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' included a call for the 'creation of a common assessment basis for corporate income tax', the Commission was able to publish its draft in March 2011.⁴¹ After careful study, the European Parliament approved this draft, although with some significant proposed amendments, by a large majority in April 2012.⁴²

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 (which means most TNCs) within five years, while 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 such harmonisation 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 to set off losses in one country against gains in another, which is a significant problem for TNCs. Unitary taxation would automatically pool losses and gains, 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 see it as a disadvantage, but it can be seen as a necessary concomitant of the single European market. It would also remove tax impediments to intra-group reorganisations. Most significantly, it would cut tax compliance costs: the Commission estimated a 7% 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. A far better approach would be to require submission of a worldwide combined report.

⁴⁰ 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>.

⁴¹ 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.

⁴² 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>

The proposal is currently under consideration by the European Council.⁴³ 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). It seems that not all the EU member states would be willing to adopt the proposal,⁴⁴ but it could still proceed among a smaller group.⁴⁵ Although continuing 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 both major types of international tax avoidance, the use of tax havens and 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 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.⁴⁶

A strategy to help accustom tax administrations to operating a unitary approach would greatly assist a managed transition. 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 task 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. Internet-based businesses, such as Google and Amazon (discussed above, Box 5), would also be better dealt with under a unitary approach.

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 be 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.

⁴³ In a working party on tax questions: 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.

⁴⁴ Objections were expressed during the earlier stages by 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>.

⁴⁵ Under the 'enhanced cooperation' procedure, once the Council decides that a 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.

⁴⁶ 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.

Sources

- Avi-Yonah, R. S. (1995) The rise and fall of arm's length: A study in the evolution of U.S. international taxation. *Virginia Tax Review* 15: 89
- Avi-Yonah, R. (2010) Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation. *World Tax Journal* 2: 3.
- Avi-Yonah, R. S. and Benshalom, I. (2010) Formulary Apportionment: Myths and Prospects - Promoting Better International Tax Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative. Michigan Public Law and Legal Theory Working Papers 221, SSRN E-library.
- Avi-Yonah, R. S., Clausing, K. and Durst, M. C. (2008) Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split. Michigan Law School: Public Law and Legal Theory Working Papers 138.
- Barclays v. FTB (1994) *Barclay's Bank PLC v Franchise Tax Board of California*, 512 US 298.
- Bettendorf, L., Devereux, M., van der Horst, A. and Loretz, S. (2011) Corporate Tax Reform in the EU: Weighing Pros and Cons. *OU Centre for Business Taxation Policy Brief*.
- Bettendorf, L., van der Horst, A., de Mooij, R., Devereux, M. and Loretz, S. (2009) The economic effects of EU-reforms in corporate income tax systems. Study for the European Commission, Directorate General for Taxation and Customs Union.
- Bird, R. M. and Mintz, J. M. (2003) Sharing the international tax base in a changing world. In Cnossen, S and Sinn, H-W (eds) *Public finance and public policy in the new century*. Cambridge, Mass.: MIT Press
- Carroll, Mitchell B. (1933) *Taxation of Foreign and National Enterprises*. Volume 4: Methods of Allocating Taxable Income. League of Nations, Geneva. Available at <http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=cartaxa.sgm&tag=law&images=acdp/gifs&data=/usr/ot&part=0>
- Clausing, K. A. and Avi-Yonah, R. S. (2007) *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*. Washington: Brookings Institution.
- Devereux, M. P. (2006) *The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence*. Oxford University Centre for Business Taxation Working Paper 07/02.
- Durst, M. C. (2010) It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws *Tax Notes International* 57(3): 247-256.
- Kellerman, C., Rixen, T. and Uhl, S. (2007) *Europeanizing Corporate Taxation to Regain National Tax Policy Autonomy*. International Policy Analysis. Friedrich Ebert Stiftung.
- Keuschnigg, C. and Devereux, M. P. (2012) The arm's length principle and distortions to multinational firm organization. *Journal of International Economics* <http://dx.doi.org/10.1016/j.jinteco.2012.08.007>
- Kopits, G. and Muten, L. (1984) The Relevance of the Unitary Approach for Developing Countries. In McLure (ed) *State Taxation of Multijurisdictional Income*. (pp 268-280).
- Langbein, S. I. (1986) The Unitary Method and the Myth of Arm's Length. *Tax Notes*: 625-681
- League of Nations (1932) *Taxation of Foreign and National Enterprises. A study of the tax systems and methods of allocation of the profits of enterprises operating in more than one country*. Vol. I (France, Germany, Spain, the UK and the USA). C.562.M.178, 1932 II A 3, Geneva.
- Lindencrona, G. (1982) What is Wrong with Unitary Taxation? In Hopt, K. (ed) *Groups of Companies in European Laws*. (pp 230-242). Berlin: De Gruyter
- McCann, B., Yesnowitz, J. C., Jones, C. and Sutton, G. (2010) The Recent Growth of Mandatory Unitary Combined Reporting. *The Tax Adviser*: 94-97
- McIntyre, M. J. (2004) The Use of Combined Reporting by Nation States. *Tax Notes International* 35: 917-948
- McIntyre, M. J. (2012) Challenging the Status Quo: The Case for Combined Reporting. *Tax Management Transfer Pricing Report* 20: 1165-1173
- McIntyre, M. J., Mines, P. and Pomp, R. D. (2001) *Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana*. Louisiana Law Review 61.
- McLure, C. E. (ed.) (1984) *The State Corporation Income Tax. Issues in Worldwide Unitary Combination*. Stanford, California: Hoover Institution Press.
- Murphy, R. (2012) *Country-by-Country Reporting. Accounting for globalisation locally*. Available from <http://www.taxresearch.org.uk/Documents/CBC2012.pdf>
- OECD (2000) *Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5*. Committee on Fiscal Affairs, available from <http://www.oecd.org/tax/taxtreaties/1923380.pdf>
- OECD (2002) *Issues in International Taxation. Reports Related to the OECD Model Tax Convention No. 8, Part II Treaty characterisation issues arising from e-commerce*.
- OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Available for purchase at <http://www.oecd.org/ctp/transferpricing/>, or to view at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en
- PwC (2012) *Tax Transparency and Country-by-Country Reporting*. Available from http://www.pwc.com/en_GX/gx/tax/publications/assets/pwc-tax-transparency.pdf
- Ruding, H. O. (2012) *The Euro Crisis: Implications for the Internal Market and Harmonisation of Corporate Taxes*. CEPS Policy Brief No. 269. Available at SSRN: <http://ssrn.com/abstract=2060102>
- Sadiq, K. (2011-2) *Taxation of Multinational Banks. Using Formulary Apportionment to Reflect Economic Reality*. *Journal of International Taxation* 22-23
- Sheppard, LA (2012) *News Analysis: Is Transfer Pricing Worth Salvaging?* *Worldwide Tax Daily*: 30 July 384-476
- Sullivan, MA (2004) *With billions at Stake, Glaxo puts U.S. APA Program on Trial*. *Tax Notes International Magazine* 34: 456
- Tax Justice Network (2007) *Identifying Tax Havens and Offshore Financial Centres*. http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf.
- Tripathi, K. K. (1992) *Unitary Method of Taxation and its Adaptability to the Indian System*. *Journal of the Indian Law Institute* 34: 385-398
- United Nations (2012) *Practical Manual on Transfer Pricing for Developing Countries*. UN Committee of Experts on Cooperation in Tax matters, Geneva, available from http://www.un.org/esa/ffd/tax/documents/bgrrd_tp.htm
- US GAO (1981) *IRS Could Better Protect Tax Interests in Determining the Income of Multinational Corporations*. Report of the Comptroller-General to the Chairman, House Committee of Ways and Means. GGD-81-81, available from <http://www.gao.gov/assets/140/135312.pdf>
- US Treasury & IRS (1988) *A Study of Intercompany Pricing. Discussion draft (The White Paper)*. Available from <http://archive.org/details/studyofintercomp00unit>
- Vijayaraghavan, V (2012) *The Great Indian Transfer Pricing Circus - A Critical View of Indian TP Provisions*. *Tax Justice Focus* 7 (3): 7-9.