REPLACING THE TRANSFER PRICING REGIME WITH A FORMULARY APPORTIONMENT APPROACH IN THE INTERNATIONAL SETTINGS

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ABSTRACT

Multinational corporations are responsible for trillions of dollars in transactions, most of which are being conducted between affiliates.[1] They employ millions of people all over the world and, consequently, exert great influence on national economies. Their powerful role in the global economies has generally forced national governments to surrender their taxing rights (in full or in part) in order to attract these entities to invest in their domestic economies. The desire to attract multinational corporations to invest in local economies has led to vigorous tax competition, which put immense pressure on the current "international tax regime." The existing rules provide multinational corporations with a great degree of flexibility to fashion their operations such that they would pay very little, if any, tax on the worldwide income.[2]

This phenomenon is troubling. It jeopardizes national states' ability to provide social insurance for their residents. It also reduces the national states' ability to invest in infrastructure and education, both of which are essential to the production of income in future generations.[3] The tax competition among the different states over foreign investments has reduced the ability of governments to redistribute wealth between the wealthy and the poor. Redistribution of wealth is very difficult to achieve not only because the income tax rates are low and, presumably, the revenues from corporate income taxes have decreased over the years, but also because

[1] Just to get a sense of it, in 2007, intra-trade among affiliates of multinational corporations amounted to nearly $950 billion (or 42% of total goods trade), out of which $698 billion represented 48% of all imports and nearly $252 billion represented 31% of all exports. Tanweer Akram,Haidar A. Khan & J Scott Holladay, *U.S. Intra-Firm International Trade*, available at http://ssrn.com/abstract=103088; Surprisingly, most intra-company trade is made between affiliates incorporated in Western countries and not with affiliates incorporated in developing countries or in countries which are usually referred to as tax havens; Dhammika Dharmapala & James R. Hines Jr., *Which Countries Become Tax Havens?* (2006).

[2] These changes have made global trade more important due to the increasing dependency nation-state developed. See APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (Office of Tax Policy U.S. Department of the Treasury, December 20, 2007).

[3] Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1573-1574 (2000).

governments all over the world turned to rely more heavily on consumption taxes (which are viewed as having regressive effects on wealth distribution).

To the extent that states wish to tax multinational corporations and "fairly" allocate their corporate income taxes among the different states in which these entities operate, a new set of tax rules should replace the existing ones. Experience shows that amending existing rules (most of which were adopted almost a century ago, when lifestyles and the economy were very different) would not suffice. The various provisions that were enacted over the last eight decades to recapture untaxed income had very little success and mainly produced work for accountants, economists, and lawyers. These attempts also made the existing rules very complex and increased tremendously compliance costs.

My position is that replacing the current system with a formulary apportionment system that includes unitary tax methodology and mandatory global consolidation could work much better.[4] However, it is important to design the proposed system on the fundamental understanding that it does not serve as a surrogate for transfer pricing methods that are based on the separate entity and the arm's length principles, but rather provides a conceptually different method for determining the taxing rights of the relevant participating states.

This study proposes that the change in the existing rules would start with rejecting the arm's length and separate entity principles altogether. It seems that most of the major economies have, in fact, deviated from the separate entity concept in many respects and provide group treatment (allowing taxpayers to treat affiliates as a single taxpayer for tax purposes) mainly for domestic tax purposes. Moreover, most of the major economies do not fully tax the corporation and the shareholders but rather provide different tax relieves (either at the shareholder level, at the corporate level, or at both). Additionally, it seems that the chances of finding the Holy Grail

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[4] Formulary apportionment methodology is often referred to the use of a mathematical formula to divide the income of an enterprise among the jurisdictions in which the enterprise operates and does business. Formulary apportionment is often referred to as unitary business or unitary business but the terms are different. Whereas formulary apportionment refers solely to the process of allocating cross-border income among the different participating jurisdictions according to a mathematical formula, unitary business refers to the process of dividing and integrating operations of different members in a corporate group or within a single entity into distinct lines of business. Generally, the unitary business methodology then allocates cross-border income in each line of business to the different countries according to the apportionment formula. I will demonstrate the differences between the application of an FA system which initially applies the unitary business methodology and an FA system that does not apply the unitary business methodology.

are better than finding a comparable (arm's length) transaction, which can be used in analysing one's pricing practices.

This study will then examine the justification for adopting an FA system using a unitary business methodology. It will analyse the advantages and disadvantages of adopting an FA system and review the four existing FA systems in the United States, Canada, Switzerland, and Germany (although these states adopted the FA methodology to tax businesses at the sub-national level and not at the international level). The analysis, among other things, would question whether any of these systems could replace the existing rules for taxing cross-border business income at the international level; and if not what modifications should be made in order for such methodology to operate successfully and "fairly" apportion business income among nation-states. It would also review and analyse the recent major proposals for replacing the existing rules with modified FA systems.

The study asserts that replacing the existing rules that rely on the separate entity doctrine with the Formulary Apportionment (FA) would successfully subject multinational corporations to a two digit tax rate (in comparison with the single digit that multinational corporate are currently effectively taxed at, at best) and would not less important, allocate such income taxes among the different states more justly. The study also asserts that the existing formulas currently used in in the United States, Canada, Switzerland, and Germany could not allocate business income successfully at the international level (for example, it seems that relying heavily on the "sales" (gross receipt) factor (as the sole factor or in giving it extra weight) could be easily manipulated by multinational corporations in artificially reducing their overall tax rate).

My proposal introduces an important allocating factor in the formula, which to my knowledge has not yet been raised in this context. The existing systems and proposals to adopt a formulary apportionment methodology recommend applying the conventional three factors: property and payroll, both of which allocate income to the manufacturing market, and sales/gross receipt that allocates income to the consumption market. Different proposals to adopt an FA system to allocate cross border income suggest giving the conventional factors different proportions or weights. In my view, an important market that should also be allocated income is the financial market, which provides the multinational corporation the resources to operate. I also propose raising the issue of corporate integration such that the overall tax liability (at the corporate level and the shareholder level) is capped.

Accordingly, I propose replacing the property factor with the equity and quasi equity factor. Applying this formula would allocate business income among the jurisdictions that hosted production/generation of such income (including the jurisdictions whose residents contributed equity and quasi equity that enabled the business to operate) and to the jurisdictions whose residents purchase the goods or receive the services. I also suggest that taxpayers be allowed to reach a multinational FA agreement with respect to the applicable formula, even though such agreements would naturally not be easily reached since it requires the consent of the multiple taxing authorities in addition to the taxpayer.

I believe that these contributions would improve the proposed FA system and provide a solution to the transfer pricing problem that the world has been experiencing and has been trying to solve with very little success. In my view, the FA method is superior to the existing tax regime as well as to the other proposals to replace the existing tax regime (e.g. replacing the income tax system with a consumption tax system). It is relatively simple, transparent and has been used successfully such that most of the important technical issues that could arise in administering it have been confronted and resolved. Moreover, were the proposed changes adopted, many of the existing complexity would be eliminated, including: the transfer pricing rules, the subpart F rules, the foreign tax credit rules. Elimination of all of these regimes would significantly simplify the current tax rules for taxing cross-border business income and would simplify compliance for taxpayers and for the government. Lastly, and not less important, I also believe that the proposed system would produce a fairer allocation of corporate income tax revenues among nation-states.