

Faltering Blocks in the Arguments against Unitary Taxation and the Formulary Apportionment Approach to Income Allocation

A L E X A N D E R E Z E N A G U *

SYNOPSIS

Tax treaties represent a highly developed area of international cooperation. They are the primary means by which countries cooperate to avoid double taxation and remove barriers to international business, but they have also become tools used by multinationals to avoid or evade taxation on a global scale. Integral to the present day model of tax treaties is the separate accounting and arm's length standard of income allocation (SA-AL), adjudged to be fraught with challenges and accountable largely for the widespread tax evasion and avoidance practices of the modern era.

While this existing method for measuring and taxing the income of multinationals is increasingly unsatisfactory, viable alternatives have traditionally been rejected as equally unworkable. This paper will make the case that the alternatives are actually becoming increasingly viable and should be adopted going forward, despite the

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inevitable transition costs that will arise in the short term. First, this paper will set out the two distinct approaches to taxing multinational: the treatment of companies as separate entities with separate accounting and an arm's length standard of transfer pricing or rather as integrated entities with total net income being apportioned among integrated entities by means of a uniform apportionment formula. Second, it will explain why one method has been chosen instead of the other, further exploring why the chosen method is failing and why a viable alternative is necessary. Third, it will explore why the alternative is simultaneously becoming more viable despite past resistance. The paper will conclude that the alternative is now possible and should be adopted before the current method fails completely.

INTRODUCTION: CONCEPTS AND HISTORY

This paper focuses on limitations with regards to the tax treatment of multinational entities (MNEs) under the existing global system, which treats related entities as separate and further demands they act at arm's length when dealing with each other. It further seeks to advance an alternative global tax system where MNEs are treated as single entities for tax purposes with their global profits apportioned among jurisdictions based on the value of the economic activities taking place in those jurisdictions. It advocates for a unitary taxation and formulary apportionment approach to income allocation arising from the cross-border economic activities of MNEs.

The paper opens by defining two concepts: the separate entity and arm's length standard (SE-ALS) of income allocation and the unitary taxation and formulary apportionment approach (UT-FA) of income allocation. It provides a history of the existing system, its limitations and efforts by supranational bodies to improve it. It considers the arguments against the alternatives to UT-FA, why those arguments are neither as relevant nor potent today as they were decades ago, and ultimately makes recommendations. It concludes by arguing that the transitional cost is not as costly as the negative effects of continuing and defending the existing system in the long run.

Concepts

Arm's Length Standard

The global consensus to treat multinational entities (MNEs) as separate entities requires that in the transfer of goods and services among entities within the MNE, especially with regards to setting the prices of such transfers, they act at arm's length. This implies that while they are integrated entities

under the ownership and control of a parent company (a central management and vertical organizational structure) they must act as independent entities would. This treatment of subsidiaries by a parent company is contained in Article 9 of both the OECD Model Treaty and the UN Model Treaty. It provides that:

Where:

- a) An enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or
- b) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state,

and in either case, conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.¹

This treatment is equally applied to the treatment of branches or permanent establishments (PEs) of companies resident in other jurisdictions. Article 7(2) of the model convention provides that:

...the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise².

To achieve the arm's length treatment of MNEs in the transfer of goods and services among them, methodologies have been recommended by supranational bodies such as the OECD and the UN to guide taxpayers and tax authorities in agreeing on a price for the transfer of goods and services that would be deemed to be arm's length. Three of these methods are aimed at the transaction or the price charged for the goods and services, and the other two are aimed at the profit declared by the taxpayer for the overall transaction.

¹ Organisation for Economic Co-operation and Development, *Model Convention with Respect to Taxes on Income and on Capital: Condensed Version*, (OECD, 2014), art 9, online: <<http://bit.ly/2uszEPa>> [OECD Model].

² *Ibid*, art 7(2).

The traditional transactional methods are the Comparable Uncontrolled Price Method (CUP), the Resale Price Margin (RPM) and the Cost Plus Method (CPM). The traditional profit methods are the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM). For all five methods, the taxpayer must include comparables in justifying the arm's length standard, that is, the taxpayer must show that the price fixed or the profit declared is the same as would be achieved by unrelated parties dealing with each other under the same conditions and on the same terms. There is a provision for adjustment by the tax authority where this may not completely be the case.

The taxpayer needs to convince the tax authority by preparing transfer pricing (TP) documentation – a process that is resource-intensive, demands expertise, incurs great costs and takes time. Where the tax authority is not convinced, it may re-characterize the transaction and adjust the profits.

Unitary Taxation and Formulary Apportionment

Unitary taxation (UT) operates from the understanding that the profits generated by an integrated firm arise from the integration of its activities. Under this approach, a consolidated account for the integrated firm is furnished and profits apportioned based on factors that reflecting the economic activities in each jurisdiction in relation to the functions performed, assets used and risks assumed.³ Cobham and Loretz describe UT as:

...treating each multinational group of companies as a unit, regardless of the geographical and jurisdictional location of the individual subsidiaries; calculating profit and loss on a group-wide basis; and then allocating the taxing rights on this consolidated profit between the jurisdictions with which the group has a nexus, according to the extent of the economic activity.⁴

³ Prem Sikka, "How to Take a Serious Bite out of Corporate Tax Avoidance", *The Guardian* (24 May 2013), online: <<https://www.theguardian.com/commentisfree/2013/may/24/corporate-tax-avoidance-unitary-taxation-g8>>. Here, the author argues that though unitary taxation is not a magical solution to the deep-seated problems of capitalism, its strong points call for its adoption.

⁴ Alex Cobham & Simon Loretz, "International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation" (2014) International Center for Tax and Development Working Paper 27 at 7 [Cobham].

This approach starts with the basic idea that both the residence state and the source state have a co-existing interest in the combined income.⁵ It further considers an MNE as a single business, which for the sake of convenience, is divided into purely formal, separately-incorporated subsidiaries. Under this approach, “the global income of the MNE needs to be computed, then such income is apportioned between the various component parts of the enterprise by way of a formula which reflects the economic contribution of each part to the derivation of profits”⁶. Consequently, a state may subject that portion of the multi-national corporate group’s income deemed attributable to the state to taxation based upon the group’s presence or activities within the state.

In the United States, where the unitary taxation and formulary apportionment approach of income allocation has been used for decades when allocating profits among taxing jurisdictions within the US, the Supreme Court established the pillars of a unitary business to be: functional integration, centralized management and economies of scale.⁷ Segal further opines that the Unitary Taxation and Formulary Apportionment (UT-FA) approach differs from the Separate Accounting and Arm’s Length Standard (SA-ALS) in two main aspects: the fact that intra-group transfers negate each other as the tax is based on the worldwide income of the group rather than the individual income of some particular unit of the group; and the unitary method takes into account the income of the unitary group as a whole rather than merely transactions undergone directly by the unit within the taxing jurisdiction.⁸

Notwithstanding the presence and use of the UT-FA approach for over a century, the OECD has consistently refused to consider its application on a global scale. In the 2017, transfer pricing guidelines published by the OECD stated that “...no legitimate alternative to the arm’s length principle has emerged. Global formulary apportionment, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or

⁵ Bret Wells & Cym H Lowell, “Income Tax Treaty Policy in the 21st Century: Residence vs. Source” 5:1 Columbia J Tax Law at 16 [Wells].

⁶ Lindsay C Celestin, *The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?* (PhD Dissertation, University of Sydney, 2000) at 12 [unpublished].

⁷ Kimberley Reeder, Sarah McGahan & Jon Sedon, “The Unitary Group’s Identity Crisis: Is There Really an “I” in Unitary?” (2008) *The State and Local Tax Lawyer Symposium Edition* 83 at 84.

⁸ Mark A Segal, “The Unitary Tax Reconsidered” (1994) 10:3 J Applied Business Research 1.

practice”.⁹ It further stated that the most significant concern with global formulary apportionment is the difficulty in implementing the system in a manner that both protects against double taxation and ensures single taxation.¹⁰ Julie Roin holds the view that formulary apportionment will be vulnerable to the well-known avoidance techniques present in a separate-entity/transactional environment, further suggesting that the perceived benefits associated with formulary apportionment may not exceed the associated costs, calling on national tax policy makers to more effectively focus on ways to buttress the separate entity/transactional approach.¹¹

History: The Journey to the Existing System

The end of World War I saw the immediate commencement of a second war, a resource war. International trade was gaining steam in the 19th century and trade, shipping,¹² and aviation agreements expanded rapidly as countries were committed to rebuilding their economies and territories after the damage caused by war. These expansionary plans and the associated cross-border trade meant that states were further determined to secure and increase their revenue streams. The MNEs, which had become the vehicles for international trade, were worried about double taxation of their income arising from trade engagements with more than one country, for example their home state and the host state. These concerns, fears, and worries brought countries to agree on the prevention of double taxation; hence, the birth of international tax treaties on the prevention of double taxation. All stakeholders agreed that taxation, and the risk of double taxation, presented hindrances to economic relations between countries.

In 1920, the International Chamber of Commerce (ICC) advocated for a profit-split method of income allocation, and stated that profits should be

⁹ See Organisation for Economic Co-operation and Development, *The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, OECD Publishing, 2017), online: <<http://bit.ly/2vkaWzy>> [OECD Transfer Pricing Guidelines].

¹⁰ *Ibid.*

¹¹ Julie Roin, “Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment” (2008) 61:3 Tax L Rev 169.

¹² The Netherlands Law of May 21st, 1819 exempted, on condition of reciprocity, foreign ships from the business licence tax, setting precedent for the exemption of income from shipping from tax. See Mitchell Carroll, *Prevention of International Double Taxation and Tax Evasion: Two Decades of Progress Under the League of Nations* (Geneva: League of Nations Publications, 1939) [Carroll, “Double Taxation”].

taxed in each country in proportion to the profit realized therein.¹³ The ICC further suggested that where countries could not agree, allocation would be presumed to be proportional to sales (turn-over), effectively advocating for the adoption of the formulary apportionment mechanism in income allocation.¹⁴ The ICC's work in addressing double taxation of global income was transferred to the League of Nations in 1923,¹⁵ which favored the primacy of residence in the allocation of taxing rights.

This meant that residual income was allocated to residence countries while source countries were left to collect withholding taxes on the categories of income where permanent establishment was decided by the state. Experts also recommended that companies be treated as separate entities rather than a global company for the purpose of taxation. The implication of this is that companies treated transactions with related companies as independent, fixing prices that reflect market in the transfer of prices amongst them.¹⁶

Wells and Lowell have argued that the:

...framework of taxation that evolved in the 1920s was based on the mercantilist belief that imperial countries were the source of capital and know-how while the colonies were passive suppliers of goods or services with little value added functionality. As a result, the right to tax residual income belonged to the residence countries of the imperial companies (England in this example). Source countries (India in the example) were allowed to tax only routine profits deemed earned therein and impose withholding taxes on certain types of outbound payments.¹⁷

They further argue that the League of Nations model was constructed from distinct policy judgments, such as:

- (i) source country should tax local operations;
- (ii) residual income should be earned by the residence country;
- (iii) the presence of an interim holding company in a country should cause that country to be treated as a residence country;
- (iv) subsidiaries, by themselves, should not be treated as permanent establishments of the offshore parent company; and
- (v) transfer pricing is to be applied on a separate account basis (collectively, the "foundational premise").¹⁸

¹³ Wells, *supra* note 5.

¹⁴ *Ibid.*

¹⁵ The League of Nations was established by the Treaty of Versailles on June 28, 1919, with the aim of promoting international cooperation and to secure international peace and security.

¹⁶ See generally Solomon Picciotto, *International Business Taxation: A Study in the Internalization of Business Regulation* (London: Weidenfeld and Nicholson, 2013) [Picciotto].

¹⁷ Wells, *supra* note 5 at 10.

¹⁸ *Ibid* at 27.

These five principles would come to define tax relations between countries and influence both the current OECD and UN Tax Treaty.

It is important to note that the economic experts at the League of Nations framed and stated the issues as involving a conflict of interest between debtor countries who import capital, and creditor countries who export capital. They further posited that double taxation should be avoided by vesting the primary taxing jurisdiction in the country to which the taxpayer owed its “economic allegiance”,¹⁹ relying on Schanz’s economic allegiance theory.²⁰ In the end, a classification-and-assignment approach was adopted, which classified income into various categories and assigned taxing jurisdiction based on the classification.

Schanz’s economic allegiance theory provided that revenue should be apportioned according to contribution, and recommended a 75-25 sharing formula between source and residence states. Relying on Schanz’s theory, it is difficult to appreciate the classification-and-assignment approach used by the League of Nations. From a logical standpoint, the proper choice should have been option 3 (the proportional allocation of income) as recommended by Schanz in his economic allegiance theory.

This model of income allocation was subsequently accepted by the Organisation for European Economic Co-operation (OEEC) and the Organisation for Economic Cooperation and Development (OECD).²¹ It has become the basis for treaty negotiations amongst states.²² Thus, the ICC model approach of treating global companies as unitary for tax purposes and apportioning the residual income of a global company between the residence and source countries based on economic contributions conducted in each country (formulary apportionment) was rejected in favour of treating entities as separate and taxing based on classification and assignment of income, which favored the country of residence.²³

Arguments against the UT-FA approach to income allocation include the following: the jurisdiction of a state to tax income should be limited to

¹⁹ *Ibid* at 15.

²⁰ Discussed in Klaus Vogel, “Worldwide vs Source Taxation of Income- A Review and Re-evaluation of Arguments” (1988) 16:8/9 *Intertax* 216.

²¹ The OECD is an advisory organization for economic cooperation established in 1961, which currently has 35 member countries.

²² See generally Mitchell Carroll, “Income Tax Conventions as an Aid to International Trade and Investment” (1961) 6:3 *Section of Intl and Comparative L Bull* 16; Mitchell Carroll, “The New Tax Convention between the United States and Canada” (1942) 20 *Taxes* 459.

²³ See generally Picciotto, *supra* note 16.

income derived from its territory; only a state of residence may tax the worldwide income of a taxpayer; tax authorities do not have the right to demand information about an enterprise's business establishments in other states; the exercise of cross-border tax controls could contribute to animosity; global calculations of income according to the different principles of the various states would impose heavy administrative burdens on enterprises; differences in accounting principles, languages, currencies, etc. would create practical problems; profit potentials differed from country to country; and that it would be difficult to reach agreement on common rules for the calculation of the worldwide income.

Inhibitory factors in the election of the UT-FA approach include: on 'consolidating or combining' separate entities, the question is whether to delineate the group in terms of legal or economic relationships; do we apply the formulary apportionment to worldwide income or a "water-edge" limitation; what is an acceptable formulary apportionment formula; what are the factors to include in such formula and the definition of the factors such as payroll, property and sales; how do we reconcile the challenge posed by the divergence between financial and tax accounting in adopting formulaic apportionment approach. Further, what income is to be apportioned, should it include dividends, interest, patent and copyright royalties, rents and royalties from real estate and income from the purchase and sale of real property or capital assets? How do we treat intangibles and the advent and prominence of e-commerce/digital economy?²⁴ Other arguments regularly advanced against the election of the UT-FA approach are: fiscal sovereignty of states; hurdles to exchange of information among states; administrative burdens of transition to a new global tax system; and political will of nations to agree on formula, factors, accounting standards, language of reporting, profit determination and delineation of integrated entities.²⁵

In summary, issues of sovereignty, exchange of information, agreement on appropriate factors and formulae, and implementation hurdles, have all

²⁴ See generally Reuven Avi-Yonah & Zachee Pouga Tinhaga, "Unitary Taxation and International Tax Rules" (2015) International Centre for Tax Development Working Paper 26 [Avi-Yonah]; Prem Sikka & Richard Murphy, "Unitary Taxation and the Role of Accounting" (2015) International Centre for Tax Development Working Paper 34 [Sikka & Murphy]; Marco Runkel & Guttorm Schjelderup, "The Choice of Appointment Factors under Formula Apportionment" (2011) 52:3 Intl Economic Rev 913.

²⁵ See generally Erika Siu et al, "Unitary Taxation in Federal and Regionally-Integrated Markets" (2014) Intl Centre for Tax and Development Research Report 3 [Siu et al, "Unitary Taxation"]; Sikka & Murphy, *ibid*; Avi-Yonah, *ibid*.

influenced the decision of the experts. I set out to address these concerns below.

A FAILING SYSTEM

Litany of Woes

The League of Nation's election to use a classification-and-assignment approach has created a platform for multinational companies to earn a material portion of their income in low or no tax jurisdictions through base erosion and profit shifting. The argument quickly moved from double taxation to double non-taxation.²⁶ It became obvious to the international community that companies manipulated the transfer price amongst themselves to pay low or no tax in jurisdictions where they operated from, and equally shifted profit to low tax jurisdictions or eroded tax bases in countries with high tax rates. The League of Nations Model presented the opportunity for rent-seeking and manipulation of the system. It equally provided substantial advantage to MNEs over non-MNEs, thereby raising horizontal equity issues. A consequence of transfer pricing²⁷ manipulation by MNEs is that national tax jurisdictions suffer economic stress and may have to bridge the revenue gap by taxing middle or low income earners at a higher rate than they are able to pay.²⁸

In more concrete terms, the 2015 UN Conference on Trade and Development publication claims that developing countries lose \$100 billion per year due to tax avoidance by multinational companies and as much as \$300 billion in total lost development finance.²⁹ Between 1970 and 2010,

²⁶ See generally Reuven Avi-Yonah & Kimberly Clausing, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment", (1 June 2007) The *Brookings Institution* (website), online: <<https://www.brookings.edu/research/reforming-corporate-taxation-in-a-global-economy-a-proposal-to-adopt-formulary-apportionment/>>.

²⁷ This is the unit price assigned to goods and services between the parent company and subsidiaries or between divisions within the same firm.

²⁸ The "Ability to Pay" principle of taxation provides that taxation ought to be progressive, taxing those with the ability to pay more than those without the ability, however, the rent-seeking activities of MNEs have resulted in a regressive tax system in most tax jurisdictions and this trend is unjust. See Eduardo Baistrocchi, "The Transfer Pricing Problem: A Global Proposal for Simplification" (2006) 59:4 *The Tax Lawyer* 941 [Baistrocchi].

²⁹ Tax Justice Network, "UNCTAD: multinational tax avoidance costs developing countries \$100 billion+" (16 March 2015), online: <<http://www.taxjustice.net/2015/03/26/unctad-multinational-tax-avoidance-costs-developing-countries-100-billion/>>.

capital flight through tax evasion and avoidance schemes stood at \$814 billion, exceeding the official development aid of \$659 billion and foreign direct investment of \$306 billion for the same period.³⁰ Developed countries are not spared. In 2008, the US alone lost an estimated \$90 billion to the practice of shifting profits overseas, which was about 30% corporate income tax revenues or three times the federal budget for foreign aid.³¹ In 2009, Barclays Bank declared global profits of £4.6 billion but paid only £113 million in UK corporation tax, an effective rate of 2.4%.³² Google was accused of generating £11.5 billion from the UK between 2006 and 2011, but paid just £10 million in UK corporation tax.³³ Amazon paid £11.9 million in corporation tax in 2014 even though it made £5.3 billion in sales from the UK.³⁴ Using tax-planning schemes, such as the ‘double Irish, Dutch sandwich’, companies are able to move the bulk of their revenues to low or no tax jurisdictions like Ireland, Luxembourg and Bermuda. From 2009 to 2012, Apple got away with sending \$74 billion in profits to its Irish subsidiaries, even though Apple products were designed in the United States, assembled mostly in China, and sold in Europe, Africa, Asia, and the Middle East, with relatively few sales in Ireland. Apple was able to assign \$74 billion to Ireland, by taking advantage of loopholes in tax treaties modeled after the League of Nations’ Model, alongside a secret tax deal with Ireland, which enabled Apple to pay a total effective tax rate of 1% in Ireland. Though Apple had three subsidiaries in Ireland, each claimed to have tax residency nowhere, which effectively led to tax dodging.³⁵

³⁰ JK Boyce & L Ndikumana, “Capital Flight From sub-Saharan African Countries: Updated Estimates, 1970 – 2010” (October 2012) University of Massachusetts Amherst PERI Research Report.

³¹ Oxfam America, “You vs Big Business” (13 November, 2014), online: <<http://politicsofpoverty.oxfamamerica.org/2014/11/g20-corporate-tax-evasion>>.

³² Jill Trainor, “Barclays Bank Forced to Admit it paid Just £113m in Corporation Tax in 2009”, *The Guardian* (18 February 2011), online: <<https://www.theguardian.com/business/2011/feb/18/barclays-bank-113m-corporation-tax>>.

³³ Tom Bergin, “Special Report – How Google UK Clouds its Tax Liabilities”, *Reuters* (1 May 2013), online: <<http://uk.reuters.com/article/uk-tax-uk-google-specialreport-idUKBRE94005R20130501>>.

³⁴ Simone Bowers, “Amazon UK’s Business Paid Just £11.9m in Tax Last Year”, *The Guardian* (24 June 2015), online: <<https://www.theguardian.com/technology/2015/jun/24/amazons-uk-business-paid-119m-tax-last-year>>.

³⁵ Walter Hickey, “Apple Avoids Paying \$17 Million in Taxes Everyday Through a Ballys but Genius Tax Avoidance Scheme”, *Business Insider* (21 May 2013), online: <[show-apple-reduces-what-it-pays-in-taxes-2013-5](http://www.businessinsider.com/show-apple-reduces-what-it-pays-in-taxes-2013-5)>.

However, developing countries are worse hit by tax avoidance schemes because, unlike developed countries, they rely heavily on corporate tax revenue. Durst aptly describes the situation thus:

Countries with highly developed economies often place limited reliance on revenue raised from corporate taxation because other sources of revenue, such as individual income taxes and consumption taxes, are arguably sufficient to meet national needs. In many developing countries, however, much domestic economic activity occurs informally, with few if any books and records maintained, so the government's ability to raise revenue from individual income taxes and consumption taxes is severely limited. For these countries, corporate taxation, and especially taxation of income from cross-border operations, represents a substantial portion of the potentially available revenue base. These countries cannot afford to sacrifice a large proportion of their corporate tax bases, and the perpetuation of BEPS therefore poses a significant national hardship.³⁶

The SE-ALS standard of income allocation is fraught with challenges. The standard ignores that MNEs are an amalgamation of branches and subsidiaries and sometimes arise specifically to take advantage of the profit potential in internalizing transactions within a group.³⁷ With globalization, multinational corporations can now have their production in one state, supply of technical support and marketing in another state and their main center of management in yet another.³⁸ Technological advancements and e-commerce further internationalize the business activities of MNEs thereby revealing the inadequacy of tax principles that are nearly a century old. Furthermore, the rise of MNEs can be attributed to the minimization of cross border transaction costs. SE-ALS is unable to provide taxpayers with a clear sense of how they are expected to behave in the legal system in which they operate.³⁹

The myth that members of a group of companies are separate entities from their parent company (and capable of independently dealing with the parent company or their subsidiaries) is problematic.⁴⁰ It poses a challenge to properly determining an arm's length price in a situation where companies transfer unique products with no existing market. This includes, for instance,

³⁶ Michael Durst, "Beyond BEPS: A Tax Policy Agenda for Developing Countries" (June 2014) International Centre for Tax and Development Working Paper 18 at 8.

³⁷ Reuven Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation" (2009) Law & Economics Working Papers Archive: 2003-2009 Paper 102 at 4.

³⁸ Carroll, "Double Taxation", *supra* note 12 at 4.

³⁹ Baistrocchi, *supra* note 28.

⁴⁰ Celestin, *supra* note 6.

intangibles like unique patents. Also, it can be time-consuming for tax authorities to resolve conflicts regarding whether the correct taxable income has been reported in a particular jurisdiction. This can lead to significant adjustments and reassessments against the relevant entity.

The arm's length standard asserts that associated enterprises should always deal with each other on the same business terms as fully independent entities. To arrive at an arm's length for the transfer of goods and services among related entities, methodologies have been recommended by supranational bodies such as the OECD and the UN in order to guide tax authorities in arriving at a price for the transfer of goods and services that would be deemed 'arm's length'. Three of these methods are aimed at the transaction or the price charged for the goods and services, the other two are aimed at the profit declared by the taxpayer for the overall transaction. The traditional transactional methods are the Comparable Uncontrolled Price Method (CUP), the Resale Price Margin (RPM) and the Cost Plus Method (CPM). The traditional profit methods are the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM).⁴¹ For all five methods, the taxpayer must include comparables in justifying the arm's length standard, that is, that the price fixed or the profit declared is the same as would be achieved by unrelated parties dealing with each other under the same conditions and on the same terms. There is provision for adjustment by the tax authority where this may not completely be the case.

Having arrived at an arm's length price, the taxpayer must convince the tax authority by preparing transfer pricing (TP) documentation. This is time and resource-intensive and demands expertise. Where the tax authority is not convinced, it may re-characterize the transaction and adjust the profits. This could lead to double taxation where the corresponding tax jurisdiction or authority does not do same. Also, in developing countries with limited capacity, taxpayers employ tax firms who have better knowledge and can effectively engage in tax planning. This could either shift profits to low tax jurisdiction or erode the bases of the host jurisdiction.

These methodologies are limited by the incapacity of tax authorities expected to properly implement them. Insufficient comparables of similar

⁴¹ See generally United Nations, *The United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York, Department of Economic and Social Affairs, 2017), online: <<http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf>>; OECD Transfer Pricing Guidelines, *supra* note 9.

transactions, dearth of database, and the non-applicability of comparables to other jurisdictions creates a need for adjustment among other limitations.⁴²

The complexity of applying transfer pricing methodologies to the transfer of goods and services among related entities, and the exchange of goods and services among entities of the same MNE create opportunities to undercharge or overcharge the transfer prices, especially in developing countries. Where the transfer price does not reflect market value (due to an over or undercharge resulting in loss or profit on the part of the buyer or the seller) what arises is the opportunity to manipulate where the profit was realized.⁴³ This profit is often shifted to a low-or-no-tax jurisdiction, thus depriving the host or home state of revenue which would have otherwise accrued to them.⁴⁴ Kale and Mahoney write that the SA-ALS approach “proved to be an administrative headache due to the accounting process of arm’s length pricing and consequently inconsistent with corporate interests”⁴⁵. These loopholes allow for base erosion and profit shifting and make the existing system indefensible.

Rescuing a Failing System

Attempts have been made at domestic and international levels to address the base erosion and profit shifting of income occurring in both residence and source countries through regimes such as controlled foreign corporations (CFC) rules, anti-avoidance principles, transfer pricing guidelines, penalties, exchange of information agreements, general anti-avoidance rules (GAAR) and stringent disclosure requirements.⁴⁶

At the domestic level, countries insert safe harbor provisions in their tax regime to limit the arm’s length standard of income allocation and the application of the transfer pricing methodologies. For instance, Regulation 15

⁴² Lachlan Cooper et al, *Transfer Pricing and Developing Economies. A Handbook for Policy Makers and Practitioners* (Washington, DC: World Bank Publications, 2016) [Cooper et al].

⁴³ See generally Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (Oxford: Oxford University Press, 2015); L Eden, *Taxes, Transfer Pricing, and the Multinational Enterprise*, in AM Rugman & TL Brewer, eds, *The Oxford Handbook of International Business* (Oxford: Oxford University Press, 2001) at 591-619

⁴⁴ See generally Richard Murphy, *The Joy of Tax: How a Fair Tax System Can Create a Better Society* (London: Bantam Press, 2015); Avi-Yona, *supra* note 26.

⁴⁵ Tracy Kaye & Michael Mahoney, “Various Approaches to Sourcing Multijurisdictional Values: Sourcing Options Available to Tax Policy Makers” (2009) *State & Local Tax Lawyer: Symposium Edition* 57 at 61.

⁴⁶ Cooper et al, *supra* note 42.

of the *Transfer Pricing Regulations of Nigeria 2012*, provides that a connected taxable person may be exempted from the requirements of TP documentation where

- a) the controlled transactions are priced in accordance with the requirement of Nigerian statutory provisions; or
- b) the prices of connected transactions have been approved by other Government regulatory agencies or authorities established under Nigerian law and satisfactory to the Service to be at arm's length.⁴⁷

The implications of this provision are to provide reliance on statutory prices quoted in a market, and agreements reached by the taxpayer with other government agencies, such as the National Office for Technology Acquisition and Promotion (NOTAP), in the case of Nigeria.

Apart from promulgating safe harbor provisions, some jurisdictions have amended the existing transfer pricing methodologies to reflect economic realities or achieve expected outcomes. For instance, in Brazil, the CUP, RPM and CPM transfer pricing methodologies have been amended by introducing acceptable fixed margin and mark up ratios. In 2013, the Brazilian government further amended the transfer price methodologies to provide greater certainty to taxpayers. The new amendments cover sectors trading in pharmaceutical products, tobacco-related products (40% profit margin), chemical products, glass-related products, cellulose, paper or paper-related products and metallurgy (30% profit margin) and all other sectors (20% profit margin). For companies engaged in import and export of goods, predetermined gross profit mark-up may be used by the taxpayer (15% for exports and 20% for imports) in arriving at an acceptable price for the Brazilian tax authority.⁴⁸

These adjustments set out to reduce the need for extensive TP documentation and provide price or profit benchmarks upon which parties

⁴⁷ See Federal Inland Revenue Service, *Transfer Pricing Regulation in Nigeria: The Income Tax (Transfer Pricing) Regulations No. 1* (2012), online: <<http://bit.ly/2uCU5ZX>>.

⁴⁸ See generally Price Waterhouse Coopers, "International Transfer Pricing: Brazil", (2013-14), online: <<http://www.pwc.com/gx/en/international-transfer-pricing/assets/brazil.pdf>>; Thiago Medaglia, "Brazilian Transfer Pricing Rules" (2014) 16:91 *International Tax Rev* at 17, online: <<http://www.internationaltaxreview.com/Article/3354483/Brazilian-transfer-pricing-rules.html>>; Tatiana Falcao, "Brazilian Transfer Pricing- A Practical Approach, Could this be a Model for Developing Countries?" *Tax Justice Network* (website), online: <<https://www.taxjustice.net/cms/upload/pdf/Tatiana%20Falcao%201206%20Helsinki%20p pt.pdf>>.

may agree, thus eliminating the search for comparables and guarantees certainty in tax revenue to the tax jurisdiction.

At the global level, the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"), which were first issued in 1979 and most recently revised in July 2017, provide guidance for application of the arm's length principle. The guidelines detail a nine-step process for conducting an arm's length analysis, which includes conducting a comparability study using one of five comparability methods (three so-called traditional transactions methods and two transactional profit methods) to determine what an arm's length price would be. The steps culminate in a comparability adjustment, and a determination of an arm's length price.⁴⁹

Also, the OECD, in conjunction with G20 members⁵⁰ initiated the Base Erosion and Profit Shifting (BEPS) Project⁵¹ to address the risk of transfer price abuse. A key aspect of the BEPS Action Plan is the country-by-country reporting (CBCR). The OECD hopes that, with CBCR, tax administrations where a company operates will get aggregate information annually, starting with 2016 accounts, relating to the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the MNE group. It will also cover information on which entities do business in a particular jurisdiction and the business activities each entity engages in. It urges countries across the world to require all multi-national enterprises resident within their jurisdiction to file reports that detail how their global operations are structured. The project also incorporates rules that will oblige companies based in a non-compliant country to file the same

⁴⁹OECD Transfer Pricing Guidelines, *supra* note 9.

⁵⁰ The G20 members in their St. Petersburg Declaration (2013) called for changes to the international tax laws in order to ensure that profits are taxed where economic activities occur and value is created. The Declaration can be accessed through the G20 Research Group website: G20 Information Centre, *G20 Leader's Declaration*, September 6, 2013 Summit in St. Petersburg, Russia (University of Toronto G20 Research Group website, 2017), online: <<http://www.g20.utoronto.ca/2013/2013-0906-declaration.html>>.

⁵¹ This is particularly harmful to developing countries where tax revenue as a percentage of GDP is around half of that in OECD countries. Governments across the world rely on five primary sources of tax revenue: personal income taxes, corporate taxes, sales and excise taxes, property and wealth taxes, and payroll taxes.

information elsewhere. The expectation is that tax authorities will thereby find it easier to recognize and tackle transfer pricing abuses.⁵²

Other attempts at fixing the broken system by the OECD, include the Multilateral Competent Authority Agreement (MCAA) and the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum). The MCAA, a multilateral framework agreement, provides a standardized and efficient mechanism to facilitate the automatic exchange of information in accordance with the Standard for Automatic Exchange of Financial Information in Tax Matters (the Standard⁵³), thus avoiding the need for several bilateral agreements. This agreement enables joint audit and automatic exchange of information, thereby promoting transparency and accessibility of information. The Global Forum on the other hand, already entered into by 135 jurisdictions, utilizes robust peer review that ensures that standards are adhered to on transparency and information sharing. The OECD seeks to level the playing field for developing countries as these countries can now get relevant information from all other signatories to the agreements.⁵⁴

However, these remedies introduced by the OECD and other stakeholders have failed to address the biting tax evasion and avoidance practices of multinational companies. From a developing country perspective, they are deemed non-inclusive and fail to address some of the pressing tax issues faced by developing countries, such as tax incentives. The current international tax system appears to have created a monster. It birthed a global tax war, and has led to direct tax competition among developing countries.

⁵² For further discussion on the BEPS project, see Organization for Economic Cooperation and Development (OECD), *OECD Library* (website), online: <http://www.oecd-ilibrary.org/taxation/oecd-g20-base-erosion-and-profit-shifting-project_23132612>.

⁵³ Represents the international consensus on automatic exchange of financial account information for tax purposes on a reciprocal basis; see OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, (Paris: OECD Publishing, 2014), online: <<http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters-9789264216525-en.htm>>. See also Organization for Economic Cooperation and Development (OECD), “Automatic Exchange Portal > International Framework for the CRS”, online: <<http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/>>.

⁵⁴ See Organization for Economic Cooperation and Development (OECD), “OECD’s Global Forum on Transparency and Exchange of Information for Tax Purposes” (2017), online: <<http://www.oecd.org/tax/transparency/>>.

THE RISING CLAMOUR FOR AN ALTERNATIVE

At the center of global tax discourse is the question of ‘the right to tax’. While the Global North advocates taxation based on the residence of the MNE, developing countries would rather base their revenues on the “source income” as this allows them to obtain tax revenues from the local operations of foreign companies. The OECD BEPS project shies away from addressing the elephant in the room (the inherent right to tax). Any meaningful progress in addressing the failing system of international taxation will necessitate a return to the negotiation table, as was done under the auspices of the League of Nations, to consider viable alternatives to the present system. Overhauling the global tax system and its practices is fundamental if we are to deliver stronger growth for a post-crisis world. This next section considers the alternative of the unitary taxation and formulary apportionment methodology of income allocation. First, we start by addressing some of the criticisms of the UT-FA approach in the past, and whether such challenges are present today and are still relevant in today’s course. Secondly, we analyze the UT-FA approach on its merits.

DEBUNKING EXISTING MYTHS

Below, we highlight some of the arguments frequently canvassed against the election or transition to a UT-FA approach of income allocation.

Sovereignty

The primordial politico-economic territorial structure and division of the world is under threat. Technological advancement, the expansion of e-commerce, and the birth of the internet economy, coupled with the gradual erosion of the physical-presence business concept, necessitate that we re-think the bonds that tie us together and the international laws by which we play the game of peaceful and meaningful co-existence. International trade, investment, and finance have become the hallmarks of economic globalization.⁵⁵ As we inevitably transcend to a “stateless world” it becomes important that we negotiate the terms of the sovereignty states claim to inalienably possess.

⁵⁵ Gary Gereffi, “The Global Economy: Organization, Governance, and Development” in Neil J Smelser & Richard Swedberg, eds, *The Handbook of Economic Sociology* (New Jersey: Princeton University Press, 2005) 160 at 162-63.

The claim that a country's unlimited right to tax income derived from it, or accruing to it, might no longer be true (if not in theory at least in practice).⁵⁶ Physical markets are becoming obsolete, and virtual marketplaces (networks of computers and computer terminals), are emerging as the site for transactions.⁵⁷ Enforcement of the tax liability of a corporation by a state may not be achievable without the cooperation of other states, thus giving rise to a conflict of interest between the host state and the home state. Equally, the tax policies pursued by one state can impact the economies of other states—termed “fiscal externalities”.⁵⁸ A case in support of this point is the recent European Commission decision involving Apple and the Irish government. The European Commission ruled that Apple owed the Irish government €13 billion in tax non-remittance attributable to Ireland's state aid program.⁵⁹ The interesting perspective in this case is the potential threat to a country's claim of fiscal sovereignty, power to attract FDI and control its market, though one may argue that Ireland gave up this right and power by joining the EU. Thus, we are faced with a global issue: the balance of the fiscal sovereignty of states, and the need to have a fair allocation of income where taxes are paid in jurisdictions where they are actually realized.

Also, the world has moved from an aggregation of different national economies to reliant and interdependent economies with integrated factors of production which produce income for all.⁶⁰ Under the present global tax system, this integration and inter-dependence is not accounted for nor rewarded. Formulary apportionment allocates income to the states who contribute to income generation. The global consensus is that income should

⁵⁶ See Allison Christians, “Sovereignty, Taxation and Social Contract” (2009) 18:1 *Minn J Intl L* 99; Diane Ring, “What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State” (2008) 49:1 *Va J Intl L* 155; Geoffrey Brennan & James Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Indianapolis: Liberty Fund Inc., 2000).

⁵⁷ Andrew Snyder, “Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology” (1995) 48:4 *The Tax Lawyer* 1057.

⁵⁸ For example, the Luxleaks case and the state aid cases in the EU reveal the limitations of economic determinism and fiscal sovereignty as we know them.

⁵⁹ European Commission, Press Release, “State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth up to 13 Billion” (30 August 2016), online: <http://europa.eu/rapid/press-release_IP-16-2923_en.htm>.

⁶⁰ Intra-firm trade accounts for about 60 per cent of world trade. See Marie-Laure Djelic & Kerstin Sahlin-Anderson, *Introduction: A World of Governance: The Rise of Transnational Regulation* (2008) *Transnational Governance: Institutional Dynamics of Regulation* (Cambridge: Cambridge Univ. Press, 2006); Gereffi, *supra* note 55 at 160-82; Snyder, *supra* note 57 at 1057.

be taxed where the economic activities take place and where value is created.⁶¹ Furthermore, tax competition among countries only leads to a broken international tax system. This is favorable to MNEs who take advantage of the loopholes in the international tax system to shift profits to low (or zero) tax jurisdictions, and avoid paying their share of taxes in the jurisdictions where the real economic activities occur.⁶²

This implies that there is an urgent need to move beyond the narrow definition of sovereignty and the separate entity approach of MNEs to a pragmatic approach embracing the integrated and reliant nature of MNEs. In line with globalization and the current international nature of business, taxation must shift from national/domestic control to international control. Roger Wesley puts it thus:

As the world slowly emerges from its worst recession in thirty years, it has become painfully evident that no nation-state rich or strong is insulated from the actions of its neighbors. Ours is a global economy. "Recessions, inflation, trade relations, monetary stability, gluts and scarcities of products and materials...are international phenomena" affecting all national participants. The realities of economic life push toward global interdependence, discrediting in the process outgrown concepts of economic determinism.⁶³

Mintz argues that coordination of tax policies can ameliorate the impact of fiscal externalities and improve economic performance in coordinating countries, and that coordination facilitates the free flow of business inputs across national boundaries, minimizes fiscal externalities, and reduces the cost of compliance and administration.⁶⁴ I tend to agree.⁶⁵

⁶¹ Organisation for Economic Co-operation and Development, *Explanatory Statement*, G20 Base Erosion and Profit Shifting Project, (2014), online: <<https://www.oecd.org/ctp/beps-2014-deliverables-explanatory-statement.pdf>>.

⁶² Peter Dietsch in his book, "Catching Capital" argues for the regulation of tax competition and the creation of an International Tax Organisation to enforce tax competition among states. See Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (Oxford: Oxford University Press, 2015).

⁶³ Roger Wesley, "Problems in Regulating the Multinational Enterprise- An Overview" (1976) 10:4 *The Intl Lawyer* at 613-22.

⁶⁴ Jack M Mintz, "Globalisation of the Corporate Income Tax: The Role of Allocation" (1999) 56 *FinanzArchiv/Public Finance Analysis* 389.

⁶⁵ Important to note that the global impacts of recessions are attributable to the presence of MNEs abroad and the increase in FDI by firms.

Information Exchange and the Finance Sector

An offshoot of the exercise of the sovereignty of a state is the state's exercise of sovereign power to exchange information with other states as it wills as well as the unfettered control of its finance sector. The events of the last decade prove that these powers are constantly slipping from the state's grip. In 2010, the US enacted the Foreign Account Tax Compliance Act (FATCA), requiring financial institutions around the world to disclose to the IRS large accounts of US persons, or pay a 30% withholding tax on the institution's US earnings.⁶⁶ Countries, following FATCA, are setting up similar bank account disclosure systems with global reach. Central to the OECD's BEPS project is the access to information. The OECD, with the backing of the G-20 leaders, has initiated and successfully procured countries to sign MCAA for the automatic exchange of Country-by-Country reports (CbCR).⁶⁷ The OECD hopes that:

...with country-by-country reporting, tax administrations where a company operates will get aggregate information annually, starting with 2016 accounts, relating to the global allocation of income and taxes paid, together with other indicators of the location of economic activity within the MNE group. It will also cover information about which entities do business in a particular jurisdiction and the business activities each entity engages in. The information will be collected by the country of residence of the MNE group, and will then be exchanged through exchange of information supported by such agreements as signed today.⁶⁸

⁶⁶ For further information, see Internal Revenue Service (IRS), "Foreign Account Tax Compliance Act" (2016), online: <<https://www.irs.gov/businesses/corporations/foreign-account-tax-compliance-act-fatca>>; Internal Revenue Service (IRS), "Summary of FATCA Reporting for US Taxpayers", (7 November 2016), online: <<https://www.irs.gov/businesses/corporations/summary-of-fatca-reporting-for-u-s-taxpayers>>; US Department of the Treasury, "Resource Center" (8 January 2017), online: <<https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx>>.

⁶⁷ As of 22 June, 2017, 64 countries have signed the multilateral competence authority agreement (MCAA) on the exchange of country by country reports (CbC MCAA). List accessible at Organisation for Economic Co-operation and Development (OECD), "Signatories of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC MCAA) and Signing Dates" (22 June 2017) OECD, online: <<https://www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf>>. See also Organisation for Economic Co-operation and Development (OECD), "Country-by-Country Reporting" OECD (website), online: <<http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/country-by-country-reporting.htm>>.

⁶⁸ See Organisation for Economic and Co-operative Development (OECD), "A Boost to Transparency in International Tax Matters: 31 Countries sign Tax Co-Operation Agreement to Enable Automatic Sharing of Country by Country Information", (27 January 2016) OECD

Based on information gathered in 2016, it is expected by the OECD that the first exchanges will start in 2017-2018. Global expectation is that the Country-by-Country reports will result in the exchange of information between tax authorities relating to financial accounts in each jurisdiction operated by MNEs and residents of the other jurisdictions. Account information to be reported on includes account balances, interest, dividends, and sale and redemption proceeds from financial assets. The financial institutions here include deposit-taking banks, custodial institutions, investment entities and insurance companies. For developing countries struggling with tax evasion and illicit capital flight, the OECD's Country-by-Country report model is a viable tool for addressing tax evasion considering that these developing countries will be armed with relevant information in the fight against tax evasion and avoidance. The OECD, in conjunction with the Global Forum, is working to enhance the capacity of developing countries to exchange information with other jurisdictions so that they can take advantage of these tools. The reciprocal nature of the Country-by-Country reports facilitates this endeavor.

The EU has accepted the recommendations to introduce: country-by-country reporting of multinationals' activities; common consolidated tax base (CCTB); better protection of whistleblowers; extension of automatic exchange of information on tax rulings to all tax rulings and available to the public; countermeasures towards companies that make use of tax havens; changes to the EU state aid regime as it relates to tax through binding guidelines; etc.⁶⁹

The US FATCA, OECD's BEPS project and the MCAA and the Country-by-Country reports models, EU's CCCTB and general proposals, underscore the commitment of stakeholders to address the ills of tax evasion and tax avoidance, and the importance of information in the fight. To ensure the accessibility of information, bank and tax secrecy would necessarily have to give way. A country's power over this information will necessarily be lessened or redefined in today's globalized world.

(website), online: <<http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/a-boost-to-transparency-in-international-tax-matters-31-countries-sign-tax-co-operation-agreement.htm>>.

⁶⁹ For further information, see Taxation and Customs Union, "Common Consolidated Corporate Tax Base" (2017) *European Commission* (website), online: <https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en>.

Implementation Hurdles

Admittedly, moving from the SA-ALS approach to the UT-FA approach of income allocation presents massive implementation issues, justifying the present fears, skepticism and reluctance amongst stakeholders⁷⁰. One such hurdle is the accounting standard to be adopted. Conventional accounting standards are not suitable for tax purposes as taxable profit or chargeable income differs from accounting profits of a corporation. Secondly, the accounting world is split between choice of IFRS (used mostly in the EU), and the GAAP (the system used in the US). From an accounting perspective, these are two significant challenges that will hinder the development of a global tax system. How do we achieve convergence between accounting standards and tax standards, and how do we achieve convergence between the IFRS or the GAAP? Do we pick one over the other? How do we reconcile the fundamental differences between the US GAAP and IFRS? How do we define the tax base? Or is mutual recognition the passport to having agreeable tax accounting standards? Can one standard be deemed equivalent to the other?⁷¹ Or is compliance with one standard a sufficient substitute for the other? How do we ensure countries comply with any chosen standard?⁷² Will this be a multilateral or bilateral treaty agreement? Are there lessons to learn from the EU, with the adoption of the IAS/IFRS Regulation (EC) 1606/2002? Also, the verification of a group's financial accounts raises technical and administrative challenges which require time and effort to resolve.

Prem Sikka and Richard Murphy argue that the

relationship between tax and financial reporting is now remote, and that no jurisdiction we can identify relies upon unadjusted traditional accounting profit as a basis for the taxation of corporate income. [They] recognize the divergence between the bases on which expenses, revenue and profits are recognized in corporate financial statements and those allowed for tax purposes.”⁷³

They further opine that “since consolidated group accounting is now the normal arrangement for most multinational group entities, it might seem that their accounts prepared on this method could form the basis for tax assessment under a unitary taxation system.”⁷⁴ I agree, however, the tasks of

⁷⁰ See Avi-Yonah, *supra* note 24 at 26.

⁷¹ GAAPs of US, Japan, China, Canada, South Korea and India are found to be equivalent to International Financial Reporting Standards (IFRS) as adopted by the EU.

⁷² The Indian tax authority rejects the use of the IFRS system for tax purposes.

⁷³ Sikka & Murphy, *supra* note 24 at 3.

⁷⁴ *Ibid* at 9.

converting accounting profit to tax profit and verification of that conversion poses the daunting task. Sikka and Murphy further recommend starting with the worldwide consolidated financial accounts of the corporate group and adjusting them to the appropriate tax accounting standards, and providing a trail from financial accounts representing actual economic activity undertaken to tax accounts.⁷⁵

It must be said that cooperation among countries, including cooperation in achieving greater convergence between book and tax accounting in order to ease the problems in the translation of accounts, is a *sine qua non* to the adoption of the UT-FA approach.⁷⁶ Cooperation is also needed in the areas of enforcement and examination of tax standards.⁷⁷

Also, defining the tax base presents opportunities for tax avoidance. Siu et al. caution that “for any instrument assessed on a base that incorporates expenses (such as overheads, transportation or intra-firm services), or capital costs (such as depreciation, inventory cost or risk), the scope of aggregation will have a significant effect on determination of the taxable base.”⁷⁸ Canada uses a harmonized tax base where similar allocation formulae is used by all provinces; it is federally-defined although provinces are left to determine the tax rates and reliefs to levy and grant on the apportioned income. The proposed EU’s CCCTB approach provides for a high degree of tax base harmonization, including the definitions of profit, loss, revenue, expenses, deductible items and depreciation framework. Tax base under the EU’s CCCTB is defined as revenue less any exempt revenue, deductible expenses and other deductible items.⁷⁹

Language and currency impediments are surmountable in today’s 21st century world and have been addressed by different trade and international agreements and practices. The relative success of the OECD’s BEPS Project, and the political strength shown by the OECD in orchestrating the passage and ratification of the *Multilateral Convention to Implement Tax Treaty Related*

⁷⁵ *Ibid.*

⁷⁶ The EU’s proposed CCCTB offers a conceptual taxation framework, which can be improved upon for global or regional adoption.

⁷⁷ Durst, *supra* note 36.

⁷⁸ Erika Siu et al, “Unitary Taxation in the Extractive Industry Sector” (2015) International Center for Tax and Development Working Paper 35 at 14 [Siu et al, “Extractive Industry”].

⁷⁹ European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, (Strasbourg: European Commission, 2016), art 7, online:

<https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en> [CCCTB].

Measures to Prevent BEPS (MLI) by over 70 countries, makes the claim of transitional cost or difficulty fall on its face.

Determination of the Factors and the Formula

No literature has succeeded in proposing a formula that agreeably captures the location of economic activity; however, countries have experimented with different factors, formulae and combinations. Canada allocates corporate income through a formula of two factors: sales by destination and payroll.⁸⁰ The Massachusetts equally-weighted formula of three factors – property, payroll and sales – was the prevailing formula in the U.S. but has only been implemented by twelve US states.⁸¹ Alaska uses an extraction factor in addition to the factors of property and sales, in the oil, gas and pipeline sector when a corporation is involved in all three businesses and reverts to the two-factor approach of property and sales by destination. For mineral revenue dependent source states, an origin-based sales factor is believed to capture returns from extraction.⁸²

Payroll captures the wages and salaries paid to employees. The argument for a payroll factor is that it recognizes the source state as an integral aspect of income generation. It also offers administrative advantages. Arguments against payroll are the treatment of fringe benefits and payment to independent contractors. Should payroll be on the cost or turnover of employees or should it be on the number of employees? Apportionment by cost or turnover of employees may favour developed countries, given the high wage rates and per capita income, while apportionment by number of employees would have a strong redistributive effect, favoring developing countries. The EU CCCTB proposes an equally weighted turnover of employees and number of employees in the payroll factor.⁸³

⁸⁰ Jinyan Li, “Tax Sovereignty and International Tax Reform: The Author’s Response” (2004) 52:1 Can Tax J 141; Sol Picciotto, “ICTD summary Brief 3: International Corporate Taxation” *International Centre for Tax and Development* (website), online: <<http://www.ictd.ac/research/themes/international-tax>>.

⁸¹ The single-sales by destination formula is now being implemented in sixteen U.S. states. See generally Siu et al, “Unitary Taxation”, *supra* note 25.

⁸² *Ibid.*

⁸³ See generally Cobham, *supra* note 4; see also Sol Picciotto, “Towards Unitary Taxation of Transnational Corporations” (2012) Tax Justice Network, online: <https://www.taxjustice.net/cms/upload/pdf/Towards_Unitary_Taxation_1-1.pdf> [Picciotto, “Towards Unitary”].

In the proposed EU CCCTB the asset factor will consist of all fixed tangible assets. Intangibles and financial assets will be excluded from the formula due to their mobile nature and the risk of circumventing the system. In the US, the property factor considers only tangible property, and excludes intangible property. The value of property is based on historical cost rather than its actual value, with no adjustment for either depreciation or inflation. This use of historical cost provides a poor approximation of both the value of the asset and the user cost of capital. Ignoring intangible assets is one of the failings of the US formulary apportionment model. Recognizing it presents transfer pricing problems similar to those currently faced.

The proposed EU CCCTB addresses the sales factor by including the proceeds of sales and of any other transaction, net of value added tax and other taxes and duties collected on behalf of government agencies.⁸⁴ Sales factor in the US, in addition to capturing the sale of goods, also captures receipts from the provision of services, rentals, and royalties. Sale of tangible property is generally attributed to the state of destination, while intangible properties are commonly attributed to the state where income-producing activities are performed, or the state of the market for such services or intangibles (the destination). Some US states deploy a “throwback” provision. These provisions enable the ‘state of origin’ to tax sales made to the federal government, or sales made to a state who lacks jurisdiction to tax the vendor’s income. Canada applies a destination-based rule that attributes gross revenue to the permanent establishment where the customer is located. The average of the share of income deemed earned in each province is the average of the share of gross revenue attributed to the permanent establishment in the province, and salaries and wages paid in the year by the corporation to employees of the permanent establishment. Canada also applies the throwback rule.⁸⁵

Determining the appropriate formula and factors presents the biggest challenge to adopting the UT-FA approach. Avi-Yonah and Clausing propose a sales-based formula to be determined on the basis of the location of the customer rather than the location of production.⁸⁶ The apparent limitation of

⁸⁴ CCCTB, *supra* note 79, art 4.

⁸⁵ Stefan Mayer, *Formulary Apportionment for the Internal Market* 17 IBFD Doctoral Series, Vol. 17 (IBFD Academic Council, 2009) at 61, online: <<https://www.ibfd.org/IBFD-Products/Formulary-Apportionment-Internal-Market-Review>>.

⁸⁶ Kimberly Clausing & Reuven Avi-Yonah, “Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment” (2008) *The Brookings Institution* (website), online: <<https://www.brookings.edu/research/reforming-corporate-taxation-in-a>

a sales-based only formula is that it caters to the demand side of the market without providing for the supply side. This formula is inappropriate for a global adoption of the UT-FA approach to income allocation as many developing countries are suppliers, rather than purchasers, of goods and services. This exclusive formula deprives them of needed and earned revenue. Also, determining the destination of sales and what constitutes sales may prove difficult for tax authorities, and even more so with e-commerce and technological advancement. For example, is the transfer of software a sale or a license? Who is the customer for the purpose of tax jurisdiction? Do intermediaries exist?

Experts have proposed replacing the property factor with the equity and quasi-equity factor.⁸⁷ They claim that 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. As a commercial lawyer, it is my opinion that incorporating the financial market and the equity/quasi-equity factors in the current mix will exacerbate the current situation as both factors are easily open to manipulations. With bank secrecy still in place, it becomes easy to shift the origin of financing deals to tax havens and protective jurisdictions, notwithstanding that the real financing is in a different jurisdiction. Also, equity/quasi-equity capital may be routed through offshore tax havens as these countries provide ease of incorporation and bank secrecy.⁸⁸

Another consideration is whether to apply formulary apportionment to worldwide income or a “water’s edge” limitation. Walter Hellerstein writes that the unitary taxation of corporate income by some US states was the worldwide combination of “the consolidation of the activities of related entities deemed to be engaged in a unitary business, no matter where such activities occurred and no matter where the entities or their parents were

global-economy-a-proposal-to-adopt-formulary-apportionment/>; Jason Furman & Jason Bordoff, “Path to Prosperity: Hamilton Project Ideas on Income Security, Education and Tax” (Brookings Institution Press, 2008) at 319-44.

⁸⁷ Tamir Shanan, “Replacing the Transfer Pricing Regime with a Formulary Apportionment Approach in the International Settings” [unpublished], online: <<http://portal.idc.ac.il/he/lawreview/conferences/documents/2014-shanan.pdf>>.

⁸⁸ Mauritius, British Virgin Islands and the Netherlands are some jurisdictions I have come across in practice as a commercial lawyer used for round-tripping with protective measures.

resident.”⁸⁹ He further opines that states abandoned worldwide combination and retreated to a “water’s edge” definition of a combined (or consolidated) group limited to US domestic corporations. Certain tax haven corporations, and foreign corporations that exceed a threshold of business activity in the US.⁹⁰ Canada adopts a “water’s edge” limitation. The proposed EU CCCTB would apply only within the EU, using a strict water’s edge approach.

Developing suitable factors and formulae demands great political will and cooperation, since the factors and formulae determine the allocation of income to any state. Cobham and Loretz warn that “the specific apportionment formula chosen is likely to have substantial redistributive consequences- given that proposals for unitary taxation originate largely from the observation that profits are misaligned under the current system...”⁹¹ This is where the real work lies. Unlike a century ago, relevant research is ongoing to bridge this knowledge gap, and as such, a strong case for shifting to the UT-FA approach exists. The EU’s CCCTB, which addresses most of these issues, presents useful guidance for the rest of the world.

Unitary Taxation and Formulary Apportionment Approach on its Merit

In the assessment of the appropriate international tax policy, some criteria are widely accepted. These criteria are: inter-nation equity, inter-taxpayer equity, neutrality, simplicity, and administrative efficiency.⁹² It is on the basis of these criteria that we assess the suitability or otherwise of the UT-FA approach to income allocation.⁹³

Advocates for the adoption of the UT-FA approach believe that the incentive to shift income to low tax jurisdiction will disappear.⁹⁴ Sol Picciotto argues that:

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

⁸⁹ Walter Hellerstein & Charles McLure, “The European Commission’s Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States” (2004) 11:2 Intl Tax & Public Finance at 199-220.

⁹⁰ *Ibid.*

⁹¹ Cobham, *supra* note 4 at 7.

⁹² For a richer discussion on these criteria, see Jinyan Li, “Global Profit Split: An Evolutionary Approach to International Income Allocation” (2002) 50:3 Can Tax J 823.

⁹³ For a broader discussion, see Siu et al, “Unitary Taxation”, *supra* note 25.

⁹⁴ Picciotto, “Towards Unitary”, *supra* note 83.

havens, by complex anti-avoidance measures, such as rules against thin capitalization, controlled foreign corporations, and abuse of treaty benefits; and (iii) source and residence attribution rules.⁹⁵

Michael Durst opines that, “the adoption by a country of a formulary approach to income apportionment would appear to offer a more reliable means of curtailing base erosion, particularly over the long term, than attempting to apply a mixture of politically vulnerable, and often only partially effective, anti-avoidance measures.”⁹⁶ This does not necessarily mean the end of tax havens, however, and tax havens would have to be engaged in real economic activities to be allotted income.⁹⁷ Alex Cobham and Loretz,⁹⁸ argue that a shift to unitary taxation will shift the corporate tax base away from countries with ‘favorable’ tax regimes, for example, Luxembourg, the Netherlands and Ireland, to countries where real economic activities occur. This ensures inter-taxpayer equity, as companies are now forced to pay taxes where the economic activities occur, ending the shift of the tax burden to individual taxpayers.

The requirement for MNEs to prepare a combined report covering the whole of the corporate group engaged in a unitary business ensures administrative efficiency and simplicity of applying the tax system for tax authorities, given that the information becomes available to administer effectively. Consolidated or combined reporting is essential to an effective UT-FA approach.⁹⁹ Derek Devgun writes that, “under worldwide combine reporting, local taxable income is recalculated by multiplying the worldwide combined income of related or controlled parties (i.e. the unitary business) by a fraction based on the proportion of payroll, property and sales within the

⁹⁵ *Ibid* at 10.

⁹⁶ Durst, *supra* note 36.

⁹⁷ Kerrie Sadiq, “Unitary Taxation of the Finance Sector” (2014) International Centre for Tax and Development Working Paper 25. Sadiq further proposes that unitary taxation based on formulary apportionment be implemented in the financial sector and recommends an equally weighted two-factor formula of labour and sales, where labour reflects both remuneration and number of staff, and the formula should be applied to all the income of a multinational financial institution (MNFI) on a combined income basis. In his paper, he specifically argues that the nature of the business of MNFI, the integrated nature and inter-connectedness demands the UT-FA approach, as a contrary approach will be fertile ground for transfer pricing abuses.

⁹⁸ Cobham, *supra* note 4.

⁹⁹ Derek Devgun, “Worldwide Combined Reporting in the United States after Barclays” (1995) 58:2 Mod L Rev 248.

jurisdiction imposing the tax”.¹⁰⁰ The proposed EU CCCTB condemns the current system as “a cumbersome process, both timing-wise and economically, which diverts the effort out of the main thrust of doing business.”¹⁰¹ The EU equally seeks to reduce firms’ compliance cost, and to achieve simplicity and neutrality through harmonization of the tax base, a consolidated account and a pre-determined formula.¹⁰² Siu et al., in their study of the application of UT-FA in the extractive industry (EI), recommend a shift from the current system to the UT-FA approach.¹⁰³ They claim this would assist governments not only to improve general CIT design but also to develop better rent/profit-related levies. Also, the use of UT based on a common global corporate group tax base for TNCs in the EI sector could reduce administration and compliance costs associated with both CIT and rent/profit-related levies. They surmised that a UT approach, which requires country-by-country reporting on revenue, costs and tax payments, and the apportionment of global revenue based on that information, could assist in the development of better EI levy policies that are sensitive to the risks and costs incurred by private companies when extracting resources.¹⁰⁴

Inter-nation equity is achieved through global redistribution of income. This ensures that countries earn a fair share of return on their factors of production and do not suffer from base erosion and profit shifting that currently occur where profit declaration is disproportionate to real economic activities taking place in some jurisdictions, and willful tax competition aimed to attract return but do not necessarily result in substantial investment in their country. The LuxLeaks scandal provides a suitable example. Runkel and Schjelderup argue that the switch from Separate Accounting to Formulary Apportionment substantially increases average tax revenue and welfare of the

¹⁰⁰ *Ibid* at 250.

¹⁰¹ European Commission, Initiative “Re-launch of the Common Consolidated Corporate Tax Base (CCCTB)”, (October 2015) at 2, online: <http://ec.europa.eu/smart-regulation/roadmaps/docs/2016_taxud_006_ccctb_rm_en.pdf>.

¹⁰² See Wolfgang Eggert & Andreas Haufler, “Fiscal Policy in Action- Coordination cum Tax Rate Competition in the European Union” (2006) 62:4 *FinanzArchiv/Public Finance Analysis* 579. See also Thomas Eichner & Marco Runkel, “Why the European Union Should Adopt Formulary Apportionment with a Sales Factor” (2007) *Scandinavia J Economics* 110 at 567-89.

¹⁰³ One reason for this is that in addition to the usual CIT on business profits, governments seek to tax economic rent through levies, such as royalties. See Siu et al, “Extractive Industry”, *supra* note 78.

¹⁰⁴ *Ibid*.

member states.¹⁰⁵ It has been argued that a switch to the UT-FA approach would subject MNEs to a two-digit tax rate (in comparison with the single digit that multinational corporations are currently effectively taxed) and would allocate income among states more justly.

Avi-Yonah and Clausing propose a system of formulary apportionment for taxing the corporate income of multinational firms. They hold the same view that in an increasingly global world economy it is difficult to assign profits to individual countries, and attempts to do so create opportunities for tax avoidance.¹⁰⁶ Avi-Yonah and Clausing argue that under their proposed formulary apportionment system, firms would no longer have an artificial tax incentive to shift income to low-tax locations. The complexity and administrative burden of the current system would also be reduced, and the proposed system would be better suited to an integrated world economy and more compatible with the tax policy goals of efficiency, equity and simplicity.¹⁰⁷ They argue that the present US system provides an artificial tax incentive to earn income in low-tax jurisdictions, rewards aggressive tax planning, and is not compatible with any common metrics of efficiency.¹⁰⁸ I conclude that a shift to the UT-FA approach of income allocation would achieve inter-nation equity.

RECOMMENDATIONS AND CONCLUSION

Admittedly, the transition to the UT-FA approach has a high cost. The inhibitory factors are still present; however, the biggest hurdle is that of the political will on the part of supranational bodies like the OECD to accept its strength and relevance in today's global economy. Achieving global consensus on the factors and formula to be applied presents a daunting task.

While this is a subject that calls for more research and focus, I recommend a system that incorporates the sales factor, asset and payroll. The sales factor will be equally weighted between an origin-based sales factor and a destination-based sales factor, with provisions for throwbacks. The origin-based sales factor captures source states and the destination-based sales factor accommodates the market for the goods. Throwbacks should be extended to states that refuse to tax in spite of having jurisdiction, thus eliminating any

¹⁰⁵ Marco Runkel & Guttorm Schjelderup, "The Choice of Appointment Factors under Formula Apportionment" (2011) 52:3 Intl Economic Rev 913.

¹⁰⁶ Avi-Yonah, *supra* note 26

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

tax sparing provisions. I admit that special formulae may have to be created for specific industries and goods such as intangibles and e-commerce. Just as the EU, payroll should be equally weighted between number of employees and turnover of employees. Assets present a more daunting task and demand further reflection.

Seeking a one-size-fits-all UT-FA approach is impractical and will hinder any real actualization of the UT-FA approach of income allocation. Some industries, goods and services are distinct from others and must be accorded such distinct treatment. The valuation of intangibles such as intellectual property rights (IPRs) cannot be treated in the same way as tangible products such as shoes.

Finally, while there are many uncertainties in the design and implementation of the UT-FA approach, this paper argues that the setbacks and challenges, hitherto claimed, are being remedied and may not pose as great of a challenge as they did in the past. It further argues that given the failing system of income allocation that currently exists, a change to a viable alternative, as offered by the UT-FA approach, is worthwhile and appropriate in today's further globalizing and integrating economies.