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TOWARD A 21ST-CENTURY INTERNATIONAL TAX REGIME

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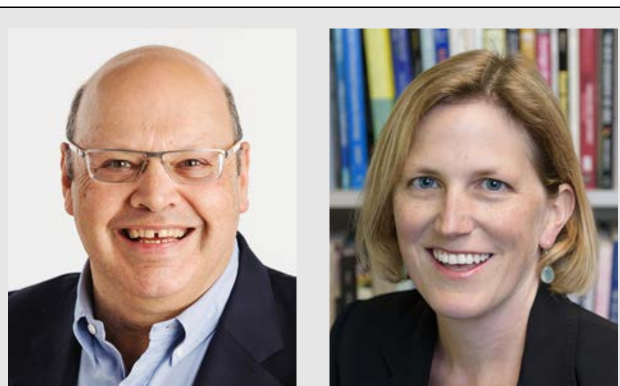

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In this article, the authors argue that the United States should consider adopting sales-based formulary apportionment and applying it to all large enterprises because it is more likely to lead to a stable outcome than recent OECD proposals and has important advantages relative to other proposals such as residual profit allocation by income or the destination-based cash flow tax.

Background

The international tax regime is almost a century old, and it is showing its age. In recent decades, the regime could be maintained despite increasing evidence that some of its key components, such as the arm's-length standard or permanent establishment threshold, were unfit for a 21st-century economy. However, starting with the U.K. diverted profits tax (2015), Australia's multinational anti-tax-avoidance law (2015), and India's equalization levy (2016), it has become clear that many countries are unwilling to live with a situation in which large U.S. technology companies (such as Amazon, Apple, Facebook, Google, and Netflix) earn billions in profits by exploiting their consumer base and paying little tax.[1] More recently, the digital services taxes adopted by Italy (2018) and France (2019) and proposed in the United Kingdom and the EU have threatened to undermine the entire system. The United States has threatened to impose retaliatory tariffs on France, and an escalating trade war could ensue.[2]

Profit shifting and corporate tax base erosion are large problems with serious revenue consequences for non-haven countries. Prior work suggests revenue losses for the U.S. government in excess of $100 billion per year by 2015, with costs for all non-haven countries likely exceeding $300 billion per year.[3] While researchers disagree on the magnitude of the problem, most analyses that rely on survey or tax data (which allow one to measure tax haven income, unlike financial reporting databases) find comparably large magnitudes of revenue loss because of profit

[1] Reuven S. Avi-Yonah, "Three Steps Forward, One Step Back? Reflections on 'Google Taxes' and the Destination-Based Corporate Tax," 2016(2) *Nordic Tax J.* 69 (2016).

[2] Ana Swanson, "U.S. Announces Inquiry of French Digital Tax That May End in Tariffs," *The New York Times*, July 10, 2019. Another option for the United States is to impose retaliatory taxes on French companies under IRC sections 891 and 896, as suggested by Itai Grinberg in "A Constructive U.S. Counter to EU State Aid Cases," *Tax Notes Int'l*, Jan. 11, 2016, p. 167.

[3] *See* Kimberly A. Clausing, "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond," 69(4) *Nat. Tax J.* 905 (Dec. 2016); and Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act," SSRN (Nov. 21, 2018).

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shifting.[4] At a time when government budgets are tight and income inequality has risen substantially, protecting the corporate tax base serves both revenue and fairness goals.[5]

The OECD's base erosion and profit-shifting project was supposed to respond to those challenges to the international tax regime, and action 1 was meant to address digital taxation. While the process certainly represented a step forward for international cooperation on those issues, the myriad suggested guidelines were far from an end to the problem of corporate tax base erosion. Moreover, the OECD was unable to reach a consensus on action 1, so the can was kicked down the road, with an interim report published in 2018 and a final report due in 2020 intended to provide a consensus-based long-term solution.

In February the OECD issued a public consultation document that includes two proposals for taxing the digital economy.[6] The first is a global anti-base-erosion minimum tax proposal that builds on the U.S. global intangible low-taxed income regime and base erosion and antiabuse tax. The idea is to implement the single-tax principle by imposing residence-based taxation when the source tax is too low and imposing source-based taxation when the residence tax is too low.[7] That is a relatively simple extension of existing principles, but it begs the question of how much profit should be allocated to the source jurisdiction: A GILTI-type, residence-based minimum tax works well only if there is a consensus on profit allocation, because it envisages granting foreign tax credits for source-country taxes on profits properly allocable to the source country. Similarly, a BEAT-type minimum tax that extends to all deductible payments (including cost of goods sold) requires agreement by the residence jurisdiction to prevent double taxation.[8]

The OECD recognized that, and so laid out three alternative options for profit allocation in the context of digitalization. All three eliminate the physical presence requirement for having a PE but take different approaches to determining how much profits should be subject to tax in the source (or market) jurisdiction.

The narrowest option is the user participation proposal, which applies only to companies like Facebook, Google, and Amazon and lets the market jurisdiction tax profits attributable to user participation. It would apply only to U.S. tech giants, fueling U.S. government wariness. The United States countered with a broader option, the marketing intangible proposal, which would allocate residuals arising under the traditional, arm's-length-based profit-split method to the market jurisdiction. It would apply to all companies, and builds on the U.S. government experience in *Glaxo*, in which the EU company paid $3.4 billion in tax to the U.S. government, based on marketing intangibles allocated to the United States.[9]

Those two proposals, while radical in abandoning the traditional PE concept, still build on the arm's-length standard because they allocate residuals to the market (or user) jurisdiction only after routine profits have been allocated using the arm's-length standard.

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[4] *See* OECD, "Measuring and Monitoring BEPS, Action 11 — 2015 Final Report" (2015); Gabriel Zucman, *The Hidden Wealth of Nations* (2015); Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018," JCX-97-14 (Aug. 5, 2014); Fatih Guvenen et al., "Offshore Profit Shifting and Domestic Productivity Measurement," National Bureau of Economic Research Working Paper No. 23324 (Apr. 2017); and Thomas R. Tørsløv, Ludvig S. Wier, and Gabriel Zucman, "The Missing Profits of Nations," NBER Working Paper No. 24701 (June 2018).

[5] Beyond that, a strong corporate tax is an important part of an efficient tax system, and it helps protect the tax base against other forms of erosion. For more on the arguments in defense of the corporate tax, see Clausing, "Strengthening the Indispensable U.S. Corporate Tax," Equitable Growth (Sept. 12, 2016).

[6] OECD, "Addressing the Tax Challenges of the Digitalisation of the Economy" (2019). *See also* OECD, "Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising From the Digitalisation of the Economy" (May 2019).

[7] On the single-tax principle, see Avi-Yonah, "International Taxation of Electronic Commerce," 52 *Tax L. Rev.* 507 (1997); Avi-Yonah, "Who Invented the Single Tax Principle? An Essay on the History of U.S. Treaty Policy," 59 *N.Y.L. Sch. L. Rev.* 305 (2015); and Gianluca Mazzoni, "Complete Distributive Rules and the Single Tax Principle: A Review of Recent Italian Case Law," 73 *Bull. Int'l Tax'n* (Feb. 20, 2019).

[8] That problem is why the BEAT as enacted does not include the House proposal to include cost of goods sold in the payments subject to the BEAT, even though doing so leaves a gaping hole.

[9] *Glaxo* involved an asserted deficiency of $30 billion as a result of the IRS's contention that more profit from Zantac, a drug developed in the United Kingdom and sold in the United States, should be allocated to marketing intangibles. The case was settled in 2006 for $3.4 billion in tax, but the United Kingdom refused to accept the shift of $10 billion in profit to the United States. Thus, Glaxo was double taxed. *See* Avi-Yonah and Mazzoni, "The Apple State Aid Decision: The Wrong Way to Enforce the Benefits Principle?" *Tax Notes Int'l*, Nov. 28, 2016, p. 837.

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Similarly, the residual profit allocation by income (RPA-I) proposal builds on the arm's-length standard in allocating routine profits but allocates residual (non-routine) profits to the destination jurisdiction.[10] While RPA-I is an extension of a 2009 proposal,[11] it retains the arm's-length standard to determine routine profits (whereas the 2009 proposal assumes a rate of returns on costs) and allocates residual profits based on a measure of those profits that considers both sales and the allocable expenses attributed to those sales, as well as a routine profit. The RPA-I proposal is more limited than an earlier proposal, the destination-based cash flow tax (DBCFT),[12] which was included in the 2016 House GOP blueprint for tax reform but was not included in the Tax Cuts and Jobs Act (P.L. 115-97).

The third option in the OECD consultation is more extreme, because it not only abandons the PE for a significant economic presence threshold (similar to the proposed EU directive)[13] but also explicitly abandons the arm's-length standard in favor of what it calls a "fractional apportionment method," which is based on the formulary approach recently adopted by India.[14] That is a remarkable turnaround by the OECD, which has traditionally resisted any attempt to replace the arm's-length standard with a formulary method.[15] However, the fractional apportionment option is a latecomer and seems unlikely to be favored over the two more traditional and better-developed options.[16]

In what follows, we will first address the OECD proposals in Section I. In Section II, we discuss other proposals that have been discussed in more academic proposals but not enacted as legislation (RPA-I and DBCFT). Finally, we revisit our 2007 sales-based formulary apportionment proposal in Section III.[17]

I. The Two Main OECD Proposals

The user participation proposal in the OECD program is an attempt by the EU to impose income tax on those U.S. tech giants (Amazon, Facebook, and Google) that derive revenue primarily from advertising.[18] The proposal has been criticized as intellectually vague and difficult to administer.[19] While those kinds of arguments can be made against digital services taxes, it has been convincingly argued that a user network adds value.[20] The ability of Amazon, Facebook, and Google to sell user data to advertisers is the key to their business model.

The problem with user participation, however, is that it is limited to Amazon, Facebook, and Google; even Apple and Netflix are not affected because their main source of revenue is not advertising (nor is Spotify's, the EU's big tech contender). The United States has responded with the marketing intangibles proposal, which would apply to all corporations. But it has been convincingly argued that the proposal does nothing to resolve the transfer pricing mess because it is impossible to separate marketing from other intangibles, and any attempt to do so

[10] *See* Michael P. Devereux et al., "Residual Profit Allocation by Income," Working Paper 19/01 of the International Tax Group and the Max Planck Institute for Tax Law and Public Finance No. 2019-04 (Mar. 2019).

[11] Avi-Yonah, Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," 9 *Fla. Tax Rev.* 497 (2009).

[12] Alan J. Auerbach et al., "Destination-Based Cash Flow Taxation," Oxford University Centre for Business Taxation Working Paper 17/01 (Jan. 2017).

[13] European Parliament, "Corporate Taxation of a Significant Digital Presence," Briefing (2018).

[14] OECD, *supra* note 6, at 16. *See also* Indian Department of Revenue, Central Board of Direct Taxes, "Public Consultation on the Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment," F. No. 500/33/2017-FTD.I (Apr. 18, 2019). On the Indian proposal, see Avi-Yonah and Ajitesh Kir, "India's New Profit Attribution Proposal and the Arm's-Length Standard," *Tax Notes Int'l*, June 17, 2019, p. 1183.

[15] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017" (July 10, 2017).

[16] *See* OECD, *supra* note 6, at 9:

> To date, the discussion has focused primarily on two of these proposals, the user participation proposal and the marketing intangible proposal, where a number of commonalities emerged. A detailed discussion of the concept of significant economic presence is also taking place, but this concept was revisited more recently.

[17] Clausing and Avi-Yonah, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," The Brookings Institution Discussion Paper 2007-08 (June 2007).

[18] This section addresses the two more traditional OECD proposals, user participation and marketing intangibles. Fractional apportionment and the Indian proposal are covered in Section III.

[19] Itai Grinberg, "User Participation in Value Creation," *Brit. Tax Rev.* 407 (2018).

[20] Wei Cui, "The Digital Services Tax: A Conceptual Defense" (Apr. 22, 2019).

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risks double taxation, as happened in the leading marketing intangibles case, *Glaxo*.[21]

Thus, neither of the lead OECD proposals is likely to bring about a stable international tax regime fit for 21st-century conditions. They both are an attempt to adopt minimal tweaks — but radical surgery is needed.

II. The RPA-I and DBCFT Proposals

RPA-I is an adaptation of a 2009 proposal. It improves on the earlier proposal in detail, addressing several issues not fully considered, such as interest allocation and losses. Yet, it still suffers from a major drawback: It uses the arm's-length standard to tax routine profits. Relying on that standard makes the proposal more palatable and familiar to practitioners but means that it also retains some of the standard's flaws. Moreover, while the 2009 proposal simply adopts a standard numerical value for routine profits, RPA-I seeks to segregate the routine from the extraordinary by keeping the arm's-length standard in place and relying on an analysis of comparables to calculate routine profits, which creates substantial complexity and administrative costs.

The RPA-I proposal allocates residual profits based on a measure of those profits that considers both sales and the allocable expenses attributed to those sales, as well as a routine profit, whereas the 2009 proposal allocated residual profits based on destination of sales. Often the two outcomes will be similar, but the allocation based on residual income is more suited to situations in which profit-to-cost ratios would naturally vary substantially by country. Still, that choice introduces substantial complexity.

The RPA-I reform is clearly a hybrid, using aspects of both the arm's-length standard and formulary approaches. It is a compromise between systems, and it is also a compromise in terms of which jurisdictions get the revenue from taxation; source countries tax the routine profits, and destination countries tax the residual profits.

In comparison with India's full-fledged adoption of formulary apportionment, RPA-I stops short of fundamental reform. The proposal's drafters acknowledge that it is also a large step back from the more fundamental reform of the DBCFT, primarily because the events of 2016-2017 indicated that a DBCFT is hard to enact because of opposition from importers.

In addition to the politics, there are serious problems with the DBCFT (which have been explored at length elsewhere[22]). The main difference between a DBCFT and sales-based formulary apportionment is that under a DBCFT, a border tax is needed because the full value of goods and services is taxed by not allowing any deduction for imports. As recognized by proponents and observers, the DBCFT is equivalent to a VAT with a deduction for wages, and as previously argued, that kind of tax is incompatible with the WTO rules, in addition to its other flaws.[23]

The WTO incompatibility risks further pressure on the world trading system at a time when those kinds of pressures are substantial. The DBCFT is incompatible with U.S. treaty obligations. Further, unless U.S. trading partners adopt their own DBCFT, U.S. adoption will harm them, increasing their profit-shifting problems.

Absent smooth exchange-rate adjustment, the DBCFT also risks creating large sector-specific shocks. While economists are quite capable of showing in models why the exchange rate fully adjusts, experience with countries adopting VATs challenges that easy consensus. There are four developed countries that have adopted VATs during the floating exchange-rate era, and in all cases, the exchange rate did not adjust as smoothly as predicted; in some cases, the movement of the exchange rate was the wrong sign.[24] And, even if the exchange rate does change as expected, that comes with larger risks to the global economy.

Further, because of the wage deduction, there will be difficult issues with tax refunds that are not present with VATs. Indeed, many exporters would be expected to report losses, and absent

[21] David L. Forst, "One World, Two Transfer Pricing Laws: What's to Be Done?" *Tax Notes*, Apr. 22, 2019, p. 551.

[22] *See* Avi-Yonah and Clausing, "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint," 8 *Colum. J. Tax L.* 229 (2017).

[23] *Id.*

[24] Of course, there are many reasons why exchange rates move, but that is part of the point. Indeed, models of exchange rates are quite poor at predicting their future value. *See* Kenneth Rogoff, "Perspectives on Exchange Rate Variability," *Int'l Capital Flows* 441 (1999), as summarized in Avi-Yonah and Clausing, *supra* note 22.

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full loss rebates, there would be a strong incentive for inefficient mergers. There are also important questions regarding how financial companies and transactions would be handled, how U.S. state corporate tax systems would be affected, and how the transition to the new tax system would be addressed.[25]

The inability of the GOP majority and White House to enact a DBCFT in 2017 bears out some of those concerns and indicates that the tax is not a viable unilateral reform option for the United States. The opposition from importers like Walmart and Target doomed the DBCFT, despite the reassurances of some economists that exchange-rate adjustments would offset any tax liability on imports.

III. Sales-Based Formulary Apportionment

Sales-based formulary apportionment is an improvement over the proposals in sections II and III, and it should be seriously considered by the United States for adoption. Multilateral adoption is ideal, but there is also a strong case for unilateral adoption, after due attention to transition and implementation issues.[26]

On April 18 the Indian Central Board of Direct Taxes released a public consultation document on amending India's rules for profit attribution to PEs.[27] This is the first time a national government has officially proposed abandoning the arm's-length standard, the governing standard for dividing business profits among taxing jurisdictions since the 1930s, and replacing it with a system that bears close resemblance to the historic rival of the arm's-length standard, formulary apportionment.[28]

Unlike the other well-known proposal for replacing the arm's-length standard, the European Commission's common consolidated corporate tax base proposal,[29] the Indian proposal has a good chance of becoming law after the recent Indian national election. The OECD has reflected the Indian proposal in the third option in its public consultation document on the digital economy.

Like the Indian proposal, the third OECD option is extreme because it not only abandons the PE for a significant economic presence threshold (similar to the proposed EU directive)[30] but also abandons the arm's-length standard in favor of what it calls a fractional apportionment method. That is a remarkable step by the OECD, which has traditionally resisted any attempt to replace the arm's-length standard with a formulary method, even rejecting formulas for allocating residuals (which by definition arise only in the absence of comparables) at the beginning of the BEPS process in 2013.[31] The OECD is here envisaging taking the global profit rate of a multinational enterprise and applying it to revenue from a jurisdiction to determine the potential tax base, and then apportioning that tax base by using the traditional three-factor formula (used by U.S. states and the CCCTB). It then adds a users factor, because Facebook, for example, might not have any direct sales (as opposed to revenue from showing ads), assets, or employees in a given jurisdiction. There is no mention of using the traditional arm's-length standard when possible or allocating residuals based only on user participation or marketing intangibles, as in the other two proposals.

As stated above, although India is going ahead, the OECD seems unlikely to embrace its proposal and more likely to adopt some combination of user participation and marketing intangibles (the EU and U.S. proposals) instead. But the Indian proposal is important because it shows that formulary apportionment can be implemented unilaterally.

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[25] For further discussion, see Avi-Yonah and Clausing, *supra* note 22.

[26] This discussion updates and summarizes our 2007 proposal, which discusses many of these points in more detail. *See* Clausing and Avi-Yonah, *supra* note 17.

[27] F. No. 500/33/2017-FTD.I, *supra* note 14.

[28] On the history of that debate see, e.g., Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," 15 *Va. Tax Rev.* 89 (1995); Avi-Yonah, Clausing, and Durst, *supra* note 11; Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation," 2 *World Tax J.* 3 (2010); Avi-Yonah and Ilan Benshalom, "Formulary Apportionment: Myths and Prospects — Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative," 3 *World Tax J.* 371 (2011); and Sol Picciotto, "Taxing Multinational Enterprises as Unitary Firms," International Centre for Tax and Development Working Paper 53 (June 2016).

[29] *See* European Commission, "Common Consolidated Corporate Tax Base (CCCTB)" (2016).

[30] *See* European Parliament, *supra* note 13.

[31] *See* OECD transfer pricing guidelines, *supra* note 15.

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For the United States, sales-based formulary apportionment has many advantages. First, it is well suited to its complex, global, technologically sophisticated economy. In contrast to the arm's-length standard, which presumes that companies earn the same amount of profit when they are integrated as they would at arm's length, sales-based formulary apportionment acknowledges that multinationals earn additional profits, which might not be easily sourced (even in the abstract) to particular countries, because of the benefits of their global production processes.

While it has long been recognized that both the supply and demand side of the market create value, demand is far easier to measure than supply. The source of supply-side value is increasingly ambiguous; value is not just created by machinery and labor. Intangible assets and the value of user data (in the digital economy) also create value.

A crucial argument for sales-based formulary apportionment is that it reduces tax competition pressures. Because profit shifting is shut down, and customers are relatively immobile, companies have limited ability to adjust their operations to reduce their tax obligations, which preserves governments' abilities to levy their desired tax rates without fear of base erosion.

In contrast, under the arm's-length standard, ambiguities about the proper source of income create many opportunities for tax avoidance, and companies are more than happy to arrange their finances so that income is booked in the most lightly taxed jurisdiction, often going so far as to create income that is completely stateless (and thus free of tax). Of the foreign income reported in the U.S. Treasury's 2016 country-by-country database, 22 percent is classified as stateless, and an additional 37 percent is classified in known havens with very low tax rates.[32]

Because of that massive profit shifting, the U.S. government is losing substantial corporate tax revenues, a problem far larger than it was when the 2007 proposal was drafted. Before the TCJA, estimates indicated revenue loss in excess of $100 billion a year.[33] While the TCJA reduced profit-shifting incentives in some respects, it increased them in others, and analyses by the Joint Committee on Taxation indicate that the revenue effects of the international provisions of the legislation were approximately neutral.[34] Ignoring the one-time repatriation revenue (which represents a tax cut relative to prior law), the international provisions actually lose $14 billion in revenue over the 10-year estimate window. Still, because the new corporate tax rate is lower, that will mechanically lower the revenue costs of profit shifting (because the foregone profit would now be taxed at a lower rate).

Also, as has been recounted elsewhere,[35] the arm's-length standard generates extraordinary complexity, and while there would of course be transition and implementation issues with a formulary system, on net the vast complexity of the current system would be substantially diminished. As one indication of the complexity of addressing BEPS in the context of the arm's-length standard, the first round of the OECD BEPS process generated nearly 2,000 pages in guidelines. Moreover, the slew of international provisions in the TCJA (including GILTI, BEAT, and foreign-derived intangible income) hardly simplifies matters.

Of course, there are also arguments against sales-based formulary apportionment. Some simply stem from confusion. For example, while profits are allocated to tax bases based on the destination of sales, the incidence of the tax is very much the same as the incidence of a profits tax, not a VAT. Indeed, companies without profits would pay no tax, and the normal return to capital could be exempted from tax (or taxed more

[32]The income totals appear to miss some income that shows up in other Treasury data sources, perhaps as a result of incomplete coverage of the country-by-country company sample in 2016. This only includes a subset of havens: Bahamas, Bermuda, Caymans, Ireland, Netherlands, Puerto Rico, and Singapore.

[33]*See* Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act" (Jan. 29, 2019).

[34]Territorial treatment of foreign income increases the incentive to shift profit abroad because of the absence of tax on repatriation. The minimum taxes (BEAT and GILTI) and the lower statutory rate should reduce profit-shifting incentives. According to the JCT, the net impact of all international provisions is (very slightly) negative, setting to one side the one-time repatriation tax on past earnings; see "Estimated Budget Effects of the Conference Agreement for H.R.1, The 'Tax Cuts And Jobs Act,'" JCX-67-17 (Dec. 18, 2017).

[35]*See* Clausing and Avi-Yonah, *supra* note 17.

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lightly) by including expensing (or partial expensing).[36]

Some argue that sales-based formulary apportionment would tilt revenues too much away from developing countries toward countries with rich markets. However, it is important to note that less developed countries have even larger revenue losses (as a share of GDP) from corporate tax avoidance and profit shifting than developed ones and thus stand to especially gain from proposals that stem profit shifting, especially those that are easy to administer.[37]

The data on U.S. MNEs illustrate that phenomenon nicely. In 2015 the share of foreign direct investment earnings of U.S. affiliates that are in major, less developed countries is 8.5 percent after tax and 12 percent before tax.[38] Those shares are far lower than the share of real activities in those countries; the less developed countries host 22 percent of sales, 48 percent of employment, and 22 percent of employee compensation.[39]

Also, studies that simulate the effects of sales-based formulary apportionment systems sometimes neglect to consider that MNE sales data are likely distorted by tax avoidance, and a clean administration of sales-based formulary apportionment could be expected to more accurately tax the true destination of sales. Of course, countries with substantial natural resource rents (for example, because of extractive industries) should likely retain source taxation for those streams of income.

Another key argument against rapid adoption of sales-based formulary apportionment is that it is too radical because it completely abandons not just PEs but also the arm's-length standard. Of course, India is about to do precisely that, and we can learn from its experience.

One problem with the Indian proposal (as well as the CCCTB) is the formula, which is an adaptation of the traditional U.S. state formula of assets, payroll, and sales. As shown in the 2007 proposal, including assets and payroll can lead to job losses for the United States because MNEs might move assets and payroll to lower-tax jurisdictions.[40] That argues in favor of sales-based formulary apportionment.

However, comprehensive evidence from U.S. states indicates that formula factors are not particularly sensitive to taxes.[41] Indeed, that evidence fits with literature in public finance that shows that real factors (such as employment, tangible assets, and customers) are far less sensitive to taxation than financial factors (such as income).[42] Still, the U.S. state experience might be insufficient to dispel fears of factor mobility in response to taxation, especially because typical state tax rates are far lower than typical central government tax rates. That said, tax competition is also expected to be fiercer at the state level because there are fewer economic frictions between states (for example, borders, trade barriers, and language differences) than between countries.

A multifactor formula might balance the political concern that market locations benefit more from sales-based formulary apportionment than production locations. Those kinds of concerns might lie behind the compromise proposal of RPA-I because routine revenues are given to source locations, whereas residual revenues are given to market locations. However, RPA-I also retains the complexity of the arm's-length standard, so an alternative approach would be to use a multifactor formula. A possible compromise formula would weight both the

[36] The normal returns on debt-financed investments are typically already exempt from taxation even without expensing, if interest costs are deductible.

[37] *See* IMF, "Corporate Taxation in the Global Economy," IMF Policy Paper (Mar. 2019). *See also* Ernesto Crivelli, Ruud de Mooij, and Michael Keen, "Base Erosion, Profit Shifting and Developing Countries," 72 *FinanzArchiv: Pub. Fin. Analysis* 268 (2016).

[38] Data are from the U.S. Bureau of Economic Analysis surveys of U.S. multinationals using revised 2015 data. The major developing countries used for the purpose of this calculation are: Argentina, Brazil, Chile, China, Colombia, Costa Rica, the Dominican Republic, Ecuador, Egypt, Guatemala, Honduras, India, Indonesia, Malaysia, Mexico, Nigeria, Peru, the Philippines, South Africa, Thailand, Turkey, and Venezuela.

[39] *Id.* The developing country share of assets is only 9 percent, likely reflecting the tax sensitivity of assets, and their share of gross income is also 9 percent.

[40] *See* Clausing and Avi-Yonah, *supra* note 17.

[41] *See* Clausing, "The U.S. State Experience Under Formulary Apportionment: Are There Lessons for International Reform?" 69 *Nat'l Tax J.* 353. That is in contrast to studies that rely on simulations, which often simply assume that factors are tax responsive, rather than relying on the actual experience with formulary apportionment.

[42] *See* Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," 35 *J. Econ. Lit.* 589 (June 1997); and Emmanuel Saez, Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review," 50 *J. Econ. Lit.* 3 (Mar. 2012).

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market and production jurisdictions at 50 percent, using a combination of payroll and employee headcount to capture the production side.[43]

Still, absent international agreement on the ideal formula, one concern with multifactor formulas is that they may prove harder to harmonize across countries. The U.S. experience suggests that states have a strong incentive to increase the weight on the sales factors, often in response to lobbying by companies with local production.[44] And, of course, if different countries adopt different formulas, that can create double taxation or double nontaxation.

While it would be ideal to adopt formulary apportionment multilaterally, the United States should strongly consider unilateral adoption, because multilateral adoption is likely infeasible. Unilateral action provides incentives for other countries to adopt, leading to a stable 21st-century international tax regime. As argued in 2007, unilateral adoption pressures other countries to adopt because otherwise their MNEs will move operations (and shift profits) to the United States.[45] That will not change an MNE's tax obligations in the United States (because it does not change its U.S. sales) or in third countries (because there is no PE), but it will reduce its tax payments in its home country. Without foreign adoption, U.S.-based MNEs that sell abroad will have a tax advantage over foreign MNEs. At the same time, all MNEs that access the U.S. market will pay U.S. tax.

Another critique of sales-based formulary apportionment is the need to get other countries to agree to the formula to prevent double taxation, but the experience with VAT has shown that a treaty is not needed for every country to adopt the destination basis unilaterally. Double taxation or double nontaxation might still occur, but it will diminish if other countries follow suit.

The argument that sales-based formulary apportionment cannot be implemented unilaterally because the necessary information is unavailable will be undermined by the Indian proposal. The experience with the VAT also shows that it is possible to establish the destination of services and intangible goods. Tangible goods, of course, are inherently less problematic.

A final common critique of sales-based formulary apportionment by DBCFT proponents is that unlike a DBCFT, it is possible to game apportionment by selling through thin margin distributors in low-tax jurisdictions. But as noted, that problem can be solved by looking through the thin margin distributor.[46] Moreover, it is unlikely that companies such as Apple would give up control over the distribution of their products.

As a way of indicating how sales-based formulary apportionment might work, the appendix to this article provides draft legislative language for sales-based formulary apportionment. The key elements are:

(a) Sales-based formulary apportionment applies to all enterprises (incorporated or not) with sales (or licenses) of goods or services into the United States that exceed a threshold (for example, $1 million, adjusted for inflation). The threshold is needed to exclude (foreign or domestic) small business from the business tax and to replace the PE threshold, which is obsolete.[47]

(b) Sales-based formulary apportionment is based on common control, without attempting to define unitary enterprises.[48]

[43] That is a compromise to production jurisdictions that would account for both labor intensity (with headcount) and high-income employees (with payroll). Assets are omitted because of the greater mobility of capital (than labor), and thus greater tax sensitivity, as well as the greater difficulty of measuring the value of assets, which opens opportunities for tax avoidance.

[44] While states have been eager to increase the weight on the sales factor, there is little evidence that those decisions ultimately affect the location of jobs or assets across U.S. states. *See* Clausing, *supra* note 40.

[45] *See* Clausing and Avi-Yonah, *supra* note 17.

[46] *See* Avi-Yonah, Clausing, and Durst, *supra* note 11; see also the legislative language in Avi-Yonah, "Destination Based Corporate Tax: An Alternative Approach," University of Michigan Law & Economics Research Paper No. 16-028 (Dec. 12, 2016).

[47] Because enterprises with gross receipts below $1 million are exempt from tax, the IRS will need to enforce the personal holding company and accumulated earnings tax rules to prevent high-income individuals from sheltering their income in those exempt enterprises. Alternatively, passthrough treatment for small enterprises could be required.

[48] That simplifying feature could cause high-profit-margin enterprises to acquire low-profit-margin ones to benefit from their sales into lower-tax jurisdictions, but if the tax rate is too low, the sales do not count. It is possible to ignore those kinds of tax-motivated acquisitions under IRC section 269 or a revised version of section 382.

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(c) Sales-based formulary apportionment defines destination based on the proposed CCCTB, which builds on the EU experience with VAT. Sales of goods are treated as made into the United States if the dispatch or transport of the goods to the person acquiring them ends in the United States, supplies of services are treated as made into the United States if the services are physically carried out in or actually supplied into the United States, and licensing of intangibles are treated as made into the United States if the royalty income resulting from that licensing is sourced to the United States under U.S.-sourcing rules in IRC 861(a)(4).[49]

(d) The thin margin distributor problem is addressed by using the language in the base company rule of section 954 that defines sales outside the country of incorporation and putting the burden of proof on the seller:

Goods, services, or intangibles that are sold or licensed to an unrelated person will be presumed for purposes of this section to have been sold or licensed for use, consumption, or disposition in the country of destination of the property sold or services provided; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property or services or license of intangibles to an unrelated person the enterprise knew, or should have known from the facts and circumstances surrounding the transaction, that the property probably would not be used, consumed, or disposed of in the country of destination, the enterprise must determine the country of ultimate use, consumption, or disposition of the property or the property will be presumed to have been used, consumed, or disposed of in the United States.

Further, to prevent manipulation, the throwout rule used by many states should be copied, so that receipts from low-tax jurisdictions (jurisdiction with an effective income tax rate of less than half the U.S. rate) are not included in the apportionment formula.

IV. Conclusion

It is clear that the international tax regime needs to be updated. Corporate tax base erosion through profit shifting remains a serious problem, costing non-haven governments substantial revenue. The OECD has conceded that the PE threshold must be abandoned and is showing signs that even the sacrosanct arm's-length standard is not immune to revision. One key question is how to best achieve a stable outcome.

Current OECD and other efforts are flawed. The user participation proposal is too limited and the marketing intangibles proposal, as well as the routine component of the RPA-I, are too dependent on the flawed arm's-length standard. The DBCFT has worthy aspects, but it also has problems.

Sales-based formulary apportionment has many of the advantages of RPA-I and DBCFT, but with fewer downsides. If it were unilaterally adopted by the United States, many other countries would have strong incentives to adopt to protect their corporate tax base. Like the VAT, sales-based formulary apportionment can be adopted unilaterally worldwide without the adoption of a multilateral treaty, a feat proven elusive over the past century since it was first envisaged by the League of Nations.

[49] Alternatively, the destination of sales and services could be determined based on the proposed FDII regulations, applied to both imports (subject to tax under sales-based formulary apportionment) and exports (not subject to tax under apportionment). Section 250(b)(4)(A) provides that foreign-derived deduction-eligible income (FDDEI) includes income from property the taxpayer sells to any person who is not a U.S. person, and which the taxpayer establishes to the satisfaction of the secretary is for a foreign use. Accordingly, the proposed regulations define an FDDEI sale as a sale of property to a foreign person for a foreign use. They state that a recipient is treated as a foreign person only if the seller obtains documentation of the recipient's foreign status and does not know or have reason to know that the recipient is not a foreign person. They also provide several types of permissible documentation for that purpose, such as a written statement by the recipient indicating that the recipient is a foreign person. The proposed regs provide that a sale of property (whether general or intangible property) is treated as for a foreign use only if the seller obtains documentation that the property is for a foreign use and does not know or have reason to know, as of the FDII filing date, that it is not for a foreign use (or, for intangible property, that the portion of the sale of the property for which the seller establishes foreign use is not for a foreign use). The proposed regs state that a sale of intangible property is for a foreign use if the revenue is earned from exploiting the property outside the United States, the documentation requirements are satisfied, and the seller does not know or have reason to know that the portion of the sale of the intangible property for which the seller establishes foreign use is not for a foreign use.

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Appendix: Legislative Language for Sales-Based Formulary Apportionment

H. R. ____________

AN ACT

To amend the Internal Revenue Code of 1986, and for other purposes.

1. Short title; table of contents

(a) Short title

This Act may be cited as the American Competitiveness Act of 20XX.

(b) Table of contents

The table of contents for this Act is as follows: [TBA]

2. Tax imposed.

Section 11 of 26 USC is amended as follows:

11(a) ENTERPRISES IN GENERAL

A tax is hereby imposed for each taxable year on the taxable income of every enterprise apportioned to the United States.

(b) AMOUNT OF TAX

The amount of the tax imposed by subsection (a) shall be [xx percent].

(c) Definitions

For purposes of this section,

(1) the term "enterprise" shall mean any business whose taxable income apportioned to the United States under this section exceeds the threshold amount;

(2) The term "threshold amount" shall mean $1,000,000, increased with respect to taxable years beginning in any calendar year by the cost of living adjustment for such calendar year. For purposes of paragraph (c)(2), the cost of living adjustment for any calendar year is the percentage (if any) by which —

(A) the consumer price index for the preceding calendar year, exceeds *(B)* the CPI for the calendar year 2017.

For purposes of this paragraph, the CPI for any calendar year is the average of the CPI as of the close of the 12-month period ending on August 31 of such calendar year. The term "consumer price index" means the last CPI for all urban consumers published by the Department of Labor.

(3) The term "business" shall mean any person (as defined in section 7701) who sells goods, provides services, or licenses intangibles into the United States.

The term "taxable income" shall mean the total taxable income (as defined in section 63) of an enterprise from whatever source derived.

(4) The term "apportioned to the United States" shall mean the total taxable income of each enterprise multiplied by a fraction whose numerator is receipts from unrelated customers in the United States and whose denominator is total receipts from unrelated customers. See section 11C for determination of the location of receipts.

(5) The term "receipts" shall include sale of goods, provision of services, or license of intangibles.

3. Enterprises subject to tax.

Section 11A of 26 USC is added to read as follows:

(a) For purposes of section 11, the term "enterprise" shall include every entity treated as a corporation under Treas. Reg. 301.7701-1 and its affiliated group. An affiliated group will be defined as in section 1504, except that —

(1) The percentage in section 1504(a)(2) shall be 50 percent, and (2) section 1504(b)(3) shall be disregarded.

(b) In the case of any entity not treated as a corporation under Treas. Reg. 301.7701-1, the term "enterprise" shall include any two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests.

4. Interaction with treaties.

Section 11B of 26 USC is added to read as follows:

(a) Section 11 shall apply regardless of any treaty of the United States.

(b) Subject to paragraph (c), in the case of any country with whom the United States has an income tax treaty, section 11 shall apply as of the first taxable year beginning on or after five years after the enactment of this Act.

(c) Notwithstanding paragraph (b), section 11 shall take effect immediately in the case of any country that the secretary determines has failed to provide information required to carry out the purposes of this Act.

(d) The secretary is hereby authorized to suspend the operation of section 11 for a period of up to five years from the date of enactment of this

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Act for enterprises organized in any country that is not a member of the OECD.

5. Location of receipts.

Section 11C of 26 USC is added to read as follows:

(a) For purposes of calculating taxable income apportioned to the United States under section 11, receipts shall mean the proceeds of all sales of goods and supplies of services and licensing of intangibles after discounts and returns, excluding taxes and duties. Interest, dividends, and proceeds from the disposal of fixed assets shall not be treated as receipts, unless they are revenues earned in the ordinary course of trade or business. Sales of goods and supplies of services and licensing of intangibles within an enterprise (as defined in section 11) shall not be regarded as receipts.

(b) Destination of receipts

1. Sales of goods shall be treated as made into the United States if the dispatch or transport of the goods to the person acquiring them ends in the United States.

2. Supplies of services shall be treated as made into the United States if the services are physically carried out in or actually supplied into the United States.

3. Licensing of intangibles shall be treated as made into the United States if the royalty income resulting from such licensing is sourced to the United States under section 861(a)(4).

6. Antiavoidance rules.

Section 11D of 26 USC is added to read as follows:

(a) For purposes of section 11, goods, services or intangibles which are sold or licensed to an unrelated person will be presumed for purposes of this section to have been sold or licensed for use, consumption, or disposition in the country of destination of the property sold or services or intangibles provided; for such purpose, the occurrence in a country of a temporary interruption in shipment of goods shall not constitute such country the country of destination. However, if at the time of a sale of personal property or services or license of intangibles to an unrelated person the enterprise knew, or should have known from the facts and circumstances surrounding the transaction, that the property, services or intangibles probably would not be used, consumed, or disposed of in the country of destination, the enterprise must determine the country of ultimate use, consumption, or disposition of the property, services or intangibles or the property, services or intangibles will be presumed to have been used, consumed, or disposed of in the United States.

(b) For purposes of section 11, receipts shall not include any receipts derived from the sale of goods, provision of services or licensing of intangibles to unrelated parties in a foreign jurisdiction unless the taxpayer establishes to the satisfaction of the secretary that such receipts are subject to an effective rate of income tax imposed by that foreign jurisdiction greater than 50 percent of the maximum rate of tax specified in section 11.

7. Simplification.

The following sections of 26 USC are hereby repealed: sections 59A, 245A, 250, 863, 864, 871(b), 881(b), 901, 903, 904, 905, 951, 951A, 952, 953, 954, 955, 956, 957, 958, 959, 960.

8. Effective date.

This Act shall be effective as of January 1, 20XX. ■

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