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Slicing the Shadow: A Proposal for Updating U.S. International Taxation

By Reuven S. Avi-Yonah

In 2012 *Tax Notes* will celebrate the 40th anniversary of its inaugural issue, published on September 18, 1972. In recognition of that milestone and to show its appreciation for your continued readership, *Tax Notes* will be republishing select archived articles from each of the past 40 years. *Tax Notes* hopes that readers will enjoy these valuable contributions from prominent members of the tax community on issues that were and are of central importance to the field. Readers are invited to submit their own recommendations for our retrospective to taxnotes@tax.org, along with a short explanation for why the article has been recommended.

This article was originally published on March 15, 1993. Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law at the University of Michigan Law School.

In the article Avi-Yonah proposed that the United States tax multinational corporations using a formulary apportionment system based solely on income derived from sales. The background for the article was drawn principally from Robert Reich's *The Work of Nations* (1991), and the analysis was inspired by Stanley I. Langbein's work on transfer pricing, especially his seminal article ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625; see also Louis Kauder, ''Intercompany Pricing and Section 482: A Proposal to Shift From Uncontrolled Comparables to Formulary Apportionment Now,'' *Tax Notes*, Jan. 25, 1993, p. 485.

The current U.S. international tax rules are largely a product of the 1950s, with the last major changes enacted in 1962. These rules reflect a world in which the American economy accounted for over 40 percent of the world's GDP and U.S. multinational corporations dominated world trade. The United States was the world's largest creditor, its balance of trade was overwhelmingly favorable, and no other country could come close. Germany and Japan were devastated by war, and Japanese products were so suspect that Japan allegedly named an island ''Sweden'' so that it could place on its products the label ''made in Sweden.''

The major U.S. multinationals were clearly American corporations. They imported raw materials, but the vast majority of their manufacturing activity was performed in the United States by well-paid production workers. Profits were achieved by churning out high volumes of quality goods that were sold all over the world bearing unmistakably American trademarks. What was good for G.M. was good for America: American CEOs were seen, and to a degree behaved, as corporate statesmen responsible for balancing the interests of their shareholders, employees, and consumers.

Against this background, U.S. international tax policy was based on a compromise between two principles: capital export neutrality and capital import neutrality. Capital export neutrality meant that American multinationals should not be given an incentive to invest abroad rather than at home, or vice versa. Therefore, U.S. multinationals had to be subject to tax on their worldwide income, unlike the policy adopted by some other countries (whose multinationals were far less dominant worldwide) of exempting foreign-source income in an effort to bolster the competitiveness of their multinationals. Foreign corporations, on the other hand, were taxed only on income that was effectively connected with a U.S. trade or business or otherwise derived from U.S. sources (IRC section 11(d)).

However, capital import neutrality meant that U.S. corporations should not be subject to more onerous taxation on their foreign-source income than their foreign competitors. If all income earned abroad were taxed currently under capital export neutrality principles, U.S. multinationals would be subject to both U.S. and foreign taxes while the competition, based in a country that exempted foreign-source income, was subject only to local taxation. Therefore, at the urging of the multinationals, American corporations were generally allowed to defer U.S. taxation until their foreign earnings were repatriated.

The remaining basic principles of the U.S. international tax scheme, in all its stupendous complexity, can largely be derived from these basic principles and policies. Because American corporations are taxed on their worldwide income, in order to avoid multiple taxation of the same income it is necessary to give them a credit for foreign taxes. But since the United States is unwilling to subsidize foreign governments by crediting taxes that are higher than our own, the credit has to be limited to the U.S. tax rate, based on a formula that gives credit only to foreign-source income times the U.S. tax rate (section 904). That, in turn, requires a determination of what income is from sources within and without the United States, and also requires an elaborate ''basket'' system to prevent taxpayers from manipulating their foreign income to lower their overall foreign tax rate to the creditable U.S. rate (section 904(d)).

Because foreign corporations are taxed only on their U.S.-source income, once again it is necessary

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to determine the source of income (sections 861-865). Moreover, foreign corporations include corporations that are controlled by U.S. persons, and it is considered too gross a violation of capital export neutrality to permit such controlled foreign corporations (CFCs) to avoid current taxation on income that would be taxed currently to a branch of a U.S. corporation. Hence the "subpart F" rules, which deny such deferral to some, but not all, foreign-source income earned by CFCs (sections 951-964). Capital import neutrality, however, is implemented in allowing deferral for other types of income earned by CFCs.

The world has changed dramatically in the last 30 years, and particularly in the last decade. The American economy now accounts for less than a quarter of the world's GDP, and U.S. multinational corporations have to compete with larger foreign multinationals, a competition in which many of them are losing ground. The gross sales of the biggest 350 multinationals amount to a third of world GDP, more than the United States and more than the entire Third World combined. The United States is the world's largest debtor, its balance of trade is negative, and foreign investment in the United States exceeds U.S. investment abroad. The chairman of a major American manufacturer complains that American consumers prefer cars that bear a Japanese trademark to identical cars that bear an American name.

The major U.S. multinationals are fast losing their "American" character. While the majority of their financing may still come from the United States, their executives and employees are hired from a worldwide pool and their manufacturing operations are spread all over the globe, wherever labor costs are cheapest. The most successful "American" multinationals no longer depend for profit on high volume but rather on the high value added by their key employees, frequently in collaboration with strategic partners from all over the globe. More and more, "foreign" manufacturers are employing Americans in larger numbers than "U.S." corporations, making it close to impossible to tell whether a product was "made in the U.S.A." A Nissan Sentra has more American-made parts than a Pontiac LeMans.

These developments highlight the problematic assumptions that underlie the current U.S. international tax system. These assumptions are (a) that it is possible in most cases to determine the geographic source of an item of income, (b) that in the case of a multinational corporation, it is possible to allocate the income to each constituent unit of the multinational based on a separate accounting of such unit's profit or loss and by treating transactions among units as if they were at arm's length, and (c) that the place of incorporation of the parent corporation of a multinational is of fundamental significance in distinguishing between U.S. and foreign taxpayers. These assumptions are unrealistic because in an increasingly globalized economy, there is no single source of income and separate accounting for each unit of a multinational is impossible. A multinational corporation, no matter where its headquarters are located, derives its income from its entire worldwide operations, and the income cannot be either traced to a particular geographic source or divided up by separate accounting among the various subsidiaries making up the multinational. An attempt to do so is, as Justice Brennan said in the *Container* case, like "slicing a shadow."

Moreover, in a globalizing economy, the identity of multinationals as "domestic" or "foreign" based on their place of incorporation is becoming increasingly irrelevant. Multinationals recruit their executives and employees from a worldwide pool and locate their economic activities on the basis of economic, not national, considerations. As Robert Reich puts it, in the global economy, it is becoming ever harder to determine "who is us."

Both capital export neutrality and capital import neutrality, as presently implemented, are based on these unrealistic assumptions. Capital export neutrality assumes that it can be determined if income is foreign or domestic source, so as to be neutral between the sources. Capital import neutrality assumes that it can be determined that two taxpayers derive income from the same source, so as to be neutral between the taxpayers. Moreover, both theories place a strong emphasis on the presumed identity of the taxpayer as U.S. or foreign. Worldwide taxation of income applies only to U.S. corporations, although the theory of capital export neutrality would require worldwide taxation of all corporations; otherwise, "foreign" corporations are encouraged to invest outside the United States. Capital import neutrality is based on the distinction between U.S. and foreign taxpayers and the need to preserve the competitiveness of U.S. multinationals against their foreign counterparts.

What is an appropriate system for taxing such multinationals in a world in which neither the source of income nor the national identity of the multinational can be determined? As many observers (including, e.g., Ronald Pearlman) have argued, it is the system that is used by the states: formulary apportionment of the entire worldwide income of the multinational to the various taxing jurisdictions. The states generally use a three-factor formula of property, payroll, and sales. The first two

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factors represent the manufacturing capacity (capital and labor) that produces the income, and the third represents the market from which the income is derived.

In the international context, however, the three-factor formula used by the states is flawed, because basing the tax on either payroll or assets creates disincentives to corporate activities that the tax law generally should encourage, i.e., hiring and investment. The starting point in choosing a formula for allocating a multinational's income among jurisdictions cannot be ability to pay (since the ability that is determinative is that of the entire multinational, not that of its unit in any jurisdiction), but rather the benefits that the multinational derives from each jurisdiction. As regards employment, a corporation that employs workers pays for their services whatever they are worth on a consensual exchange basis, so that, arguably, it gets as much as it gives. However, the corporation is also, at the same time, giving the worker valuable experience, and it cannot get full value for this benefit on a consensual exchange basis because it usually cannot bind the worker to her job, and she will take the experience and training with her when she leaves. Therefore, the training constitutes a ''positive externality'' that confers a benefit on society in excess of what the corporation receives in return. Thus, it is advisable to base the formula on where services are rendered by the corporation (and it is the recipient of the positive externality), i.e., the sales factor, and not on where they are rendered to the corporation.

With respect to the assets factor, the question is more complicated. On a pure benefits analysis, since the exchange of money for assets confers equal benefits on buyer and seller, it may make sense to have a formula that is based equally on assets and sales (as suggested by Stanley Langbein and others). However, there are at least three reasons to exclude assets from the formula.

First, if assets are included in the formula, multinational corporations would have a tax incentive to invest in assets in jurisdictions where the tax rate is lower. Such an incentive would violate capital export neutrality principles and the traditional rule that taxation should be a neutral factor in economic investment decisions, leading to inefficient allocations of global investments.

Second, the exclusion of assets is congruent with the present emphasis on consumption over income taxation for corporations, to induce them to invest more in productive assets than is presently the case. If the tax law should encourage corporations to invest their retained earnings in productive assets rather than distribute them or spend them on corporate-level consumption, then it should not tax corporations more heavily depending on how much they invest in assets in the taxing jurisdiction.

Finally, the inclusion of assets leads to increased complexity and potential for abuse. Assets are easily shifted between jurisdictions, so that corporations will have the ability to reduce their taxes without real economic cost by moving assets within the multinational. This situation is particularly severe in the case of valuable intangibles, such as patents or trade secrets. Assets also pose severe valuation problems, because a valuation based on original book or tax cost may be obsolete and a current market valuation of all assets is expensive and hard to administer. Moreover, the rate of return on many assets can vary dramatically from one jurisdiction to another, so that including assets in the formula and assuming an equal rate of return would open it to the criticism that it distorts economic reality.

Therefore, the formula that I propose would allocate taxable business income based *solely on sales*. A market state has a right to tax the income derived from exploiting its market, and the modern theory of multinationals recognizes that multinationals mostly exist because of advantages derived from controlling sales directly (as opposed to selling through an unrelated distributor), such as the ability to control the quality of the product, prevent trademark debasement, and avoid costless appropriation of information.

The proposed system would thus tax all affiliated corporations, whether incorporated in the United States or elsewhere, in the same manner; it would take their worldwide income and multiply it by U.S. sales over worldwide sales to produce the income taxable in the United States. Note that the formula applies to all affiliated corporations, on the theory that common control is sufficient to establish that each part of the overall business effectively supports the other (at least in terms of its credit rating). This avoids the cumbersome debate, which has been waged on the state level, about what constitutes a ''unitary business.'' Note also that the formula does not distinguish between corporations that happen to be incorporated in the United States and corporations that happen to be incorporated elsewhere. As stated above, such formalistic distinctions have little meaning in a globalized economy. Finally, note that this is not a sales tax or a VAT; the multinational is taxed on its overall income, which is only allocated among jurisdictions on the basis of sales. A multinational that is in a true loss position worldwide would have no tax liability.

This system would create an advantage for multinationals that manufacture in the United States and export abroad over multinationals that manufacture

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abroad and import to the United States, thus providing an incentive to multinationals to do the former rather than the latter (see appendix). It would also preserve forms of both capital export neutrality and capital import neutrality; an investment in the United States would not be advantaged or disadvantaged compared to an investment abroad, and all multinationals that sell in the United States or outside it would be taxed on an equal basis, whether they are considered to be ''U.S.'' or ''foreign.''

The proposed system also would lead to considerable simplification compared with the current U.S. international tax rules. First, there would be no need for sourcing income within and without the United States, since all worldwide income would be apportioned under the formula. Second, the foreign tax credit would be abolished, because the United States would tax only the portion of worldwide income that is properly apportioned to it and should not have to give credit for foreign taxes on income that it does not tax. Third, subpart F of the code could be abolished because there would be no deferral; the United States would tax currently only that proportion of worldwide income that is properly apportionable to it. Since the United States would have already taxed all the income it had a right to tax, subsequent dividends (as well as interest or royalties) paid within the corporate group should be ignored and not be regarded as income. In addition, the branch profits tax (section 884) could be abolished (there would be no distinction between a branch and a subsidiary), and international transfer pricing disputes under section 482 would become irrelevant (because all sales within a multinational would be ignored).

There would, of course, be some complications under the proposed system. First, sales would have to be determined on a destination principle, similar to that currently used for ''foreign sales corporations'' (sections 921-927), to prevent taxpayers from manipulating the exemption based on ''foreign'' sales that are truly domestic. In principle, all sales of intermediate goods whose ultimate consumers (when incorporated into finished goods) are domestic should subject the seller to U.S. tax jurisdiction. For example, a sale of raw materials that will be incorporated into goods sold to consumers in the United States should subject the seller to U.S. tax by including those sales in the formula as U.S. sales, even if the seller is unrelated to the ultimate seller in the United States. In practice, because of administrability concerns, only direct and indirect sales of finished goods into the U.S. market would be counted, until a worldwide system of monitoring and coordination can be set up.

Second, the definition of ''control'' is important; to prevent multinationals from avoiding taxation by shifting income to formally unrelated intermediaries, the definition should be broad and flexible (like the current rule under section 482) and not mechanical and formalistic. Such a broad definition can more easily be adopted on a multilateral basis.

There are several major objections that can be raised against the proposal. Some of them relate to the administrative burden that formulary apportionment would impose on multinationals, which would have to compile worldwide sales data using U.S. GAAP and the U.S. dollar. These objections seem to be exaggerated. Presumably, multinationals today already have some idea of what their worldwide profit and loss accounts look like on a uniform basis. Their objections to producing such records for the IRS are more likely to stem from a desire to avoid taxation than from bona fide concerns about costs, and current law gives the IRS the means to require foreign multinationals to produce the necessary information (sections 6038-6038C).

A more serious objection relates to the fact that separate accounting (*i.e.*, the arm's length standard) is the current international norm, so that the unilateral adoption of sales-based formulary apportionment by the United States will violate its treaty obligations and (arguably) the GATT, and will lead to retaliation, double taxation, and the distortion of investment decisions and resulting loss of efficiency.

However, this objection also seems exaggerated. First, in practice, most tax administrators use formulas even now, in the absence of true arm's length prices, which cannot, in most cases, be established because of the absence of comparable transactions between unrelated parties.

Second, it would seem to be possible to reach a multilateral agreement similar to the Multistate Tax Compact or the GATT. After all, the arm's length standard did not become the international norm until the 1970s, with a lot of pressure from the United States. A formula that emphasizes sales (or ''source'' taxation) would seem to favor most countries other than those with closed markets, especially less developed countries that are disadvantaged by the current residence-based rules, and a move to such a formula would thus be relatively easy for most countries because it would entail shifting the tax burden away from exporters and onto importers (see appendix). It is no accident that all European countries adopted a destination-based VAT before any formal harmonization of VAT began in Europe; a tax system that exempts exports and is imposed on imports is generally popular, even without prodding from above.

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Third, the formulary apportionment alternative can be phased in gradually, e.g., initially by the OECD, in which most multinationals are based and whose members have increasingly similar tax systems. If the formula is adopted worldwide, it will by definition not distort investment decisions (although differences in the tax base and effective marginal tax rate will still influence investment decisions), and can even encourage open markets and free trade (see appendix).

In order to make such an agreement possible, the United States should take the lead in proposing a shift from the current system, toward a worldwide formulary apportionment system for multinationals on the basis of sales. While immediate, unilateral action by the United States is not advisable because it would violate treaty obligations, the United States can and should give notice that it regards a shift to sales-based formulary apportionment within a limited time as necessary to safeguard its legitimate tax interests *vis-à-vis* multinational corporations, and invite other countries to join it in moving to such a system.

Appendix: Effects of Single-Factor Sales Formula

A. U.S./U.K. Model

Currently, both the United States and the United Kingdom tax on the basis of both manufacturing and sales activity. Let us assume that such a tax is roughly equivalent to a tax apportioned on the basis of a three-factor property, payroll, and sales formula. USCo is a U.S. corporation with property and payroll in the United States and sales half in the United States and half in the United Kingdom. UKCo is a British corporation with property and payroll in the United Kingdom, and sales half in the United Kingdom and half in the United States. If USCo and UKCo both have taxable income of $1 million and the effective tax rate is 35 percent, then the taxes to each jurisdiction would be as follows (ignoring any foreign tax credits):

1.1	U.S.	U.K.	Total
USCo	291,667	58,333	350,000
UKCo	58,333	291,667	350,000
Total	350,000	350,000	

If the United States unilaterally adopted a sales-only formula, the taxes would be:

1.2	U.S.	U.K.	Total
USCo	175,000	58,333	233,333
UKCo	175,000	291,667	466,667
Total	350,000	350,000	

The U.S. revenue would not be affected, but USCo's taxes would go down and UKCo's taxes would go up. This would provide an incentive for the United Kingdom to also adopt the sales-only formula, resulting in the following taxes:

1.3	U.S.	U.K.	Total
USCo	175,000	175,000	350,000
UKCo	175,000	175,000	350,000
Total	350,000	350,000	

The resulting taxes would therefore be the same as under the current system, except that the United States would tax UKCo more heavily and the United Kingdom would tax USCo more heavily than at present.

B. U.S./Japan Model

Assume the same facts, except that the foreign corporation is JapCo, a Japanese corporation with property and payroll in Japan and all of its sales in the United States, while USCo's sales are half in the United States and half in Japan. If both the United States and Japan use the three-factor formula, the taxes would be as follows:

2.1	U.S.	Japan	Total
USCo	291,667	58,333	350,000
JapCo	116,667	233,333	350,000
Total	408,334	291,666	

If the United States unilaterally adopts the single-factor sales formula, the results would be:

2.2	U.S.	Japan	Total
USCo	175,000	58,333	233,333
JapCo	350,000	233,333	583,333
Total	525,000	291,666	

The result is a rise in U.S. revenue and a decline in USCo's taxes, with a rise in JapCo's taxes resulting from the double taxation imposed by Japan. If Japan responded by moving to the single-factor sales formula, the results would be:

2.3	U.S.	Japan	Total
USCo	175,000	175,000	350,000
JapCo	350,000	0	350,000
Total	525,000	175,000	

This alleviates the burden on JapCo and raises the taxes on USCo back to the right level, but at the cost of reduced revenue to Japan. Therefore, Japan should either open its markets more to USCo (so that all of its sales are in Japan) or persuade JapCo to sell more domestically.

This result applies even more forcefully if JapCo sells all its products in the United States and USCo

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also sells all its products in the United States. In that case the results under a three-factor formula are:

2.4	U.S.	Japan	Total
USCo	350,000	0	350,000
JapCo	116,667	233,333	350,000
Total	466,667	233,333	

If the United States moves to a single-factor sales formula, the result is a revenue gain for the United States:

2.5	U.S.	Japan	Total
USCo	350,000	0	350,000
JapCo	350,000	233,333	583,333
Total	700,000	233,333	

If Japan also moved to a single-factor sales formula:

2.6	U.S.	Japan	Total
USCo	350,000	0	350,000
JapCo	350,000	0	350,000
Total	700,000	0	

In this case, Japan could only regain its revenue by opening its market or by persuading JapCo to sell domestically.

Overall, thus, the single-factor sales formula provides an incentive for countries with open markets (the United States and the United Kingdom in the example) to adopt it, because it maintains the same revenue while shifting the burden from exporters to importers. For countries with closed markets (Japan in the example) that cannot retaliate by adopting the same formula, it provides an incentive to open their markets and to persuade domestic manufacturers to sell more at home.

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