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Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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Reuven S. Avi-Yonah*

Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation

In the last 30 years, a debate has been raging in international tax circles between advocates of the OECD Transfer Pricing Guidelines and the arm's length standard (ALS) they embody, on the one hand, and advocates of formulary apportionment (FA) on the other. After the adoption of the 1995 regulations and the new OECD Guidelines, the debate became quieter for a while, because everyone was waiting to see whether the issue had been resolved. However, while there have been few decided cases, it is clear by now that the transfer pricing problem is as bad as it ever was. That is why my co-authors Kimberly Clausing and Michael Durst and I have recently re-proposed adopting FA. However, it is unlikely we will persuade advocates of the ALS and in particular the OECD that FA is the way forward (although this may change if the Obama administration were to press the issue, or if the European Union adopts CCCTB). Thus, I would like to propose a compromise: Use FA in the context of the ALS. Specifically, I would suggest using FA to allocate the residual profit in the profit split method. This article is devoted to (a) explaining the drawbacks of ALS as currently applied, (b) developing the above proposal, and (c) concluding with a plea for further discussion by both sides of the FA/ALS debate.

1. A Historical Introduction

In the last 30 years, a debate has been raging in international tax circles between advocates of the OECD Transfer Pricing Guidelines and the arm's length standard (ALS) they embody, on the one hand, and advocates of formulary apportionment (FA) on the other.[1] This issue can be traced as far back as the 1930s, when the ALS was originally conceived of and introduced into the first model treaties.[2] However, before the 1960s there was not much transfer pricing enforcement and the ALS was rather indeterminate in the absence of concrete transfer pricing methods. FA, in the meantime, was applied by the US states but was not seriously considered as a method of resolving transfer pricing at the international level.

In 1962 the US House of Representatives passed a bill that would for the first time have applied FA to address transfer pricing at the federal level. This was in the context of increasing transfer pricing concerns evidenced by the *Dupont* case (which began in the 1950s, even though it was not decided until 1979) and the enactment of Subpart F, which at least in part responded to such concerns. However, Stanley Surrey, the new Assistant Secretary for Tax Policy and a great believer in the ALS, thought he had a better approach, and the ultimate legislation merely authorized the Treasury to write regulations under IRC 482 implementing the ALS.

* **Irwin I. Cohn Professor of Law and Director, International Tax LLM, the University of Michigan. The author can be contacted at aviyonah@umich.edu.**

1. Langbein, S.I., "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* (1986), p. 625 et seq.
2. Avi-Yonah, R.S., "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", 9 *Finance and Tax Law Review* (2006), p. 310 et seq. (updated version of article from 15 *Virginia Tax Review* (1995), p. 89 et seq.).

The regulations Surrey authored were eventually finalized in 1968 and for the first time imbued the ALS with practical meaning by formulating the three classical methods of comparable uncontrolled price (CUP), cost-plus and resale price, all of which depended on finding comparable uncontrolled transactions to those engaged in by the related parties. These regulations were the basis for US transfer pricing litigation in the 1970s and 1980s, as well as the basis for the original OECD Transfer Pricing Guidelines issued in 1977.

The problem that gradually became evident was that the traditional methods did not work in the majority of transfer pricing cases. The General Accounting Office did a study in the early 1990s that indicated that in over 90% of the cases the three traditional methods could not be applied because comparables could not be found.[3] Moreover, after winning *Dupont* in 1979 the IRS lost every single major transfer pricing case it litigated between 1980 and 1995, including cases against all the US pharmaceutical companies and many other US multinationals. The major reason for these losses was that the courts refused to accept the comparables used by the IRS under the traditional methods, and either accepted bogus comparables manufactured by the taxpayers, or more frequently simply made up a transfer price that also favoured the taxpayer.[4]

In the meantime, FA became more prominent because the US Supreme Court twice (in 1984 and 1993) upheld California's use of the method to apportion the worldwide income of multinationals doing business in the state. The multinationals and their supporters argued that FA was inconsistent with the internationally accepted ALS and therefore California's reliance on it was unconstitutional, but the Court rejected this argument, once for a US-based and again for a foreign-based multinational. As a result, the literature from the early 1990s is full of debates between advocates of ALS ad FA.[5]

Ultimately, the result was a compromise. In 1995, the United States adopted new transfer pricing regulations that incorporated two new methods – the comparable profit method (CPM) and profit split – which relied much less on comparables (CPM uses comparability very loosely and in profit split the residual is not allocated based on comparables). The OECD followed suit and amended the Transfer Pricing Guidelines to include the new methods, which it calls the transactional net margin method (TNMM) and profit split, although in deference to opponents of FA it still rejected FA and emphasized that the traditional methods were to be preferred to the new ones.[6] It also changed the name CPM to TNMM to emphasize that it does not involve a global profit allocation but rather allocation for the particular transaction, since the former is closer to FA.

Nevertheless, it is clear that by moving beyond traditional comparability, the OECD was moving closer to accepting FA. Once you do not base the ALS on finding comparables, then it is not very meaningful to say that a particular method is or is not compatible with the ALS,

3. General Accounting Office, *International Taxation Problems Persist in Determining Tax Effects of Intercompany Prices*, GAO/GGD 92-89 (1992).
4. Avi-Yonah (2006), note 2.
5. Avi-Yonah (1995), note 2; Bucks, D.R., and Mazerov, M., "The State Solution to the Federal Government's International Transfer Pricing Problem", 46 *National Tax Journal* 3 (1993), pp. 385-392; Cofill, E.J., and Wilson Jr, P., "Federal Formulary Apportionment As An Alternative To Arm's Length Pricing: From The Frying Pan To The Fire?", 59 *Tax Notes* (1993), p. 1103 et seq.; Wilkins, W.J., and Gideon, K.W., "Memorandum to Congress: You Wouldn't Like Worldwide Formulary Apportionment", 69 *Tax Notes* (1994), p. 1259 et seq.
6. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995).

because if there are no comparables you cannot prove that the result reached by that method was not what unrelated parties would have done at arm's length. That is why it is possible to argue that FA is compatible with Art. 7 of the OECD Model, which focuses on the results that unrelated parties would have reached and permits in Art. 7(4) the use of formulas as long as the result is compatible with the ALS.[7] And that is why a group of senior tax officials from OECD Member countries concluded in 1993 that the distinction between the ALS and FA was largely a matter of semantics, not substance.[8]

The ALS/FA debate died down somewhat after the adoption of the 1995 regulations and the new OECD Guidelines because everyone was waiting to see whether the issue had been resolved. However, while there have been few decided cases, it is clear by now that the transfer pricing problem is as bad as it ever was. That is why my co-authors Kimberly Clausing and Michael Durst and I have recently re-proposed adopting FA.[9]

However, it is clear from the reactions we received that it is unlikely we will persuade advocates of the ALS and in particular the OECD that FA is the way forward (although this may change if the Obama administration were to press the issue, or if the European Union adopts CCCTB). Thus, I would like to propose a compromise: use FA in the context of the ALS. Specifically, I would suggest using FA to allocate the residual profit in the profit split method.

The rest of this article is devoted to (a) explaining the drawbacks of ALS as currently applied, (b) developing the above proposal, and (c) concluding with a plea for further discussion by both sides of the FA/ALS debate.

2. The Problems of the ALS[10]

At the heart of the ALS system, with its reliance on estimated "arm's length" prices, is the assumption that each affiliated company within the group transacts with the other members of the group in the same way that it would transact if the members were unrelated. That central assumption defies reality, and it is not surprising that a system of "arm's length" pricing cannot yield sensible results.

Most fundamentally, the ALS system ignores the fact that multinational groups of companies arise precisely in order to avoid the inefficiencies that arise when unrelated companies must transact with one another at arm's length. Multinational enterprises arise in large part due to organizational and internalization advantages relative to the efforts of unrelated, separate companies that seek to do business with one another. Such advantages mean that within multinational enterprises, profit is generated in part by internalizing transactions within the firm. Thus, for firms that are truly integrated across borders, holding related entities within

7. That argument is developed in Avi-Yonah, R.S., and Clausing, K.A., "Art. 7 (Business Profits)", in Lang, M., et al., *Source vs. Residence: problems arising from the allocation of taxing rights in tax treaty law and possible alternatives* (2008), pp. 9-20. The argument that FA is compatible with the treaties assumes that in most cases subsidiaries can be treated as dependent-agent PEs and therefore Art. 7 rather than Art. 9 would apply. See LeGall, J.F., "When Is a Subsidiary a Permanent Establishment of Its Parent?", Tillinghast Lecture, New York University (forthcoming in *Tax Law Review*) (2006).

8. Arnold, B.J., and McDonnell, T.E., "Report on the Invitational Conference on Transfer Pricing: the Allocation of Income and Expenses Among Countries", 61 *Tax Notes* (1993), p. 1377 et seq.

9. Avi-Yonah, R.S., Clausing, K.A., and Durst, M.C., "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split", 9 *Florida Tax Review* (2009), p. 497 et seq.

10. This section and the next one are based on Avi-Yonah, Clausing and Durst, note 9. This article was written from a US perspective, but I have no reason to believe the situation in other countries is better.

the commonly controlled group to an "arm's length" standard for the pricing of intra-company transactions does not make sense, nor does allocating income and expenses on a country-by-country basis. In fact, a very similar logic was behind the use of FA for US state governments and among the Canadian provinces; in an integrated economy, it does not make sense to attribute profits and expenses to individual jurisdictions using separate-entity accounting.

Second, the porosity of current transfer pricing rules creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic activities in such countries and by shifting profits toward more lightly taxed locations. It is apparent that US multinational firms book disproportionate amounts of profit in low-tax locations. For example, Figure 1 shows the ten highest-profit locations for US multinational firms in 2005, based on the share of worldwide (non-US) profits earned in each location. While some of the countries are places with a large US presence in terms of economic activity (the United Kingdom, Canada, Germany, Japan), seven of the top-ten profit countries are locations with very low effective tax rates.

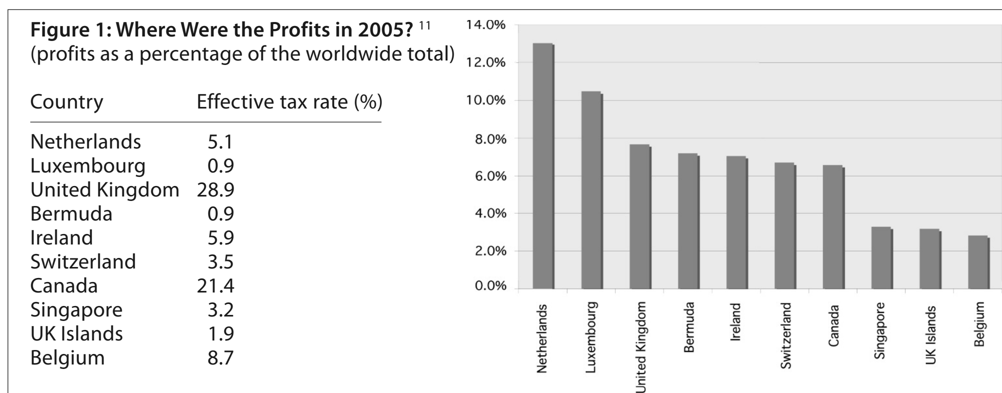

Figure 1: Where Were the Profits in 2005? [11]
(profits as a percentage of the worldwide total)

Country	Effective tax rate (%)
Netherlands	5.1
Luxembourg	0.9
United Kingdom	28.9
Bermuda	0.9
Ireland	5.9
Switzerland	3.5
Canada	21.4
Singapore	3.2
UK Islands	1.9
Belgium	8.7

The literature has consistently found that multinational firms are sensitive to corporate tax rate differences across countries in their financial decisions. Estimates from the literature suggest that the tax base responds to changes in the corporate tax rate with an average semi-elasticity of about –2; thus, countries with high corporate tax rates are likely to gain revenue by lowering their tax rate.[12] One recent study suggests that corporate income tax revenues in the United States were approximately 35% lower due to income shifting in 2004.[13]

11. In 2005, majority-owned affiliates of US multinational firms earned USD 336 billion of net income. This figure shows percentages of the worldwide (non-US) total net income occurring in each of the top-ten income countries. Thus, each percentage point translates into approximately USD 3.4 billion of net income. Effective tax rates are calculated as foreign income taxes paid relative to net (pre-tax) income. Data are from the Bureau of Economic Analysis (BEA) web page; 2005 is the most recent year with revised data available. The Bureau of Economic Analysis conducts annual surveys of *Operations of U.S. Parent Companies and Their Foreign Affiliates*. See Avi-Yonah, Clausing and Durst, note 9, Appendix A.
12. See de Mooij, R.A., "Will Corporate Income Taxation Survive?", 153 *De Economist* (2005), pp. 277-301, for an overview of this literature.
13. This estimate is from Clausing, K.A., "Multinational Firm Tax Avoidance and U.S. Government Revenue", Working paper (Wellesley, MA: Wellesley College, 2007). The calculation is based on a regression of US multinational firm affiliate profit rates on tax rate differences across countries. For more details see Avi-Yonah, Clausing and Durst, note 9, Appendix A.

This problem has worsened as US corporate rates have become increasingly out of line with those of other countries. In the past 20 years, most OECD countries have lowered their corporate income tax rates, whereas US rates have been relatively constant. This increasing discrepancy between US rates and foreign rates likely results in increasing amounts of lost revenue for the US government due to strengthening income shifting incentives.

Also, the literature suggests a substantial responsiveness of real economic activities to tax rate differences among countries.[14] These findings imply both less activity in the United States and less tax revenue for the US government. However, the tax responsiveness of real activity is less immediately apparent in the data. For example, Figure 2 shows the top-ten employment locations for US multinational firms in 2005, based on the share of worldwide (non-US) employment in each location. The high-employment countries are the usual suspects – large economies with close economic ties to the United States. As the accompanying table indicates, tax rates are not particularly low for this set of countries.

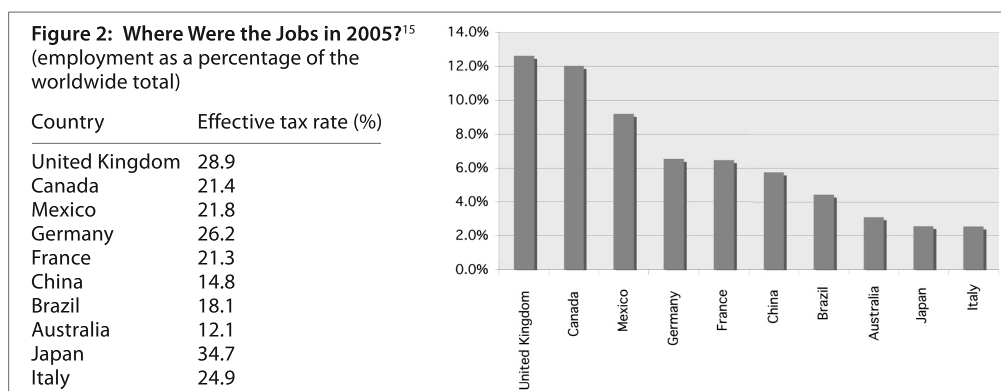

Figure 2: Where Were the Jobs in 2005?[15]
(employment as a percentage of the worldwide total)

Country	Effective tax rate (%)
United Kingdom	28.9
Canada	21.4
Mexico	21.8
Germany	26.2
France	21.3
China	14.8
Brazil	18.1
Australia	12.1
Japan	34.7
Italy	24.9

Third, the current system is absurdly complex. As Taylor notes, observers have described the system as "a cumbersome creation of stupefying complexity" with "rules that lack coherence and often work at cross purposes".[16] Altshuler and Ackerman note that observers testifying before the President's Advisory Panel on Federal Tax Reform found the system "deeply, deeply flawed", noting that "it is difficult to overstate the crisis in the administration of the international tax system of the United States".[17] Current transfer pricing rules have spawned a huge industry of lawyers, accountants and economists whose professional role is to assist multinational companies in their transfer pricing planning and compliance.

Fourth, particularly given the high US corporate statutory tax rates, the US corporate tax system raises relatively little revenue. For most OECD countries, revenues have increased as a share of GDP even as corporate tax rates have declined; the average OECD country receives about 3.25% of GDP from corporate tax revenue by the end of the sample. Most observers

14. See de Mooij, note 12.
15. See note 11 for the basis of these data.
16. Taylor, W., "Testimony before the President's Advisory Panel on Federal Tax Reform", March 31, 2005", *Tax Notes* (4 April 2005), Doc 2005-6654.
17. Altshuler, R., and Ackerman, J., "International Aspects of Recommendations from the President's Advisory Panel on Federal Tax Reform", International Tax Policy Forum Presentation, 2 December 2005.

attribute this trend to a broadening of the tax base for many OECD countries during this time period. For the United States, revenues are lower; although they fluctuate with the cyclical position of the economy, they tend to be closer to 2.25% of GDP. There are several plausible reasons for the lower amount of US revenue, including the increasingly aggressive use of corporate tax shelters, a narrower corporate tax base, and stronger incentives for tax avoidance, which tend to increase as the US tax rate is high relative to other countries.

Finally, it is important to note that the problems with the current system derive not from rules at its periphery, but instead from a fallacy that lies at the system's central core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement.[18] For example, if one wants to determine the "arm's length" level of profitability of a US distribution subsidiary of a foreign manufacturer of automobiles, one identifies one or more independent US distributors of automobiles operating in economically similar circumstances and uses the income of the independent distributor or distributors to benchmark the income of the US subsidiary.

Such an approach might well have made sense 80 years ago, when the legislative language underlying today's arm's length standard for income tax purposes was first developed.[19] At that time, although multinational groups existed, available transportation and communications technology did not permit close centralized management of geographically dispersed groups. Therefore, members of multinational groups functioned largely as independent entities, and benchmarking their incomes or transactions based on uncontrolled comparables probably made good sense.

That situation changed, however, with the technological changes precipitated by the Second World War. Today, it is possible to exercise close managerial control over multinational groups, and these groups develop in all industries and geographic market segments in which the efficiencies of common control pose significant economic advantages. Moreover, in those industries and markets where common control poses advantages, it is typically economically infeasible to remain in the market using a non-commonly controlled structure (for example, by maintaining distributors that are economically independent of manufacturers). Therefore, in those markets in which multinational groups operate – that is, in those markets in which transfer pricing issues arise – it is unlikely that reasonably close "uncontrolled comparables" can be found. For example, to my knowledge, there are no independently owned distributors of mass-market automobiles in the United States; all of the distributors are owned by their manufacturers.[20]

18. This argument is presented in detail in e.g. Avi-Yonah, note 2, Langbein, note 1, and Durst, M.C., and Culbertson, R.E., "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today", 57 *Tax Law Review* (2003), pp. 37-84.

19. For historical summaries, see e.g. Langbein, note 1, Avi-Yonah, note 2, and Durst and Culbertson, note 18, at pp. 42-64.

20. Even some of the few apparent comparables that are found to exist often prove flawed. For example, often, such comparables arise in transitional situations in which, for example, an industry is entering a new market and operates temporarily through unrelated distributors, which after several years are acquired by the manufacturing company. Prices charged in such situations are unlikely to be representative of those that would be charged among members of commonly controlled groups. Similarly, one might find within a market independent distributors of small-volume "niche market" products within an industry, whereas the large-volume distributors will almost invariably be controlled by their manufacturers. See Durst and Culbertson, note 18, at pp. 47-48.

The same is true of virtually every other industry that is conducted on a global scale. In sum, no matter how assiduously one performs "functional analyses" designed to identify "uncontrolled comparables" that are reasonably similar to members of multinational groups, one is rarely going to find them. Certainly, such comparables will not be – and have not been – found with sufficient regularity to serve as the basis for a workable transfer pricing system. If the transfer pricing rules are going to be made tolerably administrable, Congress will need to restate them on a basis other than that of reliance on uncontrolled comparables.

The results of the current system, which assumes the availability of useful comparables in an economic environment where they are very unlikely to be found, are predictable:

– Companies and the government spend extraordinary sums each year on efforts at compliance and enforcement, largely through the preparation of "contemporaneous documentation"[21] by taxpayers and attempts at comprehensive examinations by the IRS, involving some of the Service's most experienced and skilled personnel.

– Despite the expense of compliance and enforcement, companies and the IRS typically are dramatically far apart in their determinations of arm's length pricing. Controversies routinely involve hundreds of millions of dollars and are resolved at amounts that resemble neither the government's nor the taxpayer's positions, thereby casting grave doubt on the conceptual soundness of the underlying rules.[22]

– The inability to predict whether their positions will be sustained leaves companies and their investors with large areas of uncertainty in their financial statements.

– The absence of clear standards for compliance, coupled with the ability under the arm's length standard to apportion income to low-tax countries through legal arrangements governing the sitting of intangibles and (more recently) the bearing of risk, make it impossible for Congress to predict with reasonable accuracy the actual amount of federal revenue that will be raised as a result of any particular corporate tax rate that Congress believes it has enacted.

– The fact that neither taxpayers nor enforcement authorities typically have clear standards for judging compliance means that issues involving very large amounts – billions of dollars – of federal revenue are resolved in examination, settled in Appeals, resolved in negotiations under tax treaties with foreign governments, negotiated through advance pricing agreements, or settled by attorneys out-of-court after examination. In most cases, federal privacy laws require that this decision-making occur outside the public eye. In

21. See Treas. Reg. § 1.6662-6.
22. A 1992 study by the General Accounting Office concluded that less than 30% of transfer pricing adjustments proposed by IRS examiners ultimately were upheld in subsequent proceedings (GAO, note 3). Similarly, in a recent multi-billion-dollar case settled out of court, the parties agreed on payment of USD 3.4 billion in settlement of pending transfer pricing claims; this represents concession of about 50% of the deficiency before the Tax Court, although since the settlement covered years in addition to those then pending before the Court, the extent of IRS concession appears to have been larger. Overall, while results vary from case to case, the IRS typically recovers at trial only a small proportion of transfer pricing deficiencies that it has asserted. The lament by Judge Gerber in one case gives a good idea of the atmosphere to be found in this field of law, despite attempts to project an image of statistical science: "Once again, we are left stranded in a 'sea of expertise' and must navigate our own way through a complex record to decide what constitutes an appropriate arm's-length consideration", *H Group Holding, Inc. v. Comm'r*, T.C. Memo 1999-334. The supply of very large, disputed transfer pricing adjustments does not seem likely to be exhausted soon. See Nutt, A., "News Analysis: Another Transfer Pricing Dispute in the Litigation Pipeline", *Tax Notes Today*, 23 January 2007.

my experience, those involved in this process have served their roles with both integrity and skill. Nevertheless, the resolution of issues involving such large amounts of money, without the benefit of clearly discernable decision-making standards and public scrutiny, is not healthy for the tax system.

- A related problem is that the uncertain results under current transfer pricing law degrade the quality of tax practice on the parts of both taxpayer and government representatives, regardless of the high standards of practice that both sides seek to maintain. Both sides are tempted to state, as "starting points" for what is expected to be extended negotiation, positions that strain the edges of what most would consider reasonable. The resulting atmosphere contributes to a lessening of the publicly perceived credibility of both corporations and the government – a development that is seriously damaging to what will always remain a largely mixed economic system.
- The vulnerability of the current transfer pricing system to the shifting of income based on intangibles ownership and risk-bearing makes necessary numerous additional complexities in the international tax system. If the current transfer pricing regime were replaced by a more formulary approach such as that suggested below, Congress could eliminate from the Code many or all of the "base company" provisions of Subpart F, retaining only those portions of Subpart F dealing with passive investment income. Considerable complexity would, of course, be retained, but much would be eliminated. Similarly, transfer pricing vulnerabilities probably constitute the most pressing argument against adoption of a territorial tax system.[23] Reforming transfer pricing rules could tip the policy-making balance in favour of adopting a territorial system, thereby permitting elimination of the grossly complex foreign tax credit system except as it relates to US taxpayers' passive investment income (which would remain subject to the US tax jurisdiction and for which credit rules would need to be retained).[24] The current transfer pricing system therefore can be seen as the tail that wags the dog of much unnecessary tax complexity.

3. The Problems of Formulary Apportionment

As stated above, these problems of the ALS are well known. However, they do not persuade opponents to abandon the ALS in favour of FA. Instead, the advocates of the ALS point to a list of asserted deficiencies of FA, including:

- FA is inherently arbitrary;
- FA will produce double taxation because some countries will apply the ALS and others FA, and the FA countries will each have a different formula;
- FA requires an impossible-to-achieve uniformity of the tax base;
- FA violates tax treaties; and
- FA will be impossible to enact because of the opposition of the multinationals and of countries that will lose from its implementation.

I believe that there is an answer to each of these issues, as explained below.

23. Kleinbard, E.D., "Throw Territorial Taxation From the Train", *Tax Notes Today*, 6 February 2007.
24. Ibid.

(1) Is FA arbitrary?

Some would consider basing the corporate income tax liability on a formula to be arbitrary. Still, it is not clear that the current ALS regime is less arbitrary given the incentive to shift profits to low-tax jurisdictions. Under the current regime, it is quite possible that an MNE will not pay taxes either in the location of production (because of tax competition and production tax havens) or in the location of distribution (because it can avoid having a permanent establishment or minimize the profits attributable to the distribution function), while any tax due to its residence jurisdiction is subject to deferral or exemption. Such a result is more arbitrary than consistently assigning profits to the market jurisdiction, especially if most countries adopt similar formulas.

It is true that any formula can produce arbitrary results in a given industry. For example, the oil industry has long argued that it is unfair to tax it based on payroll, assets or sales because most of its profits result from the oil reserves themselves, which are not reflected in the formula (since they are typically not assets of the company for any length of time). However, while some industries will lose under any proposed formula, others will win, and most taxpayers would gain from the increased simplicity and transparency of the FA regime. If companies are willing to pay one level of tax and are only concerned about double taxation, they should be willing to accept the FA option, which prevents double taxation but also double non-taxation.[25]

(2) The problem of double taxation

It would be ideal for most major countries to coordinate implementation of FA and to come to a joint agreement on the definition of the formula for apportioning global income. Given that the European Union is already pursuing the possibility of FA within Europe, a natural forum for reaching international consensus on these issues would be the OECD. With international cooperation, the possibility of double or non-taxation would be reduced and there would be less room for multinational firms to respond strategically to variations in country formulas.

Even without formal cooperation, however, unilateral adoption by the United States of a reformed system for taxing international income would create a powerful incentive for other countries using separate accounting to adopt similar new systems. In a world with both formulary and separate-accounting system countries, formulary countries will immediately appear as tax havens from a separate-accounting country perspective. For example, a multinational firm operating in both separate-accounting and formulary countries would have an incentive to book all their income in formulary countries, as the tax liability in such countries does not depend on the income booked there, but rather the fraction of a firm's activities in that location. Such responses would likely greatly reduce the tax revenues of remaining separate-accounting countries. Thus, separate-accounting countries will have a strong

25. It can also be argued that "ignoring intangible property", which is the source of most of the value added by MNEs, is arbitrary under both our formula and the state formulas (that do not include intangibles in the property factor). But intangibles do not have a real location, and their value inheres in the whole MNE, which is why they cannot be adequately addressed under SA. Any formula that "ignores" intangibles in fact assigns their value to the entire MNE (divided based on the other factors used in the formula), and we believe this result more accurately reflects the nature of intangibles.

incentive to adopt formulary approaches, particularly if large economies adopt formulary approaches.

Still, if the United States adopts a formulary approach unilaterally and other countries do not follow suit (or follow suit much later), or if countries adopt different formulas, there is the potential for double or zero taxation. This is, arguably, the largest obstacle to unilateral adoption of a formulary system; but the significance of the obstacle should not be overstated. Although situations of double taxation or double non-taxation could arise, it is not clear that a formulary approach would produce more double or non-taxation than the current regime. The notorious absence of clear standards under the current separate-accounting system means that different countries routinely reach widely disparate divisions of income under the same facts. It is hard to imagine that a reformed system, which at least provides clear quantitative benchmarks, would lead to as many double taxation, or double non-taxation, disputes as the current system already produces.

For example, the IRS recently settled a major transfer pricing case with the British firm Glaxo for USD 3.4 billion. This additional revenue resulted from shifting to the US profits that Glaxo claimed belonged in the United Kingdom.[26] However, the UK tax authorities refused to accept the result of this settlement: Under the United States–United Kingdom tax treaty, they are not required to do so. (Art. 9 of the treaty only states that a country must make a "correlative adjustment" when profits are shifted by the other treaty partner if it agrees that the profit shift was justified.) The result was full double taxation. The dispute resolution mechanism in most current tax treaties does not provide for binding arbitration and therefore does not necessarily lead to a resolution. As Justice Brennan observed in the *Container* case (approving California's application of worldwide FA to US-based MNEs), it is not clear which method (FA or ALS) produces more over- or under-taxation, even when some countries use FA and the others use ALS, or when different formulas are used.[27]

In summary, with respect to the potential problem of double taxation, it must be remembered that the current system, which typically provides only wide ranges of potential "answers" to any given transfer pricing issue, often results in very divergent positions being taken by different countries, even when both countries ostensibly are applying the same "arm's length" principles. Therefore, as a starting point, it should not be thought that a revised transfer pricing regime would move us from a system without substantial double taxation to a system with double taxation; in fact, it is not at all clear whether adoption of a statute like that below would lead to more or less danger of double taxation. Of course, to the extent other countries, particularly those within the European Union, develop formulary systems of their own, a formulary approach by the United States would fit well into an international system for avoidance of double taxation.[28]

26. For news reports describing the *Glaxo* matter, see "Glaxo Preparing to Litigate Transfer Pricing 'Heritage Product' Dispute in United Kingdom", *Daily Tax Report*, 7 March 2007, at I-3; and "GlaxoSmithKline to Pay $3.4 Billion To Settle Largest Dispute in IRS History", *Daily Tax Report*, 12 September 2006, at GG-1.

27. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983).

28. The support among many countries for the CCTB suggests that political attitudes in some countries have changed substantially since the early 1990s when, as described in Durst and Culbertson, note 18, at pp. 80-81, international officials generally opposed actions that might lead to a more formulary transfer pricing system. Today, dissatisfaction with current transfer pricing rules appears widely shared internationally, as evidenced by government officials' expressions of concern with "restructurings" around the world. The OECD Committee on Fiscal Affairs is now devoting substantial attention to problems posed by "restructurings". See Committee on Fiscal Affairs, OECD, "Discussion Draft on the Transfer Pricing Aspects of Business Restructuring", 19 September 2008.

In order to evaluate the question of double taxation during the period when a formulary system might be mixed with arm's length systems in other countries, it should be recognized that those multinational groups that have, to date, adopted tax minimization structures involving transfer pricing typically have sought to minimize their taxable incomes in all high-tax countries in which they operate, not only the United States, and to shift income into low or zero-tax countries. As a result, a unilateral move by the United States to a formulary system is not likely to increase disputes with other high-tax countries; rather, it is likely to increase disagreements with low-tax countries that have sought actively to attract income and business from the United States. It is not clear that avoidance of these kinds of tax disputes constitutes a valid reason to delay reform of the US transfer pricing rules.

It nevertheless needs to be recognized that a unilateral move to a formula-based approach is likely to result in political controversy with the low-tax countries,[29] and because the interests of those countries will coincide with those of companies that seek to retain the subsidies implicit in the current system, those governments may find themselves in political alliance with multinational companies themselves. How to resolve the resulting controversy is a question that will need to be resolved by Congress – but the controversy should be recognized as primarily political in nature.[30] Overall, it would not appear that concerns about "double taxation", significant though they may be, should be sufficient to deter Congress from taking action that could substantially improve the efficiency and apparent fairness of the US international tax system.

(3) Defining the tax base

It would, of course, be desirable for a move to a formulary system to be accompanied by international coordination of the tax base. A common definition of the tax base (as opposed to harmonized tax rates, which are unlikely as well as undesirable) is plausible to achieve because MNEs already use uniform accounting for worldwide financial reporting purposes. Thus, it is quite possible to use financial reporting as the starting point for calculating the global profit of the MNE, to be allocated to jurisdictions based on the FA formula. While there are still differences in accounting among countries, those are diminishing due to the spread of International Accounting Standards, which have been adopted in the European Union and Japan. Further, the US Securities and Exchange Commission announced in August 2008 that it would allow some large US multinational firms to begin using international accounting standards as early as next year, and eventually require all American companies to do so. Alternatively, it may be possible to let each MNE use its home country's accounting methods for calculating the global tax base (as suggested by the EU Commission for inter-EU purposes).[31] Such changes would also have the advantage of more closely aligning book income and tax income. This could act a damper on both the under-reporting of

29. The government of Ireland, for example, currently is opposing the CCTB proposal within the European Union.

30. A resolution of this political issue might be aided through transitional rules, for example rules permitting US multinationals to receive foreign tax credits, for a limited period of time (perhaps with a phase-out) for taxes paid by affiliates to foreign governments, provided the taxes are imposed at statutory rates not exceeding a specified maximum (such as 15%) that would be based on the practices of particular low-tax countries.

31. See EU Commission, "Company Taxation in the Internal Market", COM (2001) 582 Final (2002), 13.1.

income for tax purposes as well as the overstatement of income for the purpose of signalling profitability to financial markets.[32]

However, if coordination of the tax base with accounting-based measures were unachievable or undesirable, the proposed formulary approach could also be implemented unilaterally by the United States using its definition of taxable income and applying it to the entire MNE. US-based MNEs already have to calculate the earnings and profits of CFCs for purposes of Subpart F and the foreign tax credit, so the additional information required for unilateral adoption would not be overly burdensome. For non-US-based MNEs, the US system could use financial reporting to shareholders (already required by the SEC or by home country regulators) as the base for calculating worldwide income. While this would create a disparity between US and non-US-based MNEs, the disparity would probably be no more significant than it is under current transfer pricing regimes around the world, which often must operate from measures of income as determined under local accounting systems.

Concern is sometimes expressed that a transfer pricing system depending on application of an apportionment formula to global income will require the IRS to gain access to information on both US and foreign multinational groups' operations outside the United States. Current transfer pricing law, however, already requires access to such information, both in the application of the profit split method and in the course of examinations. Indeed, current law requires both US and foreign companies to retain and provide on request to the IRS voluminous information on non-US operations.[33] There is no way to avoid offering national tax administrations access to information on activities in other jurisdictions.

(4) Interaction with tax treaties

Some have argued that tax treaties will need modification with adoption of formulary apportionment. However, it is not clear that existing US tax treaties will have to be renegotiated, at least in the short term.

Transfer pricing is currently governed by Art. 9 of the treaties, which seems to assume the ALS method because it addresses the commercial or financial relations between associated enterprises. In addition, Art. 7 of the treaties provides generally for the application of ALS principles in apportioning income among branches of single corporations – a technically complex topic not directly addressed in this article, although it raises issues similar to those raised when dealing with apportionment among separate affiliates.

There can be no question that, historically, both Art. 7 and Art. 9 have been interpreted as incorporating "arm's length" concepts, such as resorting to supposed "comparables", and the other accoutrements of attempted transfer pricing administration under the ALS regime. There is no reason, however, why the United States and its treaty partners could not agree, under the "competent authority" process contained in each treaty and discussed above, to

32. This is discussed in Desai, M., "The Degradation of Reported Corporate Profits", 19 *Journal of Economic Perspectives* 4 (2005), pp. 171-192, where he recommends reconsideration of the dual-reporting system. Desai, M., "The Divergence Between Book Income and Tax Income," in Poterba, J. (ed.), *Tax Policy and the Economy* 17 (Cambridge, MA: MIT Press, 2003), 169-206, reports an increasing divergence between book income and tax income, with more than half of the divergence not explained by conventional differences between the measures. For the United States in 1998, he estimates that this discrepancy amounts to about 34% of tax income (just over USD 150 billion), and he attributes these trends to increased tax-sheltering activities.

33. IRC §§ 6038A and 6038C and regulations thereunder.

interpret their treaties to accept the reformed apportionment approach as the closest feasible, and administrable, approximation to the "arm's length" results envisioned in Arts. 9 and 7. Except for low-tax, "tax haven" countries, one would expect many if not most US tax treaty partners eagerly to accept such an approach, since these treaty partners face the same difficulties in enforcement and administration of transfer pricing rules that the United States faces.

There may, to be sure, be some countries that will insist on retaining the current ALS-based analysis in their treaty dealings with the United States. In such instances, case-by-case negotiation will be necessary in order to avoid double taxation – but such negotiations are required to an unacceptably large extent even under the current system, the vagueness of which leads to numerous conflicts among tax jurisdictions over particular cases. The attached proposed legislation includes provisions designed to ensure that US negotiators have authority to interpret US tax treaties as authorizing the proposed reformed transfer pricing methodology in double taxation negotiations with treaty partners.[34]

One can expect low-tax countries, as well as those multinational businesses that are favoured under the current transfer pricing regime, to assert vigorously that the new regime is in violation of income tax treaties. Such assertions will, however, reflect disagreement with the reformed system on policy grounds, rather than reflecting any serious impediment in the tax treaty system to the adoption of the new system. Political opposition to the reform from low-tax countries and from businesses that will pay relatively larger shares of the corporate tax burden must be respected and dealt with – but such political opposition should be recognized for what it is.

(5) Negative effects on some corporate stakeholders

Analysts have noted that adoption of FA would disproportionately affect some industries and firms negatively. For example, Shackelford and Slemrod (1998) find that FA raises tax liabilities for some industries and firms, lowering burdens for others. They estimate that the oil and gas industry would see an increase in tax liabilities of 81% under FA, compared with 29% for all other firms in their study. (The mean oil and gas company in their study reports 68% of assets in the United States, 70% of sales in the United States, and 78% of total compensation paid to US employees, but such companies book 42% of pre-tax earnings in the United States.) The authors also estimate that some firms will experience a tax decrease, including Boeing and Procter & Gamble. The update of Clausing and Lahav (2008) suggests a similar pattern, with tax increases for oil companies (e.g.) and tax decreases for Boeing, Procter & Gamble, and Intel.

Also, negative impacts may be muted by several considerations. First, firms will benefit from reductions in complexity and compliance burdens. Small and medium-sized businesses should be particularly appreciative of such benefits. Second, accompanying the adoption of a more formulary system with a reduction in the corporate income tax rate would increase the number of firms benefiting from the adoption. A rate reduction would also appeal to those

34. This language, by manifesting congressional intent that the reformed system should be treated as acceptable under existing US income tax treaties, should preclude successful invocation of treaties in judicial challenges to application of the new system. See *Nat'l Westminster Bank PLC v. United States*, 512 F.3d 1347 (Fed. Cir. 2008).

concerned that the United States is losing competitiveness because of the current rate disparity.

4. Adopting Formulas in the Context of the ALS

As noted above, I believe there is a good answer to each of the problems raised by opponents of FA.[35] However, I also realize that my answers are unlikely to persuade FA opponents. Thus, I want to use this article to propose a more modest step forward: adopting FA only in the context of ALS (rather than replacing the ALS with FA).

The basic problem arises in situations where there are no good comparables. If good comparables exist, the traditional methods (CUP, cost-plus and resale price) can be used, and that would end the story. But as the OECD Guidelines acknowledge, in many cases good comparables are hard to find.

The next possible alternative under the OECD Guidelines is TNMM. However, TNMM requires a tougher comparability test than the US CPM, which is good because CPM has proven to be the most manipulable of the current methods: an informed economist working for a major accounting firm has told me he can achieve any result the client wants using CPM. CPM is also a huge source of transactional complexity, a boon to the large accounting firms, and a problem for those who cannot afford their services. But the tougher OECD TNMM comparability standard means that TNMM cannot be applied in many cases in which CPM is used in the United States.

This leaves profit split. Under profit split, comparables are used to allocate the return on routine functions. But that usually leaves a residual in place, which arises precisely because multinationals exist to earn a return that cannot be achieved in an arm's length relationship. That, as explained above, is why good comparables are hard to find.

Thus, the key issue in current transfer pricing is how to allocate the residual under the profit split method. The US regulations assume that the residual is the result of high-profit intangibles and allocate it to where such intangibles were developed. However, this method is not helpful because (a) the OECD and the rest of the world rejects it, (b) it penalizes multinationals for conducting R&D in the United States, and (c) it encourages multinationals to enter into cost-sharing agreements that artificially shift profits to low-tax jurisdictions. In addition, as the *Bausch & Lomb* court stated, if the value of the intangible results from the fact that two parties are related, that added value is distinct from where it was developed.

If the US approach is rejected, the question is how to allocate the residual. The OECD Guidelines are silent on this issue. This presents an opportunity: perhaps in this context, it should be possible to adopt a formula to allocate the residual.

One needs to realize that if there are no comparables (by definition) and the residual results from the relationship between the parties and would disappear if they were unrelated, then the ALS is meaningless and any allocation is arbitrary. Under these circumstances the key is to adopt the formula that is most likely to achieve consensus.

35. Avi-Yonah, Clausing and Durst, note 9; on the treaties point see also Avi-Yonah, R.S., and Clausing, K.A., "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment", in Furman, J., and Bordoff, J. (eds.), *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* (Wahington, DC: Brookings Institution Press, 2008), pp. 319-344.

In the unilateral US context, I supported a sales-based formula similar to the destination-based formula for VAT. This choice of formula favours exports and therefore is likely to be politically popular, and it favours the United States because of our trade deficit.[36] In the OECD context, I would prefer a more balanced formula with three components – payroll, tangible assets and sales.

These three components are of course the traditional US state FA formula. This formula has proven to be remarkably successful, since in addition to the US states, it is also the basis for the global dealing regulations in the United States and OECD, and is a leading candidate for the CCCTB formula. I believe it makes sense because each of its elements is objective (payroll and sales are transactions with outside parties, and while tangible assets depend on valuations, there is a lot of experience with asset-based formulas, such as the US interest allocation formula). Intangibles are excluded, but in my opinion that is appropriate because (a) their value results from physical and human capital and from the market and those elements are included, and (b) you cannot allocate their value and trying to include them invites manipulation.

Thus, I would propose that in hard transfer pricing cases, in which no comparables can be found beyond the return on routine functions, the OECD endorse using the traditional three-factor state formula to allocate the residual under the profit split method.

I believe this proposal addresses the problems with FA outlined above:

- While the formula is arbitrary it relates to economic reality, and any allocation is arbitrary in the absence of comparables. The current OECD Guidelines are also arbitrary in not allocating residuals.
- It is unlikely that this outcome would lead to more double taxation than what already occurs for residuals under the ALS. If the United States allocates residuals based on location of R&D and other countries disagree, double taxation is already a threat. Disputes can be resolved using the new arbitration provision under the OECD Model.
- If the OECD accepts the residual formula under ALS, it does not violate treaties and it can be handled in the context of Art. 9.
- Since it is only a residual formula, the base has already been defined under ALS.
- A balanced formula is less likely to produce consistent losers.

5. Conclusion: A Plea for Dialogue

The OECD has recently moved in the direction of applying the ALS and the Transfer Pricing Guidelines to branches as well as subsidiaries. Richard Vann and others have criticized this move but it is a fait accompli.

The problem with this proposal is that it treats branches as if they were subsidiaries and applies to them the ALS without acknowledging that the current ALS is imperfect.[37] A better move would have been to treat subsidiaries as if they were branches, moving the system clos-

36. Avi-Yonah and Clausing, note 35.
37. Avi-Yonah and Clausing, in Lang (2008).

er to FA. As stated above, treating a multinational as a single economic entity without distinguishing between its constituent units is an acknowledgement of economic reality.

As the recent OECD move on attribution of profits to PEs shows, opponents of FA are unlikely to agree. However, some progress may be possible along the lines suggested by this article.

In the discussion draft on transactional profit methods that was released in January 2008, the OECD proposed to expand the guidance on the practical application of profit methods and there is an Issues Note (Note No. 9) on how to split the profit in a profit split.[38] For instance, with respect to allocation keys, the OECD tentatively concluded that it is not desirable to establish a prescriptive list of criteria or allocation keys. It is, however, possible to identify a number of general requirements that should be satisfied by the criteria or allocation keys used, i.e. they should:

– be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among those parties;
– be consistent with those which would have been agreed between independents in comparable circumstances, given the profit split method seeks to determine the division of profits that independent enterprises would have expected to realize from engaging in the transaction;
– be independent of transfer pricing policy formulation, i.e. they should be based on objective data (e.g. sales to unrelated parties), not on data relating to the remuneration of controlled transactions (e.g. sales to related parties);
– be consistent with the type of profit split approach (e.g. contribution analysis, residual analysis, or other; ex-ante or ex-post approach); and
– be capable of being measured in a reasonably reliable manner.

The Working Party is currently working on revising Chap. III of the Transfer Pricing Guidelines to incorporate a large part of the conclusions that were tentatively reached in this discussion draft. The OECD expects the proposed revision of Chaps. I-III of the Transfer Pricing Guidelines to be released for public comment in fall 2009.

This is hopeful, because given the long-standing and intractable nature of the ALS/FA debate, the best we can hope for is for the two sides to begin to talk to each other. The OECD has been consistently moving since 1995 in the direction of profit-based methods and less emphasis on strict comparables. With the United States and the European Union both moving in the direction of FA, common ground may be found with the OECD, and some use of formulas may become acceptable in the context of the ALS. This article represents a plea for such a dialogue. I hope it will be the beginning of a fruitful discussion.

38. OECD, *Transactional Profit Methods, Discussion Draft for Public Comments*, 25 January 2008, available online from <http://www.oecd.org/dataoecd/18/48/39915180.pdf>, p. 65 et seq.