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Chapter 4

Formulary Apportionment and International Tax Rules

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Any proposal to adopt unitary taxation (UT) of multinationals has to contend with whether such taxation is compatible with existing international tax rules, and, in particular, with the bilateral tax treaty network. Indeed, some researchers have argued that the separate accounting (SA) method and the arm's length standard (ALS), introduced in the early twentieth century,[1] are so embodied in the treaties that they form part of customary international law, and are binding even in the absence of a treaty. We disagree, because the unitary approach is just as widely embodied in most of the current international tax treaties, and, where there are no treaties, national laws allow for a unitary approach to taxation. In this chapter we will argue that UT can be compatible with most existing tax treaties, and that developing countries, in particular, can implement it in most cases with or without a tax treaty and in accordance with their domestic laws.

UT and the existing treaty network

Transfer pricing is currently governed by Article 9 of the treaties, which assumes the SA method because it addresses the commercial or financial relations between associated enterprises.[2] Initially, the term permanent establishment (PE) was meant to include separate entities (subsidiaries). However, in 1933 the League of Nations introduced Article 5, ancestor to the current Article 9 of the Model,[3] where separate enterprises were no longer considered PEs. If UT were adopted, Article 9 would become irrelevant in those situations to which UT applies (i.e. where a unitary business is found to exist), because UT ignores the transactions between related parties, and treats them instead as part of a single enterprise.

Instead, UT would be governed by Article 7. Under Article 5(7), '[t]he fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State… shall not of itself constitute either company a permanent establishment of the other'. However, it is well established that a dependent agent can be a PE (see Art. 5(5)), and whether an agent is dependent is based on whether the principal exercises legal and economic control over the agent.[4] 'An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent'.[5]

In the case of a modern, integrated multinational enterprise (MNE) that operates as a unitary business, a strong argument can be made in most cases that the parent of the MNE exercises both legal and economic control over the operations of the subsidiaries, especially where the subsidiaries bear no real risk of loss, and acquire goods and services exclusively or almost exclusively from the parent or other related corporations. The existence of Intranets in most MNEs has resulted in most important operational decisions being centralised. In that case, the subsidiaries should be regarded as dependent agents of the parent. Such a finding is in fact made with increasing frequency in both developed and developing countries (Le Gall 2007).

If the subsidiary is an agent of the parent, Article 7(2) of the treaties requires the attribution of the same profits to the subsidiary 'that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions'. Arguably, the application of UT satisfies this arm's length condition, because in the absence of precise comparables, which almost never exist, it is not possible to determine exactly what profits would have been attributable to the subsidiary under SA.

When the US adopted the Comparable Profit Method and Profit Split in the 1994 transfer pricing regulations, some countries objected that it was violating the treaties because these methods did not rely on exact comparables to find the arm's length price. However, these objections eventually subsided, and the OECD endorsed similar methods in its transfer pricing guidelines, and more recently granted them equivalent status to the traditional methods. The US has always maintained that both the Comparable Profit and Profit Split Methods satisfy the arm's length standard despite the lack of precise comparables (and in the case of profit split, using no comparables at all to allocate any residual profits). Similarly, the US has maintained that the 'super-royalty rule' of the Internal Revenue Code section 482 (which requires royalties to be 'commensurate with the income' from an intangible, and therefore subject to periodic adjustment) is consistent with the arm's length standard, even though no comparables can be found to show that such adjustments are ever made by unrelated parties.

Before the recent changes to the OECD Model Convention (MC), it was therefore quite plausible to argue that UT was compatible with the treaties if the subsidiary were as a factual matter legally or economically dependent on the parent so as to constitute a PE. In addition, a country that wished to adopt UT could rely on the language of the OECD MC Article 7(4): 'Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting

State from determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article'.

Since it can be argued that in the absence of comparables the result reached under UT is equivalent to what could be reached under SA, this language seems to permit the use of UT for dependent agent PEs.

However, the OECD in 2010 adopted changes to Article 7 of the MC that would make this argument more difficult to sustain. Specifically, the OECD adopted the 'authorised OECD approach' to the attribution of profits to a PE, which treats a PE as the equivalent to a subsidiary, and has suggested that the transfer pricing guidelines that explicitly reject UT should be applied to PEs. In addition, the OECD has followed the US lead and deleted Article 7(4) from its MC. However, not all OECD countries accepted these changes, which were also rejected by developing countries, and the UN model still contains Article 7(4).

In fact, the vast majority of existing actual treaties have not been revised to incorporate those changes. In particular, our research shows that many developing country treaties contain Article 7(4), even when the treaties are with OECD members.[6] We identified 174 such treaties by developing countries that contain this language, including recent treaties such as India-Lithuania (2011), India-Nepal (2011), Korea-Panama (2010), and treaties with OECD members such as India-Sweden, India-UK, Mexico-UK, and Sri Lanka-US. In all of those cases, or in the absence of a treaty, countries should be free to implement UT in accordance with the analysis set out above.

Customary international law

Nor does the argument of customary international law impede the application of a UT approach. The argument is based on the contention that because SA and the ALS are embodied in all the treaties, they should be considered binding. But embodiment in the treaties is not enough to create a customary international law ban on UT, since Article 7(4) is embodied as well. Furthermore, it should be noted that model tax treaties do not, in any way or form, create a 'right to tax'.[7] The key issue is the actual practice of states – what countries actually do – as domestic laws reign supreme in the area of taxation, and many of them follow UT approaches in practice. In addition, countries should be free to follow the UN Model, which does not adopt the changes made by the OECD, and which is also widely followed.

Finally, it can be argued that even the OECD may be revising its approach. The authorised OECD approach may have marked the high point of OECD commitment to SA. With the unfolding of the base erosion and profit shifting (BEPS) project,[8] which is influenced by large developing countries like China and India, it is possible that the OECD may be stepping back from its total commitment to SA. Specifically, the adoption under BEPS of country-by-country reporting (which was already required for extractive industries in the US) can be the basis for implementation of UT.[9] This development is very important for developing counties, as many rely heavily on extractive industries. The requirements of country-by-country reporting will allow a profound change in taxation of the major industry in the developing world: the extractive industry.

Does Article 7 preclude application of UT to entire MNEs?

One important question raised by Durst (Durst 2013a: 8) is whether the requirement that profits be attributable to a PE under Article 7 of the model treaties means that if UT is applied, it must be done on an activity-by-activity basis. Otherwise, profits would be attributed to the PE that have nothing to do with it, because the PE is not engaged in the activity that generates these profits. However, one would rather not make this assumption, because allowing an MNE to split its activities among different subsidiaries is notoriously hard to combat, and facilitates precisely the kind of profit shifting that developing countries, in particular, have a hard time policing.

In our opinion, the phrase ‘attributable to a permanent establishment’ does not preclude attribution of global profits of an MNE to a PE under whatever formula is adopted for UT purposes. The reason is that once a functional analysis is performed, and whatever can be attributed to the various functions by using either comparables or a proxy, such as a fixed percentage of costs (Avi-Yonah, Clausing and Durst 2009), the remaining residual can be allocated in any way we wish, since it is attributable to the entire MNE.

Transfer pricing adjustments frequently result in a residual that cannot be allocated under the traditional functional analysis, because it results from cost savings that inhere in the relationship of the group members to each other. The classic example is the US case involving Bausch and Lomb (B and L).[10] B and L developed an unpatented technology that enabled it to manufacture contact lenses at a cost of $2.50 per lens, when its competitors had costs of $7.50 per lens. B and L contributed the knowhow to its Irish subsidiary, to enable it to manufacture the lenses. The question facing the US court was whether to accept B and L’s view that the Comparable Uncontrolled Price method should apply to determine the price charged by the Irish subsidiary to its parent for lenses based on a comparison with prices charged by independent lens manufacturers, despite the difference in production costs. The IRS argued that the residual profit from the know-how belonged to the US parent that developed it, but the court rejected that view because the residual profit inhered in the relationship between the parties. Had B and

L Ireland been unrelated to its parent, the know-how would have been disclosed, the competitors would have used it, and the residual profit would have disappeared.

The OECD *Transfer Pricing Guidelines* do not say what should be done with residuals under the Profit Split Method. The US regulations followed the White Paper,[11] in assuming that any residual results from intangibles and allocating the residual to where the intangibles were developed. This is a view that favours US revenue interests, because more intangibles are developed in the US than elsewhere, but not surprisingly it has not been accepted by other OECD members. Nor is it congruent with the facts, since residuals can result from other reasons, such as cost savings from synergies or advantages of scale, and they usually inhere in the relationship among the group members and cannot be allocated to any one of them.

The OECD's preferred method of applying the Profit Split Method is to analyse the functions, assets and risk of each member of the affiliated group. However, in the context of residuals this method also proves to be illusory. A functional analysis can only be applied to those functions that can be assigned to the group members, such as production or distribution, but it does not help with residuals that result from the relationship among the group members. Assets can include intangibles, which are usually the most valuable assets of a modern MNE, but intangibles also get their value from the relationship among the group members, as illustrated by the B and L case. This makes it very difficult for them to be allocated to either where they were developed or where they are exploited. The Glaxo case, in which the IRS and HMRC disagreed about whether the profit from selling Zantac, a drug developed in the UK, into the US market were attributable to the intangibles embodied in the drug itself or those used in Glaxo's marketing, resulted in massive double taxation.[12]

Risk is the trickiest concept of all. Recent case studies by the US Joint Committee on Taxation (US Congress 2010) reveal a model in which the entrepreneurial risk for a product is assigned to an affiliate in a low tax jurisdiction, and the manufacturing and distribution of the product in high tax jurisdictions are done on a contract manufacturing and commissionaire basis. But it is not clear what the allocation of entrepreneurial risk means among related parties. If a product fails because of technological change or defects in manufacturing or environmental hazards, the risk is effectively borne by the entire MNE – or more accurately by its management, who risk being fired, and by its shareholders, who see the stock price plummet.

Under UT, these issues can be solved by using the formula to allocate the residual by the Profit Split Method. The specific formula used can be negotiated, as discussed in other chapters in this book, and by Durst

(2014c). But in our opinion it is clear that whatever formula is decided upon should be applied under UT to the entire profit of the integrated MNE, and not divided into separate activities, and that this would be perfectly congruent with Article 7.

UT and developing countries

What can a developing country do to implement UT? In the absence of a treaty, or in the event that the treaty contains Article 7(4) language, the biggest obstacle to UT implementation may be access to information.

The recent redraft of the UN *Transfer Pricing Manual* recommends that among the documentation that a tax administration should request for a transfer pricing audit should be the 'Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years' (para. 8.6.9.12). This provides a good basis for application of UT. The development of a global template for country-by-country reports by MNEs, mandated by the G20 and developed as part of the OECD's BEPS project, would also facilitate such an approach. The rejection of UT in the OECD *Transfer Pricing Guidelines* is based on its definition of formulary apportionment as 'applying a formula fixed in advance'. This leaves considerable scope for adoption of UT approaches with ad hoc formulas, which are not based on a fixed formula.

Specifically, allocation according to operating expenses would be clearer and easier to administer, and most importantly would fit within the current rules of international tax. We have argued that in the context of the Profit Split Method, the residual profit cannot be allocated on the basis of comparables, and therefore can be allocated based on operating expenses without deviating from the ALS (Avi-Yonah *et al*. 2009). This would entail first assigning to each country an estimated market return on the tax deductible expenses incurred by the multinational group in that country.

Developing countries should therefore be encouraged to draft their transfer pricing laws to include powers to adjust the accounts of any foreign-owned local company or branch, if the revenue authority considers that its accounts do not fairly reflect the profits earned locally, to bring the taxable profits into line with those that such a business would be expected to earn, having regard to (a) similar businesses either in that country or elsewhere, and/or (b) the relationship of the local business to the worldwide activities of the corporate group of which it is a part. This would involve analysis and comparison of provisions in the tax laws of appropriate countries. A good model would be Section 482 of the US Internal Revenue Code, which predates the ALS and is very open-ended.[13]

Conclusion

The transition from SA to UT is likely to be a long process, and it may ultimately require renegotiating treaties or even drafting a multilateral treaty like the EU's Common Consolidated Corporate Tax Base. However, a good beginning can be made now by exploring how developing countries can adopt UT principles within the context of the existing treaty network. This paper has endeavoured to show that such approaches are quite feasible, because most developing countries are not bound by the authorised OECD approach to Article 7, and even the OECD may be reconsidering its approach in the context of the BEPS project.

Notes

1. The reports to the League of Nations of 1927-1933, which resulted in the first model tax conventions, were reprinted in a Legislative History of US Tax Conventions, and are now available online in the Digital Collections of the University of Sydney; for a brief account of the history see Picciotto (2013), esp. pp.10-15.
2. The quoted articles are identical in all the tax treaty models except when the differences are discussed in the text.
3. See League of Nations Fiscal Committee (1933), Annex, Art. 5.
4. See, e.g. *Roche Vitamins Europe Ltd v. Administracion General del Estado*, Case No. STS/202/2012 (Spanish Supreme Court Jan. 12) (Swiss principal had PE in Spain through an affiliated Spanish company; activity of the subsidiary was directed, organised and managed in a detailed manner by the principal); Salad Dressing, Fiscal Court Baden-Wurttemberg, 3 K 54/93, Internationales Steuerrecht 1997 (Swiss principal had a PE at the premises of an unrelated German contract manufacturer based on detailed instruction by principal); *Milcal Media Limited*, Court of Appeal, Stockholm, Case nos. 7453-54-02 (2005) (Cyprus principal had a PE through Swedish subsidiary because it was subject to detailed instructions and control); *eFunds Corp. v. ADIT*, Case 45 DTR 345 / 42 SOT 165, Income Tax Appellate Tribunal, Delhi; Lucent Technologies v. DCIT, Income Tax Appellate Tribunal, 2008 (US parent company had a service PE in India); and the cases cited by Le Gall (2007).
5. U.S. Treasury (2006: Art. 5(6)).
6. See Appendix A of Avi-Yonah and Pouga Tinhaga (2014).
7. Vogel (1997: 26) and OECD (1958: 12).
8. See final BEPS reports (OECD 2015a).
9. See BEPS final report on country-by-country reporting, available at www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm (last retrieved 26 July 2016).
10. *Bausch & Lomb Inc. v. C.I.R.*, 933 F.2d 1084.
11. US Treasury (1988) (a US Treasury study of transfer pricing methodology that resulted in the development of the Comparable Profits Method and Profit Split).
12. *GlaxoSmithKlineHoldings (Americas) Inc. and Subsidiaries v. Commissioner*, No. 5750-04 (T.C. Apr. 2).
13. 'In any case of 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, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.' IRC s. 482.