Introduction: Reassessing the Formulary Apportionment Option

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The rapid spread of income taxation across developed countries and their colonies in a relatively small window of time before, during and after the First World War, coinciding with the growth of worldwide trade in a period of rapid improvements in global communication, and transport, created the conditions for emerging tax conflicts. A significant number of new income tax laws levied tax on the worldwide income of residents and domestic source income derived by non-residents. Overlapping tax claims were inevitable in the case of cross-border transactions with both the source jurisdiction in which profits were generated and the recipient’s jurisdiction claiming the right to tax the same income.

Both residence and source-based tax claims were recognized as legitimate exercises of sovereignty in international law, leaving investors facing the prospect of double taxation if they earned income abroad and lived in a country that imposed residence-based taxation. The rationale for imposing tax on the global income of individual residents was relatively straightforward – personal income was often subject to a progressive tax rate scale with the aim of redistributing increments in economic capacity, a concept indifferent to the source of income. The logic behind taxing resident companies on their worldwide income was less obvious, with the common indicators of corporate residency – place of incorporation or place of central management and control – only tangentially, if at all, related to the generation of income in other jurisdictions.

The double tax problem was of serious concern to the business community, and governments responded to those concerns by asking the League of Nations to find a satisfactory resolution. Only a few months after its formation, the League appointed a committee of experts to develop mechanisms to address the problem. The Committee concluded there was no principled solution – the problem arose because two jurisdictions sought and had the legal jurisdiction in international law to tax the same income.
The answer, the Committee said, was political compromise – countries could enter into bilateral treaties and agree to share the tax collection.

Separately, the Committee looked at how the source of income could be determined when the same enterprises operated across multiple jurisdictions with the many arms of the firm all contributing to the profits through intra-group transactions. Two approaches were considered. The first was to treat the many arms of the enterprise, be they branches or separate subsidiaries, as parts of a single business and determine the source of total income derived by the enterprise by reference to the factors in each jurisdiction in which it operated that contributed to gross profits: capital, labour and sales. Under this approach, intra-group transactions were ignored and intangible property owned by parts of the enterprise was disregarded. Only the presence of income-generating factors was determinative of the source of income.

The second approach, now known as separate accounting or arm’s length methodology, treated each part of a multinational enterprise as if it were a separate unrelated entity and substituted arm’s length prices for those used by the taxpayers. The arm’s length pricing was based on comparables – the price that would be charged for comparable goods or services if the parts of an enterprise were truly independent and operating at arm’s length.

Apportioning profits of cross-border enterprises by reference to a formula had long been used in subnational tax systems and for a shorter time for some national income taxes. As the international community looked in the 1930s for a consensus approach to allocating global profits, both formulary apportionment and separate accounting had reasonable prospects of adoption. However, as Richard Krever and Peter Mellor note in Chapter 1, at the international level, the pendulum swung firmly in the direction of separate accounting when the League of Nations accepted the recommendation of a US expert and incorporated separate accounting in its model treaty. Since that time, the arm’s length methodology has been incorporated into all tax treaties and universally applied for international tax purposes in the domestic legislation of national governments.

I FORMULARY APPORTIONMENT IN PRACTICE

The adoption of separate accounting at the international level has not displaced the use of formulary apportionment as the preferred method of allocating profits of multi-jurisdiction enterprises at the subnational level. Decades of experience with formulary apportionment in the United States and Canada, documented by Shirley Sicilian and Joe Huddleston and Michael Smart and François Vaillancourt in Chapters 2 and 3, respectively, provide valuable lessons on both technical aspects of a formulary apportionment system in practice and, equally and perhaps more importantly, the political economy of establishing and maintaining a successful formulary apportionment regime.

While the use of factors as surrogate indicators of the place value is created or the source of income on its face sets the stage for an objective profit allocation system, policymakers enjoy significant discretion in the choice and weighting of factors. As
Michael Smart and François Vaillancourt show in Chapter 3, looking at the Canadian provincial systems, when formulary apportionment is used to divide source between multiple jurisdictions, it can be tailored to create a sustainable formula to which all parties can sign up. At the same time, the US state experience catalogued by Shirley Sicilian and Joe Huddleston in Chapter 2 shows agreements can fragment over time where some jurisdictions conclude an existing formula favours other jurisdictions at the expense of the former group.

The US and Canadian experiences demonstrate how current systems evolved. Looking forward, the very slow, but seemingly steady, march by the EU towards formulary apportionment for the allocation of profits within the Union under its Common Consolidated Corporate Tax Base (CCCTB) proposal, described by Joann Martens Weiner in Chapter 4, provides an ongoing example of the issues that must be addressed to bring different jurisdictions on board to a common formula, if that is the desired outcome.

Two models exist in respect of entities included in a formulary apportionment regime. The simpler applies separately to each legal entity but includes all branches of the entity. The broader alternative, formulary apportionment with unitary combination (or combined reporting), includes all entities within a larger economic group. The narrower formulary apportionment system, used by Canadian provinces, is relatively easily circumvented if branches are converted to separate entities. The wider unitary combination approach avoids this problem but raises a separate question of which entities should be considered part of a unitary enterprise. The experience of US states with unitary combination discussed by Walter Hellerstein in Chapter 5 provides useful lessons on applying formulary apportionment to economic entities that enjoy complete flexibility in terms of their choice of legal structures.

II ALTERNATIVES TO UNIVERSAL FORMULARY APPORTIONMENT

Despite the apparent success of formulary apportionment at the subnational level, separate accounting has prevailed at the national level since the international community chose that alternative nearly a century ago. The limited impact of advocates for a shift to formulary apportionment has led to proposals for more limited, and perhaps politically palatable, alternatives. In the absence of coordinated international agreement, one possibility is unilateral adoption of formulary apportionment. The study by J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay in Chapter 6 shows that unilateral adoption of formulary apportionment can address some problems but throws up new ones to replace them. Much will depend on the design of the tax base, they suggest, and the choice of arm’s length or formulary apportionment cannot therefore be considered separately from the base.

While universal adoption of formulary apportionment across the board may be elusive for the moment, a shift to a formulary approach may be feasible if limited to particular sectors, as Kerrie Sadiq explains in Chapter 7. One candidate, she notes, is digital enterprises that are particularly difficult to fit into a traditional arm’s length model. This approach has received attention recently following suggestions by the
Organisation for Economic Co-operation and Development (OECD) that formulary apportionment might be the optimal way to allocate profits of digital companies. Another possible candidate might be the banking industry. In almost all jurisdictions, prudential rules require banks to segregate their pure banking operations from other activities and international agreements set out guidelines for conformity of the main elements of the service across all jurisdictions, leaving this a logical nominee for formulary apportionment applied to a sector.

III APPROACHING THE MIDDLE

The central tenet of separate accounting is the application of arm’s length pricing based on the market value of comparable supplies between unconnected persons. The supposition that an uncontrolled market price exists for all intra-enterprise transactions has long been dismissed as a myth by critics who pointed out the raison d’être for a multinational enterprise is the synergy that derives from transactions and arrangements which could never take place between unconnected firms. This observation was long resisted by advocates of arm’s length transfer pricing methodology but a shift came in the wake of the 2008-2009 global financial crisis when the leaders of the Group of 20, aware of the revenue costs of international tax avoidance, delegated to the OECD responsibility for devising measures to counter transfer pricing solutions. The ‘base erosion and profit shifting’ (BEPS) project devised by the OECD in response to the call for action retained the foundations of the separate account system but opened the door to innovative variations of traditional transfer pricing methodologies. These included the incorporation of formulary-like attributes into the ‘profit-split’ method of devising a transfer price, an approach that arguably provided arm’s length advocates with cover for a de facto retreat from true separate accounting. Whether the changes amount to a gradual morphing of arm’s length methodology into a quasi-formulary apportionment approach is explored by Yariv Brauner in Chapter 8.

Seeking an inclusive outcome, at an early stage the OECD opened the BEPS project to all jurisdictions, not just OECD members, and deliberately adopted vague principles, most notably the allocation of income to the jurisdiction in which ‘value was created’, sufficiently flexible to accommodate almost all variations that different parties to the project might wish to adopt. China, the most important economic power outside the OECD, used this flexibility to move well beyond traditional arm’s length approaches to map out new profit-split methodologies that arguably go beyond formulary apportionment, bringing new factors such as inputs by users of digital social media into the calculation of profit source. The impact of this new approach is explored by Fei Gao and Antony Ting in Chapter 9.

IV FORMULARY APPORTIONMENT IN A WIDER CONTEXT

The allocation of multinational enterprise profits by means of separate accounting or formulary apportionment methodologies does not take place in a tax vacuum and determining the source of income – the place where value giving rise to profits is
created – may be a suboptimal priority in the wider context of tax goals. John Vella in Chapter 10 suggests the two alternatives are better evaluated by reference to traditional tax criteria such as economic efficiency, fairness, ease of administration, robustness to avoidance and incentive compatibility.

As illustrated by the case of China noted earlier, one by-product of the OECD’s extension of its ‘action plans’ to include much of the rest of the global community, an outreach described by the body as an ‘inclusive framework’, has been the development of many other hybrid and separate proposals for allocating profits. These proposals raise numerous conceptual and practical issues. Itai Grinberg in Chapter 11 suggests the principal attributes of formulary apportionment are sufficiently settled for it to serve as a benchmark for evaluating the alternative approaches that have emerged in recent years and provides guidelines as to how this might be done.

V THE PROSPECTS

However attractive formulary apportionment might appear in theory as a solution to the avoidance, distortions and unfairness of current allocation systems, its value as a global solution will only be realized if proponents can successfully navigate it through the political minefield of tax reform. It is a particularly treacherous minefield in the case of international taxation, where agreement is needed across multiple jurisdictions. Richard Bird and Jack Mintz set out a possible path forward in Chapter 12, drawing on lessons from current formulary apportionment systems and contemporary international tax developments. Central to a programme for success is recognition by advocates for formulary apportionment of the need for compromise to achieve widespread support; this may require financial transfers between winners and losers. Consensus can only be achieved with a formulary apportionment system with features that offer some benefits to all nations. The result will no doubt deviate from purists’ view of a model formulary apportionment regime but can nevertheless still yield important improvements over the status quo.