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Reflections on Separate Enterprise vs. Formulary Apportionment

1. Introduction

The international system for the taxation of business profits is broken. That is the premise on which the OECD project 'Addressing the tax challenges arising from digitalisation of the economy' is based.[2] Pillar One of the project encompasses a formulary approach for the allocation of taxing rights to countries. To the extent applied – not all profits will be subject to the Pillar One system – it would mean a reversal of the current practice, that reflects the separate enterprise method.[3] In this contribution I will lightly explore the development of the current system, and highlight how formulary apportionment became objectionable which, against the background of Pillar One, is remarkable. I conclude that formulary apportionment merits renewed attention.

Some of the points in this contribution have been made or alluded to by others, including Scott Wilkie, Stanley Langbein, Richard Collier and Joseph Andrus. In preparing and then delivering the IFA Travelling Lecture in Canada in 2020, on which this contribution is based, I was inspired by the works of these authors. As Wilkie noted, today's discussion bears resemblance to some of the discussions that took place in the 1920s

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[2] OECD, *Action 1 Tax Challenges Arising from Digitalisation*, n.d., https://www.oecd.org/tax/beps/beps-actions/action1/ (accessed: 12.08.2021).

[3] OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, 2020, https://www.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint_beba0634-en (accessed: 12.08.2021).

and 1930s when the International Chamber of Commerce and the League of Nations worked on the international tax architecture. Indeed, some of the language then used could easily be copied in one of the recent OECD reports.

2. From the present to the past and back to the present

At the IFA/OECD Seminar 2018, Pascal Saint-Amans, Director of the OECD's Centre for Tax Policy and Administration, said that there was a political crisis in tax policy making: "[A]t a political level, there is no trust to build consensus". He added: "The OECD is agnostic on the ALP, but the largest economy in the world seems to have passed a vote of no confidence in the current system." Of course, Saint-Amans referred to the US Base Erosion and Anti-Avoidance Tax (BEAT) but this is only part of the story. The real driver behind the current discussion is the discomfort caused by tax planning and digitalisation of the economy. The lack of confidence in the system is understandable. The interaction of current nexus rules and the allocation of taxation rights under income tax treaties, and the lack of international coherence between tax systems, have led to widespread tax planning that has led to base erosion, tax deferral and a belief that the system is broken. In addition, the 'scale without mass' challenge needed to be addressed; it is now possible to significantly participate in the economy of a country without having nexus that would give rise to taxation of the business profits connected with the presence in that country. Looking at the OECD revenue statistics as they relate to corporate income tax since 1965, and the projected revenue gains resulting from the BEPS project, one could question whether the international tax system indeed is broken. Corporate income tax as a percentage of total revenue has remained remarkably stable despite substantial cuts in the statutory rate across the OECD, and the projected revenue resulting from the BEPS project is rather modest. The Pillar One proposal can therefore not be based on the argument that it would address diminishing revenue, other than through what is now known as the 'counterfactual', i.e., if the system is not repaired, unilateral taxes will proliferate, resulting in lower economic growth and revenue. However, even if one would believe that there is no problem, the perception that there is a problem has become the problem. The main driver of the project seems to be the wish to end the discussion and the proliferation of unilateral revenue-based taxes, and also to satisfy the popular demand that digital giants be taxed where they generate revenue. If Pillar One is adopted, it would mean that the current separate enterprise method would be combined with formulary apportionment in a fashion that is exceedingly complex, and which fails to identify the principles on which it is based. Of course, when one would test a solution against principles, there are two sets of useful principles. In the first place there is the question where jurisdiction to tax originates: What is its basis in international law? What is the relevant nexus, nationality or territoriality, and, as regards the latter, residence and source are the relevant nexus points? When it comes to design principles, Adam Smith, in 1776, showed the way: fairness, certainty, convenience, efficiency. It does not take a genius to see that, in its current incarnation, Pillar One would not score well on certainty, convenience, and efficiency. As to fairness, the question is whether inter-nation equity is served better with the continuation of the existing system, with the introduction of a hybrid system that continues with the separate enterprise method, and adds to that formulary apportionment, or with a total switch to formulary apportionment.

The above musings are perhaps more interesting when they are put in a historic context.

We know that today the OECD is agnostic as to the solution that would result from the current discussion, as long as there is a solution. That is a fairly recent development. In 2002, the OECD Observer cited John Neighbour, then Head of Tax Treaties, Transfer Pricing & Financial Transactions at the OECD: "Applying transfer pricing rules based on the arm's length principle is not easy […]. But replacement systems suggested so far would be extremely complex to administer.

The most frequently advocated alternative is some kind of formulary apportionment that would split the entire profits of an MNE among all its subsidiaries, regardless of their location. But proponents of such alternatives not only have to show that their proposals are theoretically "better" but that they are capable of winning international agreement. Not easy, since the very act of building a formula makes it clear what the outcome is intended to be and who the winners and losers will be for a given set of factors. […]. Questions like how to apportion intellectual capital and R&D between jurisdictions would become contentious. Such problems would make it very difficult to reach agreement on the inputs to the formula, particularly between parent companies in wealthy countries and subsidiaries in poorer ones.

ALP avoids these pitfalls as it is based on real markets. It is tried and tested, offering MNEs and governments a single international standard for agreements that give different governments a fair share of the tax base of MNEs in their jurisdiction while avoiding double taxation problems.

Moreover, it is flexible enough to meet new challenges, such as global trading and electronic commerce. Governments so far appear to agree: much better to update the existing system than start from scratch with something new."

I will address the rejection of formulary apportionment in the OECD transfer pricing guidelines later but first go back almost a century to explore a bit the direction of the thinking in the League of Nations, thinking that was much less hostile to formulary apportionment. A few more citations will follow, but I believe that each of these will give a good insight into considerations at the time that remain valid today. First, there is the report by the four economists in 1923: "Practically, therefore, apart from the question of nationality, which still plays a minor role, the choice lies between the principle of domicile and that of location or origin. Taking the field of taxation as a whole, the reason why tax authorities waver between these two principles is that each may be considered as a part of the still broader principle of economic interest or economic allegiance, as against the original doctrine of political allegiance. A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority."

Clearly the mentioned principles of economic allegiance and political allegiance correspond with territoriality and nationality, respectively, as the foundation for taxation, the jurisdiction to tax. Also, the single taxation principle emerges from the work of the four economists: "The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived."

Nexus and attribution were challenging themes at the time: "The problem consists in ascertaining where the true economic interests of the individual are found. It is only after an analysis of the constituent elements of this economic allegiance that we shall be able to determine where a person ought to be taxed or how the division ought to be made as between the various sovereignties that impose the tax."

And the four economists recognized that there are practical problems related to the allocation of taxation rights as well: "There may be a conflict between the fiscal principle arrived at on purely theoretical grounds and the desirable financial or economic expedients, having regard to the state of the national budget in each country. In other words, what ought to be done may be quite clear; but what it may be practically possible for a Government to give up in the way of revenue in the light of its historical development may be quite another thing."

And finally, the four economists considered that any practical plan needs a theoretical underpinning: "When, however, it comes to the consideration of the taxation of pure income, it is difficult to establish that such an analysis can have great practical value; at any rate modern income is such a composite product and such a complex conception that even theoretically it is not easy to assign in a quantitative sense the proportions of allegiance of the different countries interested. Unless in theory the quantitative assignment can be made, it obviously is difficult to make it the basis of any practical plan."

Following the work of the four economists, technical experts worked on draft treaty provisions in which the concepts of permanent establishment, separate enterprise method and formulary apportionment were visible. In Art. 5 of a draft of a bilateral convention, in 1927, the following language appeared: "Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment."

A 1933 draft was a bit more specific on formulary apportionment:

"Article 3

[…]

If the methods of determination described in the preceding paragraphs [on the basis of the accounts – SvW] are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting."

Finally, the 1933 Mitchell B. Caroll Report identified the separate enterprise method and formulary apportionment as the two theories of taxing foreign enterprises with local establishments:

"The two underlying theories of taxing foreign enterprises with local establishments are:

1. That the local establishments should be taxed on the basis of separate accounts and treated in so far as possible as if they were independent enterprises.

2. That the enterprise is an organic unity and consequently the tax should be assessed on that part of the enterprise's total net income

(computed in accordance with the law of the taxing country) which corresponds to the relative economic importance of the local establishment. This method is known as unlimited fractional apportionment. The advocates of this method contend that, in a unitary business which, for example, produces raw materials, manufactures them into finished products and then sells them, no profit is realised by the enterprise as a whole until the goods have been sold. They contend furthermore that it is impossible to determine accurately what part of the profit is attributable to each function or establishment of the business and consequently the profit can only be apportioned on some empirical basis – for example, an arbitrary apportionment formula. Moreover, they say it is the only way of applying the fundamental principle of taxing the enterprise in accordance with its capacity to pay."

The Mexico and London draft conventions that emerged in the 1940's showed an interesting divergence. For sufficient nexus, the Mexico draft did not require a permanent establishment. The relevant question was whether an enterprise had carried out its business or activities in a foreign country not merely in the form of isolated or occasional transactions, whereas the London draft required that the enterprise would have a permanent establishment in a country to become subject to the income tax laws of that country.

In the context of today's discussion, the Commentary on Art. 7(4) of the 1963 OECD Model Convention (which still allowed formulary apportionment) makes for interesting reading: "24. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. […]. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. […]; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. […]"

Following the controversy surrounding unitary taxation in the United States and the introduction of the 1968 US transfer pricing regulations, the separate enterprise method, culminating in the transfer pricing guidelines and the authorized OECD approach, reigned supreme and formulary apportionment was rejected in forceful terms. The 1979 OECD report on transfer pricing and multinational enterprises states the following: "14. Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with Articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary).[4]"

The 2017 OECD transfer pricing guidelines for multinational enterprises and tax administrations contains five pages of reasoning to explain why global formulary apportionment should be rejected, and then rejects it.[5]

The most significant concern with global formulary apportionment seems to be the difficulty of implementing the system in a manner that would both protect against double taxation and ensure single taxation. Reaching agreement, the guidelines state, would be time consuming and extremely difficult and it would be far from clear that countries would be willing to agree to a universal formula. Moreover, the guidelines recognize that the transition to global formulary apportionment would present enormous political and administrative complexity and require a level of international cooperation that would be unrealistic to expect in the field of international taxation. And the guidelines mention that global formulary apportionment would present intolerable compliance costs and data requirements. Finally, global formulary apportionment would have the effect of taxing an MNE group on a consolidated basis and, as a consequence, would not recognize important geographical differences, separate company efficiencies and so forth.

Even with global formulary apportionment as the only system, the above complexity was anticipated. Complexity indeed emerges in Pillar One, including the political complexity. The administrative complexity, however, to a large degree is caused by Pillar One itself. It follows from the desire to combine the separate enterprise method with formulary apportionment for

[4] OECD, *OECD Transfer Pricing Guidelines (1979)*, 1979, https://tpguidelines.com/oecd-transfer-pricing-guidelines-1979/ (accessed: 18.08.2021).

[5] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page3 (accessed: 18.08.2021).

a subset of global businesses with super profits. Some of the complexity feared in the transfer pricing guidelines could potentially be removed with some of the features of Pillar One. In the Mitchell B. Carroll Report, part of the complexity derived from the fact that, even with formulary apportionment, apparently each country would use its own tax rules to determine the global tax base. The transfer pricing guidelines see the complexity in the process of reaching consensus about a uniform tax base and the apportionment formulae. In fact, most of the objections in the transfer pricing guidelines relate to process and the perceived impossibility of reaching consensus and show stark contrast with the optimism currently radiated by the OECD that consensus can be reached. The real complexity in the current Pillar One blueprint is the combination of the separate enterprise method and formulary apportionment, and the challenges related to sourcing, scoping and segmentation. But differing tax bases are not the problem.

3. Concluding observations

It is unfortunate that the international tax architecture cannot be drawn on a blank slate. The current architecture has so many vested interests, both in governments and in business, including tax and transfer pricing practitioners, that explain why the current debate sometimes comes across as a religious war. However, the arm's length principle as it emerges from the separate enterprise method is not a principle carved in stone. Rather, it is a set of agreed rules that has functioned reasonably well for decades. But if the starting point would be economic allegiance and the principles enunciated by Adam Smith, there is no reason to not consider a complete shift from the separate enterprise method to formulary apportionment. The EU may be moving in that direction failing consensus at the OECD/Inclusive Framework, and we know that the system functions well for state tax purposes in the United States. Depending on the elements of the formula, formulary apportionment may also render Pillar Two superfluous.

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Abstract

This contribution contains reflections on the international system for the taxation of business profits and puts the current discussion regarding the OECD Pillar One project in a historic context. The OECD transfer pricing guidelines imply that global formulary apportionment is to be rejected, but the Pillar One project in fact would introduce that system as an overlay to the existing separate enterprise method.

Keywords: OECD Pillar One project, business profits, global formulary apportionment, separate enterprise method