

INCOME ALLOCATION IN THE 21st CENTURY: THE END OF TRANSFER PRICING?

The Case for Formulary Apportionment

Walter Hellerstein¹

1. INTRODUCTION

It is most appropriate that we convene to mark the retirement of Hubert Hamaekers as Chief Executive Officer of the IBFD and to celebrate his distinguished career with a symposium devoted to "Income Allocation in the 21st century: The End of Transfer Pricing?" Professor Hamaekers has long been one of the leading international authorities on transfer pricing, and it is fitting that we honour him today with a symposium devoted to a subject to which he has made such a significant contribution.

For me personally, I must confess, there is an added pleasure – beyond that of honouring Hubert Hamaekers – in participating in a symposium that gives equal billing to formulary apportionment and transfer pricing as a basis for allocating the income of multi-jurisdictional enterprises. I have spent most of my professional life labouring in the backwaters of subnational taxation in the United States, where formulary apportionment has long been regarded as the preferred method of allocating the business income of multi-jurisdictional enterprises. From an international perspective, however, formulary apportionment has traditionally been viewed as little more than transfer pricing's "poor relation" as a division-of-income methodology. It receives only grudging recognition as a method of attributing the profits to a permanent establishment (PE) under Art. 7 of the OECD Model Tax Convention;² it receives no mention at all in Art. 9 as a method for distributing the profits of associated enterprises among the contracting states in which they conduct their activities;³ and it was assailed by the international business community and by the EU Member States as out of step with internationally accepted norms in the litigation in the United States over the constitutionality of the application of California's worldwide combined reporting regime to multinational enterprises.⁴

Yet with the European Commission's proposal for the use of formulary apportionment as a means of dividing the consolidated corporate tax base for companies' EU-wide activities among the Member States,⁵ formulary apportionment may have acquired a new respectability in the international tax arena. To be sure, there are important distinctions between the use of formulary apportionment within the framework of a political and economic union like the European Union and its use among countries that are not bound by a common legal framework, just as there are important distinctions between the use of formulary apportionment within a union of sovereign states and its use among subnational states or provinces in a federal

union like the United States or Canada. I will consider these contextual considerations below.

At the outset, I simply wanted to register my delight and gratitude that the IBFD has offered me the opportunity to sit at the same table with distinguished advocates for the arm's length/separate-geographic-accounting standard⁶ and to make the case for formulary apportionment.

2. IDENTIFYING THE OBJECTIVE OF INCOME ALLOCATION

In evaluating the relative merits of the arm's length/separate-geographic-accounting standard and formulary apportionment as methods of determining the proper allocation of income among states,⁷ it is important as an initial

1. Francis Shackelford Professor of Taxation, University of Georgia Law School of Law, Athens, Georgia (United States).

2. Organisation for Economic Cooperation and Development, Model Tax Convention on Income and on Capital (OECD Model Treaty), Art. 7(4) and commentary to Art. 7(4) (2003).

3. OECD Model Treaty, note 1, commentary to Art. 9. It has been observed, however, that, as a practical matter, the OECD and its Member countries often accept formulary methodologies in implementing the arm's length standard, a point we return to below. See e.g. Jinyan Li, "Slicing the Digital Pie with a Traditional Knife – Effectiveness of the Arm's Length Principle in the Age of E-Commerce", 24 *Tax Notes International* 8 (19 November 2001), at 775-816 (Sec. 7.3.2).

4. See e.g. *Amici Curiae* brief of the Member States of the European Communities, et al., in *Barclays Bank PLC v. Franchise Tax Bd. of California*, 512 US 298 (1994); *Amici Curiae* brief of the Kingdom of the Netherlands, *Continental Corp. of America v. Franchise Tax Bd.*, 463 US 159 (1983).

5. Commission of the European Communities, "Towards an Internal Market without tax obstacles: A Strategy for providing companies with a consolidated tax base for their EU-wide activities", COM(2001) 582 final (23 October 2001).

6. I apologize at the outset to readers for the use of the somewhat awkward phrase "arm's length/separate-geographic-accounting standard", which is repeated throughout this article. The explanation for what may appear to some as my obsessive compulsive behaviour is my desire to underscore the distinction between separate geographic accounting and separate-entity reporting, which are discrete but frequently confused concepts. I elaborate upon these concepts below.

7. Throughout this article, general references to a "state" will include both national and subnational states. Specific reference to American states will be denominated "subnational" states, except where context renders such designation unnecessary. In addition, references to the "arm's length/separate-geographic-accounting standard" as a "method of ... determining the proper allocation of income among states" encompasses not only the direct impact of the arm's length standard on the geographic allocation of income among states, when it serves as a basis for attributing a single corporation's income to PEs located in different states, but also the indirect – and economically more significant – impact of the arm's length standard on the geographic allocation of income among states, when it serves as a basis for allocating income between associated enterprises. Although assigning income to a particular entity does not directly establish its source, such assignment often effectively determines its source.

matter to identify the underlying objective that these competing methodologies are designed to accomplish. For only if we identify the objective that we are seeking to accomplish, can we sensibly compare the relative merits of the competing methodologies.

2.1. Search for the "true" geographic source of income

Advocates of the arm's length/separate-geographic-accounting standard for allocating income among states often rest their case on the premise that it more effectively determines the "true" geographic source of income than does formulary apportionment.⁸ The substance of the claim is that the arm's length/separate-geographic-accounting standard is a more particularized and accurate determination of the geographic source of the income-producing activity of an enterprise within a state⁹ than is a method that relies, as the US Supreme Court has observed, on a mere "mathematical generalization".¹⁰

I will return to the question of whether, taken on its own terms, this argument is correct. The preliminary issue, however, is whether this is even the right question. If, for any of the reasons suggested immediately below, the purpose of our income allocation rules is *not* to determine the "true" geographic source of income, then even if the arm's length/separate-geographic-accounting method is superior to formulary apportionment as a means for determining such "true" source, that point has little bearing on our inquiry.

2.2. Equitable division of income

There are many who believe that the purpose of income allocation is to effectuate an equitable division of income among the states with a legitimate claim to it, and they reject the premise that the purpose of income allocation is to determine the "true" geographic source of income. Some have taken this position as a matter of principle, arguing that income has no "true" source and that the search for the "true" source of income is therefore futile.¹¹ Others view the proper concept of source as a proxy for political, legal, economic and administrative judgments about taxation based on a wide variety of normative criteria (other than residence) as a predicate for taxing income, and they view the proper role of source as "simply devices to describe the income that either should be taxed at source pursuant to normative criteria or taken into account in implementing the rationale of the foreign tax credit limitation".¹² Still others reject the purpose of allocation as seeking the "true" geographic source of income for pragmatic reasons: the search for the "true" source of income, even if it exists, is simply not worth the candle.¹³ Rather than pursue the complex, expensive and elusive goal of determining the "true" geographic source of income, they view the sourcing rules as pragmatic means for distributing income taxing rights between source countries and residence countries.

2.3. Implications for analysis

The purpose of the preceding discussion was not to attempt to resolve – or, more importantly for present purposes, to rest my argument on – the answer to the question of whether the objective of income allocation is to determine the "true" geographic source of income or to effectuate an equitable division of income based on considerations other than geographic source. In the end, I think resolution of that question may be more a matter of faith than of logic. My point was the narrower one that the purported superiority of the arm's length/separate-geographic-accounting standard over formulary apportionment as a method of income allocation frequently rests on a questionable premise, namely that the purpose of income allocation is to determine the "true" geographic source of income. If it is not, as many believe, then at least one argument purportedly favouring the arm's length/separate-geographic-accounting standard over formulary apportionment as an income allocation method is substantially undermined.

3. IDENTIFYING THE METHODOLOGICAL ISSUES

3.1. Arm's-length/separate-geographic accounting versus formulary apportionment

The distinction between the arm's length/separate-geographic-accounting standard and formulary apportionment, to which we have already alluded and with which this audience is intimately familiar, need not be belaboured here. For the sake of completeness, however, I offer the following brief descriptions of the two methodologies. The arm's length/separate-geographic-accounting standard is a method for determining the geographic source of income of a single enterprise or a group of asso-

8. See e.g. Charles E. McLure, Jr. and Joann M. Weiner, "Deciding Whether the European Union Should Adopt Formulary Apportionment of Company Income", in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (2000), at 258. ("Formulary apportionment is conceptually inferior to separate accounting if separate accounting can be applied. First, FA does not attempt to determine the true source of income.")

9. In this context, it is important to emphasize that the claim for the superiority of the arm's length method rests on a *geographic* conception of source. If one takes the position that source-based taxation is simply a predicate of jurisdiction to tax income based on the relationship of income-producing activity to a state as distinguished from residence-based taxation, which relies on the relationship of the taxpayer to the state as a predicate for taxation, one may favour a delineation of source that is based on considerations other than geography. See e.g. Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, "The David R. Tillinghast Lecture: 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation", 56 *Tax L. Rev.* 81 (2002), at 154. ("[T]he content of any particular source rule should relate to the rule's purpose and not to debates over geographic origin".)

10. *Container*, note 4, at 188.

11. See e.g. Michael J. McIntyre, "The Use of Combined Reporting by Nation States" in Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (2003).

12. Shay, et al., note 9, at 154; see also note 9 in general.

13. Cf. William Vickrey, "The Corporate Income Tax in the U.S. Tax System", 73 *Tax Notes* 5, at 597, 601-602 (4 November 1996). ("[H]ow can one determine the source of income of a radio station in Luxembourg advertising a product made in Belgium that is sold in France? One can easily squander all of the revenue involved in costs of fruitless disputation".)

ciated enterprises that conduct economic activity in different states by reference to the income that would have been earned within a particular state if the in-state activities had been carried on by an independent enterprise dealing at arm's length with other branches of the enterprise or with the associated enterprises.¹⁴ Formulary apportionment is a method for determining the income of a single enterprise or group of associated enterprises attributable to a state by reference to a formula that assigns a proportionate share of the enterprise's or associated enterprises' income to the state by reference to the factor or factors that reflect (or are deemed to reflect) the underlying income-producing activities within the state.¹⁵

3.2. Separate-entity reporting versus consolidated or combined reporting

Separate-entity reporting respects the separate identity of each corporation within a group of associated, affiliated or commonly controlled¹⁶ corporations and determines each corporate taxpayer's income on an individualized basis. Separate-entity reporting generally respects the tax consequences of transactions and arrangements between separate corporations even though they are commonly controlled and even though they may be engaged in an economically integrated business, although intercompany transactions may be subject to adjustment under the arm's length/separate-geographic-accounting standard. Consolidated or combined reporting consolidates or combines the income of a group of associated, affiliated or commonly controlled corporations, and it generally eliminates intercompany transactions within the consolidated or combined group in determining such income.¹⁷

3.3. Relationship between the two methodological issues

3.3.1. Single corporation

Either arm's length/separate-geographic accounting or formulary apportionment may be employed to attribute the income of a single corporation to the states in which it is conducting economic activity. For example under the OECD Model Treaty, the arm's length/separate-geographic-accounting standard is the preferred method for allocating profits attributable to PEs of a single corporation in different states.¹⁸ By contrast, under prevailing US subnational state practice, formulary apportionment is the preferred method for allocating profits of a single corporation attributable to taxable activity in different states, at least when the corporation is engaged in economically integrated ("unitary") business activity across state lines.¹⁹ In this context, there simply is no issue of consolidated/combined versus separate-entity reporting, because we are dealing with only a single entity.

3.3.2. Commonly controlled corporations

The arm's length/separate-geographic-accounting method is generally linked to separate-entity reporting by commonly controlled corporations. Indeed, the *raison d'être* of the arm's length standard is the goal of treating a group of

related corporations as if they were independent corporations. Although some consolidation of accounts can occur when a group of related corporations determines the income or loss of each corporation on a separate-entity basis but then combines the separately determined incomes or losses to create a single "consolidated" income figure,²⁰ the arm's length/separate-geographic-accounting standard and separate-entity reporting are conceptual Siamese twins.

Formulary apportionment is compatible with – but by no means required by – consolidated reporting, at least as a matter of principle. Consolidated reporting effectively treats a group of related corporations as if they were a single corporation for purposes of determining its income. How that income is then attributed among states in which the consolidated group conducts its economic activity is another question. While formulary apportionment is certainly consistent with consolidated reporting, as the US subnational experience demonstrates, one can easily imagine other methods for assigning the group's income to various states. For example one could adopt an arm's length/separate-geographic-accounting approach for a consolidated group of corporations analogous to the OECD Model Treaty's preferred method for allocating profits of a single corporation attributable to PEs in different states. The point is simply that, in contrast to the inextricable link between separate-entity reporting and the

14. See e.g. OECD Model Treaty, note 1, Art. 7 and commentary to Art. 7, Art. 9 and commentary to Art. 9. As noted above, see note 7, I am aware that my description of the arm's length/separate-geographic-accounting standard collapses two analytically discrete issues into one. The issue of how one attributes profits to two or more PEs of a single enterprise or to two or more legally distinct associated enterprises is technically discrete from the issue of how one accounts, on a state-by-state basis, for the income thus attributed. However, because the attribution to a particular PE or associated enterprise as a practical matter normally determines the state to which the income will be attributed on a separate accounting basis, and because states that employ the arm's length standard do so in conjunction with separate geographic accounting for the income of the entities that are taxable by the state, it is appropriate to refer to the arm's length/separate-geographic-accounting standard in one breath, as I will do throughout this article without repeating this point.

15. Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* (3rd ed. 1998), Paras. 8.05, 8.11.

16. I use these terms ("associated", "affiliated" and "commonly controlled corporations") interchangeably throughout this discussion to denominate a group of commonly controlled companies under common control the whose commercial or financial interactions of which have the potential to deviate from the commercial or financial interactions that would exist between independent enterprises. Cf. OECD Model Treaty, note 1, Art. 9(1). I recognize, of course, that the precise definition of "association", "affiliation" or "common control" may differ from state to state.

17. For purposes of this article, I use the terms "consolidated" and "combined reporting" interchangeably as I have defined them in the text. In fact, in US subnational tax parlance, there is a distinction between combined and consolidated reporting. Combined reporting is a mandatory form of reporting for commonly controlled companies that are engaged in an economically integrated (unitary) business. There is no requirement that individual members of the combined group be subject to the state's taxing jurisdiction in order for their income to be included in the combined return. Consolidated reporting is generally an elective form of reporting for affiliated corporations that may or may not be engaged in a unitary business. Corporations joining in the state-consolidated return ordinarily must be subject to the state's taxing jurisdiction and must have joined in filing a federal consolidated return. See generally Hellerstein and Hellerstein, note 14, at Para. 8.11[1].

18. OECD Model Treaty, note 2, commentary to Art. 7(2).

19. Hellerstein and Hellerstein, note 15, Para. 8.03.

20. Some US subnational states take this approach.

arm's length/separate-geographic-accounting standard, the consolidation of the income of commonly controlled entities does not necessarily imply that the group's income should be allocated on a formulary basis.

4. THE CASE FOR FORMULARY APPORTIONMENT FOR ALLOCATING THE INCOME OF A SINGLE ENTITY

The case for formulary apportionment is at its most compelling when a single taxpayer conducts integrated economic activity in more than one state. Let me start with a simple example.²¹ Suppose that *T*, which has a PE in State *A* and State *B*, has a customer *C* in State *A* who will pay USD 100 for a horse. *T* finds that it will cost him USD 100 to purchase and deliver a horse to *C*. Accordingly, if *T* bought a horse and sold it to *C*, he would have no income. However, *T* finds that he can buy two horses for USD 150. If he buys both horses and sells one to *C*, he will suffer a USD 50 loss. But *T* now finds customer *D* in State *B* who will pay USD 75 for the second horse. *T* therefore proceeds to buy the two horses for USD 150, sell them to *C* and *D* and earn USD 25 on the transaction. Under an arm's length/separate-geographic-accounting analysis, one would presumably allocate the entire gain to State *A*, because the horses were purchased for an average cost of USD 75, and the only one that was sold for a profit was the horse that was sold in State *A*. But it would be just as reasonable to attribute the entire income to State *B* on the theory that the first horse cost *T* USD 100 and the second one cost him USD 50, and the only horse that could be sold for more than its costs price was the horse sold in State *B*.

In truth, neither solution is correct. Both sales were absolutely necessary steps in deriving profit from the transaction, and the income is therefore attributable to the two together, not to either one alone. Under these circumstances, the use of an arm's length/separate-geographic-accounting analysis to attribute income to either State *A* or State *B* ignores the economic reality that activities in each state contributed in an *essential but indeterminate* manner to the income. The appropriate solution to the division-of-income problem raised by the production of income derived from such inseparable and indeterminate contributions to profit is the use of a formula that gives weight to the various factors responsible for earning the income such as property (capital), payroll (labour) and sales (demand).

Although one may be tempted to dismiss the foregoing example as a quaint but antiquated relic of the 19th century, the underlying point is as germane to the 21st century's economy as to the 19th century's. Indeed, the foregoing analysis of the 19th-century problem of allocating the income from horse-trading is equally applicable to the 21st-century problem of allocating the income from global securities trading. Even the OECD, whose general hostility to formulary apportionment as an income allocation method is well known, has recognized in a draft report that formulary apportionment may play an appropriate role in income allocation in circumstances where other methods do "not adequately capture the integration of functions

found in global trading operations ...",²² in light of the "sheer diversity of the organisation, business strategies, products and functions of global trading businesses ...".²³ Thus the draft report describes with approval "the contribution profit split method"²⁴ under which one (i) identifies the global trading functions that need to be rewarded by a profit, (ii) determines the relative contribution of each function to the earning of the combined profit from global trading operations and (iii) determines the contribution of each location to the performance of the function. The draft report then declares:

... a common approach to applying the profit split method (a multi-factor formula) is to select factors to represent one or more of the relevant functions, to weight the functions to determine the relative contribution of the function(s) represented by each factor and to use the factors to allocate the profit to the locations performing those functions.²⁵

While the draft report stoutly maintains that this approach is simply a method of "transfer pricing"²⁶ that reflects "the arm's length principle",²⁷ one may suggest that formulary apportionment by any other name would smell as sweet.²⁸

My point here is not to play "gotcha"²⁹ with the OECD and the US Treasury.³⁰ Rather, it is simply to point out that, at least in one situation where the case for formulary apportionment is at its strongest (i.e. the carrying-on of an integrated operation by a single entity in different states with essential but indeterminate contributions to income made by labour, capital and markets in different locations), there is a powerful case for the application of formulary apportionment as a means for allocating the income among states with a plausible claim to it, which even some of the most stalwart opponents of formulary apportionment appear to recognize. The real question is whether, and under what circumstances, one should "scale up" or extend this conclusion to other situations.

21. The example is borrowed, with some modifications, from George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation* (2nd ed. 1950), at 96-97.

22. OECD, "Discussion Draft on the Attribution of Profits to Permanent Establishments (PES), Part III, (Enterprises Carrying on Global Trading of Financial Instruments)" (4 March 2003), at 156, available at www.oecd.org.

23. *Id.*, Para. 157.

24. *Id.*, Para. 156.

25. *Id.*, Para. 159.

26. *Id.*

27. *Id.*, Para. 160.

28. The US Treasury, which generally embraces the arm's length/separate-geographic-accounting standard in its regulations under Internal Revenue Code (IRC) Sec. 482 (relating to permissible adjustments that the Commissioner may make between commonly controlled organizations, trades or businesses), has taken a position similar to that espoused in the draft OECD report in proposed regulations addressed to global securities dealing. The proposed regulations' application of the profit split method to global dealing evaluates whether the allocation of the combined operating profit or loss of a global dealing operation to one or more participants in the operation is at arm's length by reference to the relative value of each participant's contribution to the combined operating profit or loss. Proposed IRC Reg. Sec. 1.482-8(e)(1). The relative value of each participant's contribution to the global trading activity must be determined in a manner that reflects the functions performed, risks assumed and resources employed by each participant in the activity. Proposed IRC Reg. Sec. 1.482-8(e)(2). The regulations specifically provide that, in appropriate cases, "the participants may find that a multi-factor formula most reliably measures the relative value of the contributions to the profitability of a global dealing operation". *Id.*

29. American slang for "I have got you".

30. See note 27.

5. THE CASE FOR EXTENDING FORMULARY APPORTIONMENT TO A GROUP OF AFFILIATED ENTITIES

Once formulary apportionment is accepted as an appropriate method (at least in some circumstances) for allocating the income of a single entity engaged in integrated economic activity in more than one state, there is no justification in principle for failing to apply formulary apportionment (in such circumstances) to the income of a group of commonly controlled corporations engaged in integrated economic activity in more than one state. The only difference between the two cases lies in the form of business organization, i.e. the organization of a business enterprise through subsidiaries, as distinguished from branches, a factor that should not affect the allocation of income among states. Indeed, it is a fundamental tenet of tax policy that substance, not form, should determine matters of taxation. Consequently, if the nature of the taxpayer's activity – be it horse trading or securities trading – warrants the use of formulary apportionment when the activity is carried on by a single entity, it likewise warrants the use of formulary apportionment when the activity is carried on by a group of formally separate legal entities.

As the California Supreme Court observed in the seminal case sustaining the application of formulary apportionment to a group of commonly controlled corporations, after formulary apportionment had been sustained in *Butler Brothers*³¹ and other cases involving a single corporation:

The business of the parent and all of its subsidiaries is owned and managed under one centralized system, to the same extent as in the *Butler Brothers* case (...) Thus the business is unitary [i.e. economically integrated across state lines] regardless of the fact that in the *Butler Brothers* case there was but one corporation involved, owning as parts of the unitary system seven different branches in as many states, and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized in corporations in as many states. No difference in principle is discernible. If the crux of the matter is to ascertain the portion of the business which is done within this state, the same considerations justify the use of the formula allocation method in the one case as in the other.³²

If formulary apportionment is accepted as a method of income allocation for a group of commonly controlled corporations, then, as a theoretical and practical matter, consolidated or combined reporting should be employed as the method for determining the apportionable tax base. The predicate for formulary apportionment of the income of a single corporation or a group of commonly controlled corporations is that they be engaged in integrated cross-border economic activities that cannot meaningfully be unbundled on an arm's length/separate-geographic-accounting basis. These same considerations justify consolidation of the income of the separate legal entities, because the transactions between them often will lack economic significance, will be difficult and expensive to disaggregate and will be subject to manipulation to minimize tax liabilities. Indeed, while I observed earlier that the consolidation of the income of commonly controlled entities

does not necessarily imply that the group's income should be allocated on a formulary basis, the converse of this proposition (like the converse of many propositions) is not true: the allocation of the income of a group of affiliated corporations on a formulary basis *does* necessarily imply that the group's income should be consolidated.

In fact, the case for formulary apportionment of the income of a group of commonly controlled corporations often goes hand in hand with the case for reporting the income of those entities on a consolidated or combined basis. For example the European Commission's proposal for a company tax strategy designed to further the goal of creating an internal market without tax obstacles, declares that it is "necessary" both to "provide companies with a consolidated corporate tax base for their EU-wide activities" and to "develop an appropriate apportionment mechanism which can be agreed by all participants".³³ Moreover, the underlying reasons advanced for consolidation and formulary apportionment are overlapping and reinforcing. They include avoiding complex, costly and theoretically questionable transfer pricing inquiries; preventing the use of tax minimization strategies that rely on the respect for transactions between commonly controlled entities; and administrative simplification, for both taxpayers and taxing authorities.

6. EVALUATING THE PROS AND CONS OF THE COMPETING METHODOLOGIES

The preceding discussion has already adverted to a number of the perceived advantages and disadvantages of the two competing approaches to income allocation. It is nevertheless appropriate to identify and evaluate these pros and cons in a more systematic manner so that we may more sensibly address the ultimate question to which this symposium is directed, namely which of the two competing methodologies should command our allegiance in the 21st century.

6.1. Theoretical concerns

The arm's length/separate-geographic-accounting approach to allocation of income is often regarded as more theoretically defensible than formulary apportionment. As the EU Commission staff has observed: "Theoretically, separate accounting is the most accurate solution in that it follows a 'bottom up' approach, with each transaction being individually recorded in the accounts of its respective jurisdiction so that the correct source of any profit can be identified".³⁴ As indicated at the outset of this paper, however, that perceived theoretical advantage is based on the premise that the purpose of the income allocation rules is to identify the "true" or "correct" source of a multi-juris-

31. *Butler Bros. v. McColgan*, 17 Cal. 2d 664, 111 P.2d 334 (1942), aff'd, 315 US 501 (1942).

32. *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472, 480, 183 P.2d 16, 21 (1947).

33. Commission of the European Communities, note 5, Sec. 5, at 16.

34. Commission of the European Communities, Commission Staff Working Paper, *Company Taxation in the Internal Market*, SEC(2001) 1681, Sec. 17.1, at 407 (23 October 2001).

dictional enterprise's profit.³⁵ If one rejects that premise, as many do,³⁶ this perceived theoretical advantage disappears.

Even assuming, for the sake of argument, that the purpose of the income allocation rules is to identify the true source of a multi-jurisdictional taxpayer's income, it is by no means clear that the arm's length/separate-geographic-accounting standard is theoretically superior to formulary apportionment. As the preceding discussion of formulary apportionment suggests,³⁷ and as I have observed elsewhere,³⁸ there is a fundamental theoretical defect in the arm's length/separate-geographic-accounting standard as applied to an economically integrated multi-jurisdictional enterprise (whether operating through a single or multiple entities). As *Alice in Wonderland*, it functions in a universe of unreality. For the essence of the arm's length/separate-geographic-accounting technique of allocating the income of an integrated multi-jurisdictional corporation is to ignore the interdependence and integration of the business operations conducted in the various states, and to treat them, instead, as if they were separate, independent and non-integrated. Thus, a corporation that owns and operates its own rubber plantations; produces rubber and related raw materials; manufactures a variety of products, ranging from tires, automobile and airplane parts to raincoats and boots; and sells them to manufacturers, wholesalers, and retailers is a very different enterprise from the sum total of a rubber plantation, a rubber products manufacturer and a wholesaler of rubber products, each separate, unaffiliated and independent, and each owning and operating one piece of the business.

The differences between such separate businesses and the multi-jurisdictional corporations that dominate the world's economy are crucial, and their wealth, power and profits are attributable to a considerable extent to the very fact that they are economically integrated businesses. It is for these reasons that the arm's length/separate-geographic-accounting method, which ignores the economically integrated character of such businesses, is not a theoretically satisfactory method for dividing taxable income among states. Rather, in these circumstances, a formula that recognizes the essential but indeterminate contributions to income from various factors of income-producing activity is theoretically superior to a method that is predicated on a false assumption.

Finally, if one rejects the premise on which the foregoing discussion proceeded, namely that the purpose of income allocation is to determine the "true" source of income, and embraces instead the view that the purpose of income allocation is to effectuate an equitable division of income,³⁹ then the theoretical question becomes which of the two competing methods better serves this objective. From a theoretical perspective, it would appear to be no more difficult – and probably easier – to translate one's judgments about an equitable division of income into a formula whose apportionment factors of which reflect those judgments than to do so through a series of specific sourcing rules that would be applied in conjunction with the arm's length/separate-geographic-accounting standard.

6.2. Practical concerns

Wholly apart from the debate over the theoretical merits of the competing methods of income allocation, there is the question as to which method is a more practical approach to income allocation. In this respect, the case for formulary apportionment seems quite compelling.

6.2.1. Complexity

If there is one proposition about which there is universal agreement in the debate over income allocation methodologies, it is that implementation of the arm's length/separate-geographic-accounting standard is extraordinarily complex. Whether one's point of reference is the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,⁴⁰ the US Treasury's 100 pages of regulations under Sec. 482 of the Internal Revenue Code,⁴¹ or the countless number of other official and secondary sources of information interpreting the arm's length/separate-geographic-accounting standard, the conclusion is inescapable that the complexity of this inquiry is staggering. That complexity has been exacerbated in recent years by the inherent difficulty of determining transfer pricing in the presence of high-profit intangibles. As one commentator observed:

As manufacturing and the importance of national borders shrink, cross-border transfers of valuable intellectual property within a single multinational are becoming increasingly common. Unfortunately, this is the type of transfer pricing issue that poses the greatest challenge to the arm's length method codified in section 482. The simple reason is that intangibles by their nature are unique, and so it is always difficult – and frequently impossible – to identify transactions between unrelated parties involving the transfer of comparable intangible assets. Administering the arm's length method without comparables is like playing hockey without a puck.⁴²

By comparison to the arm's length/separate-geographic-accounting standard, formulary apportionment is relatively simple. To be sure, there can be difficult factual issues in delineating the apportionable tax base if it is defined in terms of a unitary business,⁴³ and there may be difficult political questions regarding the selection and definition of the apportionment factors.⁴⁴ Yet these difficulties, and others that may be encountered in connection with a system based on formulary apportionment, pale by comparison to those encountered in a system based on the arm's length/separate-geographic-accounting standard.

35. See sec. 2.

36. See sec. 2.2.

37. See sec. 4.

38. Hellerstein and Hellerstein, note 15, Para. 8.03, from which the balance of this paragraph freely draws.

39. See sec. 2.2.

40. "Transfer Pricing Guidelines for Multinational Enterprises" (Paris: OECD, 1995) (OECD Transfer Pricing Guidelines).

41. IRC Reg. Sec. 1.482.

42. Martin Sullivan, "With Billions at Stake, Glaxo Puts APA Program on Trial", 103 *Tax Notes* 4 (26 April 2004), at 388.

43. See Hellerstein and Hellerstein, note 15, Paras. 8.07 - 8.10.

44. See 7.2.

6.2.2. Costs of administration and compliance

Closely related to the question of complexity is the cost of administering and complying with the system. Again, there can be little question that a system based on formula apportionment generally has lower costs of compliance and administration than one based on the arm's length/separate-geographic-accounting standard. Indeed, one of the reasons the American states abandoned the arm's length/separate-geographic-accounting standard was precisely due to the costs involved.⁴⁵ It has also been suggested that in the subnational context (e.g. in Canada, Switzerland and the United States), "[s]tates apportion income by formula ... out of practical necessity – they simply cannot administer the arm's length method".⁴⁶ The magnitude of the costs involved in complying with the arm's length/separate-geographic-accounting standard is illustrated by the fact that Exxon spent USD 25 million in fees to outside counsel, legal experts and witnesses in a single transfer pricing case involving the question of whether the Internal Revenue Service could allocate profits attributable to the excess of the market price of comparable crude oil over the Saudi official selling price.⁴⁷

6.2.3. Opportunities for tax avoidance

In the context of a group of commonly controlled corporations, where the use of formula apportionment necessarily implies the use of consolidated or combined reporting, it is apparent that formula apportionment is much more effective than the arm's length/separate-geographic-accounting standard at combating tax avoidance strategies. As suggested above,⁴⁸ one of the principal benefits of a regime that employs formula apportionment and consolidated/combined reporting is that it permits substance to prevail over form with respect to allocation of income among states. Regardless of the form of the business organization, and regardless of transactions between commonly controlled members of a corporate group, the income apportioned to a state under a consolidated/combined reporting regime remains the same, because it is based on the consolidated/combined income and consolidated/combined factors of the group and is unaffected by intercompany transactions among members of the group. In particular, combined reporting is an effective antidote to the use of separate corporate entities to achieve tax savings that are available to taxpayers under regimes that adopt the arm's length/separate-geographic-accounting standard.

By contrast, in regimes where the arm's length/separate-geographic-accounting standard prevails, commonly controlled corporations enjoy substantial opportunities to achieve tax savings by adjusting transfer prices within the controlled group. Needless to say, such commonly controlled groups take advantage of those opportunities – they would be derelict in their duties to their shareholders if they did not – to minimize their worldwide tax liabilities. They spend billions of dollars annually to lawyers, accountants, economists and other consultants in pursuing these efforts, which often are successful. Although formula apportionment coupled with consolidated/combined reporting does not eliminate all multi-jurisdictional tax planning, especially when different states adopt different rules with regard to the apportionable tax base or the

apportionment factors, these opportunities are significantly more limited than they are under an arm's length/separate-geographic-accounting regime.

6.2.4. Globalization and the growth of e-commerce

It is a commonplace to observe that the increasing globalization of the economy, spurred in significant part by the growth of e-commerce in business-to-business transactions, poses a significant challenge for application of the arm's length/separate-geographic-accounting standard and makes formula apportionment a more attractive alternative to income allocation. As my distinguished copanellist Jeffrey Owens observed in what – measured in cyberspace time – may seem to be the dark ages of the e-commerce era, "the communications revolution stands to put great pressure on the transactional and comparability principles that are the bedrock of the arm's length principle as now interpreted by OECD".⁴⁹ Needless to say, Jeffrey Owens did not embrace formula apportionment as the solution to this problem. Nevertheless, he did go on to observe that the pressure might lead to "greater use of the profit split method, where external comparable data is less important"; that "there could be a softening of the transactional principle, on the grounds of practicality"; and that the OECD Transfer Pricing Guidelines:

... are perhaps a bit prescient in seeing "continuous" transactions as eligible for aggregation – electronic continuity is most familiar in the area of innovative financial transactions, e.g. global trading, where the profit split method is often advanced as the most fitting solution.⁵⁰

Again, one may suggest that formula apportionment by any other name would smell as sweet.

6.2.5. International norms

One of the principal "practical" arguments advanced by those favouring the arm's length/separate-geographic-accounting standard over formula apportionment is that the former standard reflects accepted international norms and that adoption of formula apportionment would disrupt established modes of tax administration and taxpayer expectations.⁵¹

There are at least two responses to this point. First, there is room for debate over the extent to which the arm's length/separate-geographic-accounting standard is, or ever has been, an internationally accepted norm. Nearly two decades ago, one veteran of the US Treasury's Office of International Tax Counsel argued that the arm's length method "is not and never has been an internationally accepted norm"; that "it is simply the product of a cam-

45. Hellerstein and Hellerstein, note 15, Para. 8.03.

46. McIntyre, note 11, Sec. 2.2.

47. *Exxon v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993), aff'd sub-nom. *Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996), cert. denied, 520 US 1185 (1997); Charles Gustafson, Robert J. Peroni and Richard Pugh, *Taxation of International Transactions* (2d ed. 2001), at 632, n. 1.

48. See sec. 5.

49. Jeffrey Owens, "The Tax Man Cometh to Cyberspace", at 24, in Symposium, Harvard Law School International Tax Program, *Multijurisdictional Taxation of Electronic Commerce* (5 April 1997).

50. *Id.*

51. OECD Transfer Pricing Guidelines, note 40, I-1 to I-6.

paign by the federal government to have that norm accepted"; and that "the true norm is to use 'comparable uncontrolled prices' where comparable uncontrolled transactions can be found" and "[w]here such transactions cannot be found, the true norm applies formulary apportionment".⁵²

Second, even if historically the arm's length/separate-geographic-accounting standard may have been the internationally accepted norm, formulary apportionment has increasingly become an accepted method for income allocation. Beyond the case of global securities trading discussed above,⁵³ one observer, who advocates a formulary methodology of "global profit split" as the solution to the problem of international income allocation, has noted the "steady drift toward formulary allocation",⁵⁴ including the following:

- use of formulary apportionment in advanced pricing agreements in the United States;
- use of formulary apportionment in cost contribution arrangements under the OECD Transfer Pricing Guidelines and cost-sharing agreements in respect to research and development and other activities in the United States;
- use of formulary apportionment in connection with thin-capitalization rules in the Canada, Japan and the United States;
- use of formulary apportionment in attributing profit to a PE under Art. 7(4) of the OECD Model Treaty;
- use of formulary apportionment in defining and allocating costs; and
- use of formulary apportionment in determining a taxpayer's liability under domestic laws.⁵⁵

6.2.6. Defining the apportionable tax base, the consolidated group and the apportionment factors

The practical case for formulary apportionment is not without its own difficulties. The three most salient problems are the delineation of the apportionable tax base; the definition of the group of entities whose the consolidated or combined income of which is to be apportioned; and the choice of apportionment factors in the formula. Wholly apart from the question of how one should resolve these problems on their merits – and Charles McLure and I have expressed our views on these matters elsewhere⁵⁶ – the threshold question with which this symposium is concerned is whether the absence of a global agreement on these issues is a "show stopper". In other words, one might argue that whatever may be the other theoretical and practical advantages of formulary apportionment over the arm's length/separate-geographic-accounting standard, the resulting inconsistencies between different states' varied approaches to the tax base, the consolidated group and the choice of apportionment factors would create complexity, uncertainty and double taxation of a magnitude that outweighs the foregoing objections to the arm's length/separate-geographic-accounting standard.

There are several responses to this point. First, it is plainly a matter of judgment as to whether the uncoordinated adoption of formulary apportionment by individual states would lead to an increase in global utility. The answer to that question would presumably turn on how one weighs

the various gains and losses from the uncoordinated change that might see increased complexity for some, greater simplicity for others, a reduction in tax avoidance in some states and more instances of double taxation in others.

Second, even if the costs of uncoordinated adoption of formulary apportionment outweigh the benefits in the short run, it still may be the appropriate policy in the long run, if these uncoordinated actions lay the groundwork for a new international consensus as to the acceptability of formulary apportionment and to the essential features of the formulary regime. Indeed, based on the foregoing discussion, one may argue that the consensus building has already begun, albeit in small and still largely unacknowledged steps.

Third, the political and economic context in which formulary apportionment is implemented does matter.⁵⁷ The case for formulary apportionment is strongest where economic integration and political coordination are greatest. The final section of this paper therefore evaluates the case for formulary apportionment in light of these contextual considerations.

7. CONTEXTUAL CONSIDERATIONS

7.1. Subnational states in a federal system: Canada, Switzerland and the United States

It should come as no surprise that formulary apportionment has long functioned successfully as a mechanism for allocating income among taxing jurisdictions in the context of income allocation among subnational taxing units of federal states, such as Canada, Switzerland and the United States. The reason is self-evident: the economic and political context in which multi-jurisdictional taxation occurs is particularly well suited to – if it does not virtually compel⁵⁸ – the formulary approach. There is a single internal market with a single currency, a single set of rules governing cross-border commercial behaviour and lines between taxing jurisdictions are largely devoid of economic significance. Even if books and records are maintained on a provincial, cantonal or state-by-state basis, they often will lack the transactional detail necessary to support an arm's length/separate-geographic-accounting analysis without enormous additional expense.⁵⁹ Further-

52. Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length", 30 *Tax Notes* 7 (17 February 1986), at 625.

53. See sec. 4.

54. Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), at 607.

55. Id., at 607-612.

56. Walter Hellerstein and Charles E. McLure, Jr., "The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States", 11 *International Tax and Public Finance* 2 (2004), at 199.

57. For an elaboration of this point within the US/EU context, see Walter Hellerstein and Charles E. McLure, Jr., "Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Tax Proposals", 58 *Bulletin for International Fiscal Documentation* 3 (2004), at 86.

58. See sec. 6.2.2.

59. Hellerstein and Hellerstein, note 15, Para. 8.03.

more, there is likely to be the political power, if not always the political will,⁶⁰ to assure the existence of a uniform tax base and uniform apportionment formula. Finally, the existence of a national income tax base provides a ready template for a uniform subnational base, which (as in the United States) may create political pressures for the states to conform to the base even though it is not imposed upon the states by the national legislature.⁶¹

7.2. Sovereign states bound by a common legal framework: the European Union

In a union of sovereign states bound by a common legal framework like the European Union, conditions would also appear to be ripe for the application of formulary apportionment for many of the reasons set forth in the preceding paragraph. Although some of the features of a seamless internal market that characterize a federal state like the United States may still be aspirational in the European Union, the case for formulary apportionment is nevertheless compelling in light of the substantial economic integration of the EU economies and EU companies engaged in cross-border activity.

There are, however, important contextual differences between the United States and the European Union that are likely to influence the delineation of the apportionable tax base and the choice of apportionment factors. The European Union has no pre-existing template equivalent to the US corporate income tax as the model for the choice of a tax base, nor federal constitutional restraints that limit the application of the apportionment formula to income derived from a unitary (i.e. economically integrated) business.⁶² Hence, the EU Member States are freer to determine the apportionable tax base than were the US states, but such "freedom" may make the determination of a tax base politically more difficult. On the other hand, the substantial freedom that the US states have enjoyed to define their own apportionment factors has led them in recent years to design their factors to attract in-state investment. As Charles McLure and I have noted elsewhere:

If there is a lesson for the European Union in the US states' experience with the choice of apportionment formulas, perhaps it is the manifestation of the strong tension that exists between what may be regarded from a collective viewpoint as a defensible formula for fairly dividing the income tax base among the states and a formula that maximizes an individual state's economic interests in attracting business investment.⁶³

In this respect, the European Union is in a position to improve considerably upon the situation in the United

States by designing and overseeing implementation of a uniform and equitable apportionment formula.

7.3. Sovereign states subject only to "international norms"

I come finally to the truly international context, where there is no overriding federal authority nor even a common legal framework binding sovereign states. There are simply international norms that operate to guide the behaviour of wholly independent states. In this context, the case for formulary apportionment turns largely on the question of whether our tax rules should follow the centripetal forces of an increasingly global economy or the centrifugal forces of politically sovereign states. My sense is that the former will ultimately prevail over the latter. Although it may be a long time in coming, it is likely to come (as it is already coming) in fits and starts, and there may never be (and, perhaps never should be) a one-size-fits-all solution to the problem of income allocation.

8. CONCLUSION

In the end, the case for formulary apportionment rests on the belief that cross-border economic activity is becoming increasingly integrated and that efforts to identify the source of the income that such activity produces on a transactional basis is theoretically questionable and practically inadministrable. It is reinforced by the view that the purpose of the income allocation provisions is not to identify the "true" geographic source of income (assuming such a "true" source exists) but to effectuate an equitable allocation of income. If our tax rules are to reflect the underlying economic reality to which they apply, the arm's length/separate-geographic-accounting standard will ultimately yield to formulary apportionment as the preferred method of income allocation in the 21st century.

60. As in the United States, where, in the absence of any congressionally imposed requirements of uniformity, there is considerable diversity in the states' choice and weighting of apportionment factors. Hellerstein and McLure, note 57, at 95.

61. See Hellerstein and McLure, note 57, at 91.

62. See generally Hellerstein and McLure, note 56; Hellerstein and McLure, note 57.

63. Hellerstein and McLure, note 57, at 95.