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Reform Proposal: Uniform Source Withholding Tax and Global Profit Split

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Jinyan Li, "Reform Proposal: Uniform Source Withholding Tax and Global Profit Split"

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International
Taxation
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A Comparative
Study

This is chapter 13 of *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Canadian Tax Foundation 2003). It is now posted on SSRN to contribute the debates on the taxation of digital business.

Reform Proposal: Uniform Source Withholding Tax and Global Profit Split

Introduction

Previous chapters have discussed the existing international tax system, its application to electronic commerce, its main problems, and various proposals to deal with those problems. This chapter proposes a coherent, simpler system of taxing international income in an integrated, digital world.

This chapter first presents a case for a re-evaluation of the fundamental concepts and principles of international taxation in light of the challenges posed by electronic commerce. It also argues that inter-nation fairness should be the primary policy objective of any improvement(s) to the present system and that single taxation should be the guiding principle.

The chapter then proposes a system that consists of a uniform withholding tax (UWT) at source on portfolio income, and a global profit-split (GPS) method for the allocation of cross-border business profits. The proposal is based on some tried and true ideas: source withholding tax has been levied in most countries from the very beginning of international taxation, and formulary allocation of profit was widely practised in the world until the 1940s and is currently used in certain situations where traditional transfer-pricing methodologies do not work well. Although the two elements complement each other in achieving inter-nation fairness and ensuring single taxation of international income, they can be introduced separately.

Most of this chapter discusses the technical design issues and policy assessment of the proposed UWT and GPS and evaluates whether each or both proposals can be implemented from legal, political, and practical perspectives.

Re-Evaluation

The Need for Re-Evaluation

The need to re-evaluate the fundamental issues of international taxation arises from the problems that are aggravated by the rise of electronic commerce. As explained in previous chapters, these problems are not unique to electronic commerce, so any solution lies in fundamental tax reform. The beginning of the 21st century, with an increasingly global economy, offers a golden opportunity

to re-evaluate and reform the international tax system, which is largely a creature of the industrial age at the beginning of the 20th century.

Furthermore, it may be inevitable to revisit the rules of the game now that the players are different. Other than the United States, the five jurisdictions in this study were not active players at the table when the original international tax order was developed.¹ Canada and Japan came to the table subsequently. China, Hong Kong, and Singapore are not yet at the table, nor are most of the world's nations. It is reasonable to expect that many countries, desiring to receive their fair share of the fruits of the global economy, want to be at the table.

The need for re-evaluation has been advocated by numerous commentators. Richard Bird writes that the "present [tax] treatment of international capital flows is inefficient and inequitable, almost irrespective of how one defines those words."² Jack Mintz³ and others⁴ foresee the eventual demise of corporate income tax unless something is done to salvage it. David Tillinghast echoes that point by saying that reform efforts must be made because the alternative could be a fundamental breakdown of the international tax system.⁵ Other commentators, however, are more cautious. For example, Michael Graetz writes:

[T]he international income tax system lurches from one perceived threat to another: transfer pricing abuses yesterday, "harmful" tax competition and under-reporting of portfolio capital income today, and who knows what tomorrow. Despite the obvious strain, the wheels do not seem to be coming off, at least not yet. In fact, the international tax system has served reasonably well; it has not proven a significant barrier to the international flows of goods, services, labour, or capital, and may even have facilitated such flows. This no doubt is why it has survived intact for so long.⁶

Nevertheless, Graetz argues that the time has come for a fundamental re-examination of the system of international taxation and the principles and concepts on which it is based.

Theoretical Foundation

As explained in chapter 2, the economic allegiance theory and benefit theory provide a foundation for the current international tax system. Both theories remain valid in the world of electronic commerce, and need to be reapplied in order to give meaning to their original intent and scope.

According to the economic allegiance theory, the basis for determining a country's jurisdiction to tax international income is the taxpayer's economic allegiance to that country.⁷ Economic allegiance may be established by examining where wealth is acquired, located, and consumed and where the rights to wealth are enforced. The League of Nations economists regarded the acquisition (or origin) of wealth and the residence (or domicile) of the owner who consumes the wealth to be key factors. They imagined that both the origin of wealth and residence of the owner would be determined by economic factors. For example, the origin of wealth is to be considered in light of the original

physical appearance of the wealth and its subsequent physical adaptations, transportation, direction, and sale. Under the economic allegiance theory, therefore, both the country where income originates and the country where income is consumed have the jurisdiction to tax the income.

The current system of international taxation (as embodied in the OECD model⁸) fails to reflect fully the economic allegiance theory. This failure is biased against source countries, because

- it deprives the country where business income originates of the jurisdiction to tax the income, unless it is earned through a permanent establishment;
- it denies source-country taxation of royalties;
- it does not recognize consumption or place of sale as a factor in establishing jurisdictional nexus; and
- while limiting source-country taxation, it provides the residence country with the residual right to tax income.

In order to overcome the bias against source countries, all four factors underlying economic allegiance should be employed in determining tax jurisdiction so that a country where one of the factors is located is entitled to share in the taxation of the income. In addition, the current place of residence (especially for corporations) is not the equivalent of place of consumption as envisaged by the League of Nations economists. Therefore, the place of consumption should be given specific recognition in the allocation of tax jurisdictions. In the context of electronic commerce, this factor is crucial in ensuring that countries that provide a consumer base are entitled to tax income earned by foreign vendors.

The bias against source countries also violates the benefit theory, because taxpayers that benefit from the public services provided by source countries are not required to pay taxes in those countries. The benefit theory posits that the country that incurs expenditures in providing the infrastructure for income-producing activities is entitled to tax income from the activities.⁹ Income-earning activity is viewed as a “joint venture” between taxpayers and the society in which income is earned¹⁰—taxpayers benefit from the infrastructure, legal environment, and consumption base supported by expenditures incurred by both source and residence countries, and are thus expected to contribute to the financing of these expenditures.¹¹ Countries that provide a market for products and services and countries that provide a production base are entitled to tax profits from the sale of the products or services.

The economic allegiance theory and benefit theory thus provide justifications for tax claims by both residence and source countries. Residence-based tax claims are particularly strong in the case of investment income and income earned by individuals, whereas source-based tax claims are strong in all cases, especially in the case of business profits. The proposed uniform UWT on portfolio income and GPS for business profits overcome the bias against source taxation and allow both residence and source countries to obtain a fair share of the international tax base.

Guiding Principles

International taxation is designed to deal with the fundamental question of how countries share the taxation of international income. This question involves the determination of the international tax base and the level of sharing between countries. Ideally, international income should not be taxed either more or less than income earned domestically, and the tax on international income should be shared fairly by countries that are entitled to tax that income. In other words, the guiding principles in international tax law should be the principle of single taxation and inter-nation fairness.

Principle of Single Taxation

Under the principle of single taxation, “[I]ncome from cross-border transactions should be subject to tax once (that is, neither more nor less than once).”¹² This principle incorporates the traditional goal of avoiding double taxation and current international efforts in preventing international undertaxation.¹³

The principle of single taxation does not necessarily mean that cross-border income can be taxed in only one country (either the source or the residence country). Instead, such income may be taxable in both source and residence countries as long as the total level of taxation does not exceed the level of taxation in the residence country. The rate of source-based taxation should not exceed the rate of the residence-based taxation so that both countries can share the taxation of cross-border income without causing overtaxation.

The proposed UWT and GPS are consistent with the principle of single taxation because they ensure that portfolio income is not free of taxation worldwide and profits from globally integrated businesses are allocated among countries in accordance with a generally accepted formula.

Inter-Nation Fairness

What Does “Inter-Nation Fairness” Mean?

Inter-nation fairness requires that “fair shares” of the international tax base be allocated among countries.¹⁴ It should be the primary objective of international taxation and should override other policy objectives, such as capital export neutrality, capital import neutrality, and inter-taxpayer equity, which are often conflicting and unsatisfactory in theory and in practice.¹⁵

The advocacy of inter-nation fairness raises three questions:

- 1) What constitutes “fairness”?
- 2) What does this principle encompass?
- 3) Why should it be the primary policy objective of international taxation?

The meaning of “fairness” in the context of international taxation may be controversial, because countries do not always see it in the same light. Dictionary meanings of the word “fair” include “free from dishonesty or injustice” and

“that [which] is allowed to be done, given, etc. as under the rules of a game.”¹⁶ Tax fairness in public finance literature has a specific meaning—the distribution of the tax burden among individuals,¹⁷ or inter-individual (taxpayer) fairness. Inter-nation fairness means something more and something different.

In the context of this chapter, the notion of inter-nation fairness encompasses four elements: tax entitlement, a fair level of source taxation, fair dealing among nations, and the fair redistribution of international income among countries. Therefore, as discussed in chapter 12, “inter-nation fairness” has a broader meaning than the traditional notion of “inter-nation equity,” which is concerned with only the first two elements.¹⁸

The first element, tax entitlement, deals with the question of which country is entitled to share in the international tax base. Entitlement would be considered “fair” if a country that claims jurisdiction to tax international income has made economic contributions to the earning of that income under the economic allegiance theory or the benefit theory. In this sense, both residence and source countries are entitled to claim tax jurisdiction.

The second element of inter-nation fairness is a fair level of source taxation. This element concerns the level of sharing among jurisdictions, which is determined not only by the base but also by the rates. In general, tax rates should be determined by domestic tax policy concerns, such as revenue needs, though they would likely be affected by the principles of non-discrimination, international comity, or tax competition. In the case of business profits earned by multinational enterprises (MNEs), the proposed GPS method would allocate a share of the global income to each country according to a commonly accepted formula. The source country would tax the allocated income at the same rate applicable to resident taxpayers. In the case of portfolio income, the rate of source withholding tax would be set so as to recognize the taxing rights of the source country and allow fair sharing with residence countries, as well as help curb non-taxation through the use of intermediary tax haven entities.

The third element of inter-nation fairness is fair dealing among nations. While protecting its sovereignty, a nation would work cooperatively with other nations toward the goal of a fair sharing of the international tax base. It would discourage a “race-to-the-bottom” type of tax competition or a “beggar-thy-neighbour” tax policy. Moreover, inter-nation fairness would require fairness in the international tax policy process: the process would have to be opened up to allow countries to participate.

The fourth element of inter-nation fairness is the fair redistribution of international income among countries. Redistributive income taxation of taxpayers living in the same country on the basis of the ability-to-pay principle can be justified by considerations of vertical equity and the declining marginal utility of income.¹⁹ Globalization may have increased the need for inter-nation redistribution of income.²⁰ Reuven Avi-Yonah argues that “there appears to be no sound theoretical reason to restrict redistribution to members of any single tax jurisdiction.”²¹ According to Avi-Yonah, if there were a world taxing authority, it would be justified in redistributing wealth on a worldwide basis. Peggy

Musgrave and Richard Musgrave also envision an inter-nation redistribution system through the design of tax rates.²² Peggy Musgrave writes:

For instance, the tax share in profits earned by non-residents might be allowed to rise inversely to the level of per capita income in [the source jurisdiction] and directly in relation to per capita income in [the residence jurisdiction]. Such a scheme would be of particular interest in the relation between developed and developing countries.²³

However, inter-nation redistribution of income has not been widely espoused, even by proponents of inter-nation equity.²⁴ No nation has ever made a genuine commitment to worldwide equity.²⁵ Graetz notes that in the absence of a world government, the fact remains that “the freedom and independence, as well as the economic welfare, of people varies from nation to nation.”²⁶ He argues against having a world government on the ground that it “would likely become a dictatorship.”²⁷

Given this author’s preference for an incremental approach to international tax reform, the principle of inter-nation fairness underlying the current proposal would not mandate worldwide redistributive income taxation, but would welcome it if the appropriate political climate existed.

Why Should Inter-Nation Fairness Be the Primary Policy Objective?

Inter-nation fairness should be the primary objective of international tax policy for several reasons. The first reason is historical. The concern in removing the “evils” of international double taxation while nations share the international tax base was the original driving force for the international tax system. Inter-taxpayer equity, although important for a particular country to decide whether to adopt residence-based or source-based taxation, has never been a dominant concern in the division of the tax base between countries. The reason is that inter-taxpayer equity is limited by national boundaries, and, more important, it does not directly speak to the players in the international tax “game”—nation states. Consequently, inter-taxpayer equity has not been and cannot become the main objective or guiding principle of international taxation.

Historically, capital export or import neutrality has not successfully influenced world tax policy, even though much of the economic literature on international taxation (especially in the United States) may be seen as attempting to exhort the virtues of world efficiency as a goal of tax policy.²⁸ A questionable exception might be the introduction of subpart F rules in the United States, because this coincided with the perceived interests of both important public and private sector players. This exception is questionable because, as pointed out by some of those involved in enacting the subpart F rules,²⁹ capital export neutrality had little to do with the rules. Therefore, experience strongly suggests that inter-nation fairness operates as a more critical element in international policy making.

The second reason is political. Treaty law is the result of negotiations between countries. According to Bird and Mintz, real-world arguments are

rarely about efficiency, but rather about what is perceived to be fair.³⁰ The existence of the UN model³¹ indicates the importance of this issue: developing countries attempted to obtain a bigger share of the international tax base through “collective bargaining” when they concluded that their share under the OECD model was inadequate. Furthermore, national governments are primarily accountable to their own citizens. It is unrealistic to ask a nation to choose worldwide economic efficiency over the alternative of benefiting its own economic efficiency and residents.³²

The third reason is pragmatic. Inter-nation fairness and the principle of simplicity and administrative efficiency are not mutually exclusive. Improvement in simplicity may also effect improvement in inter-nation fairness. This point will be argued further in the context of the proposed UWT and GPS.

Finally, inter-nation fairness respects the principle of sovereignty. While a broadly defined inter-nation fairness concept provides a coherent guiding principle for the division of the tax base, it leaves the issue of distribution of tax burdens within a country to be decided in accordance with domestic policy objectives.

Reconceptualization

The current concepts of residence, characterization of income, source of income, and permanent establishment have many problems, which have been identified in chapter 12. Reconceptualization is thus necessary to retain the viability of these concepts in the world of electronic commerce.

In the case of corporate residence, the concept may be reconceptualized on the basis of the proposals described in chapter 12. Ideally, corporate residence should be based on substantive economic connections, such as the place of central management and control, the location of assets, and the residence of majority shareholders. No matter which test is adopted, uncertainty exists. In order to minimize this uncertainty, the proposed GPS method would allocate business profits to each country in which economic factors (such as assets, payroll, and sales) are located. The UWT would also reduce the reliance on corporate residence by taxing portfolio income at source. Under the proposal, corporate residence remains relevant only in limited circumstances (for example, the determination of whether a corporation is entitled to treaty benefits and sources of portfolio income).

The characterization of income remains relevant, but it needs to be rationalized and simplified. Under the proposed system, income would be characterized as either “business profits” or “portfolio income.” Business profits would include payments of portfolio income between related corporations. Portfolio income would include dividends, interest, rent, royalties, and capital gains.

Source rules and the notion of permanent establishment should be reconceptualized on the basis of the economic origin of income. The source of portfolio income, the territorial location of the economic factors under the GPS method, and the permanent establishment concept are explained in more detail below.

Reform Proposal: An Overview

The Proposal

The reform proposal has two components. The first component is a UWT applicable to portfolio income. The UWT would be a final tax if the taxpayer is not subject to residence-based taxation on the same income, and a creditable tax if the income is also taxable in the residence country. The rate of withholding tax would be reduced by tax treaties so that source and residence countries can share the taxation of international portfolio income. The residence country would have the option to apply anti-avoidance rules to portfolio income channelled through tax haven intermediaries (such as the foreign investment entities rules in Canada³³ and the passive foreign investment company [PFIC] rules in the United States³⁴). In that case, source withholding tax should be imputed to the domestic investor in order to prevent overtaxation.

The second component of the proposal is the GPS method applicable to business profits earned by MNEs. Business profits would be allocated to each jurisdiction where income-earning activities take place and taxed in the country to which they are allocated.

The proposed system assumes that countries continue to rely on income taxation as a useful instrument for raising revenue and redistributing social income. It also assumes that a country asserts as much sovereignty in tax policy as possible without endangering its economic relations with other countries.³⁵ Despite the growing difficulty in applying territorial-based tax laws in a “borderless economy,”³⁶ it is unlikely that nation states will surrender tax sovereignty in return for a global tax system.

While each country wants to retain tax sovereignty, more effective international tax cooperation will be expected and indeed demanded in the new international tax order. Not only should tax rules be redesigned, tax enforcement powers should be less restricted by national borders. Otherwise, the tax system will be “gamed”³⁷ by taxpayers as transactions circle the globe in milliseconds over the Internet, and tax inspectors remain chained to the borders of each country.³⁸ Interestingly, international cooperation will help nations preserve national control over tax policy and thus strengthen their fiscal sovereignty. As Benjamin Franklin proclaimed when he signed the US Declaration of Independence: “We must indeed hang together, or most assuredly we will all hang separately.”³⁹ The wisdom of this proclamation may be driving the OECD-led harmful tax competition campaign. It is fair to assume, however, that tax havens will continue to exist and have no interest in cooperating with other countries. The utility of tax havens as bases for avoiding taxes can be removed only through effective source withholding and GPS.

Finally, the proposed system has several limitations. It does not deal with the issue of imputation.⁴⁰ Nor does it address questions of technical administration.⁴¹ It is hoped that the technological changes that facilitate electronic commerce and create the challenges to the existing taxation framework also provide new opportunities for improving tax administration.⁴²

Simpler and Fairer

The proposed system would be simpler than the present system because (1) the number of income categories would be reduced to two (portfolio income and business profit), (2) transfer-pricing rules would be replaced by the simpler GPS method; and (3) the rules with regard to controlled foreign corporations (CFCs), thin capitalization, and surplus stripping would be unnecessary.

The proposed system would be more equitable in terms of inter-nation fairness because income would be allocated to, and taxed in, countries that contribute to the earning of such income. Both source and residence countries would share the taxation of international income, and the opportunity for tax avoidance or evasion would be significantly reduced.

Evolutionary and Pragmatic

The proposed system respects the aphorism *natura non facit saltum*—nature makes no sudden leaps.⁴³ It is an evolutionary proposal⁴⁴ and is therefore different from other proposals that would replace income taxation with a consumption-based tax such as the “X-tax”;⁴⁵ replace corporate income taxation with consumption-based taxation of multinationals⁴⁶ or some other form of cash flow or consumption tax;⁴⁷ or turn over the international tax problem to some higher, and presumably wiser, supernational authority such as an international tax organization⁴⁸ (most recently proposed by authors of a UN report⁴⁹). On the whole, the revolutionary approach seems overly ambitious, even utopian, and perhaps unnecessary.⁵⁰

The proposed UWT and GPS are based on some old ideas of international taxation. Withholding taxes have always been imposed by countries on investment income earned by non-resident taxpayers primarily because these taxes are easier to enforce. Formulary apportionment of profits between jurisdictions was widely used until the arm’s-length principle became the dominant principle and is used by subnational governments in Canada and the United States. As explained in more detail later this chapter, in recent years there has been a growing movement toward the use of formulary allocation.

The proposal is also pragmatic. Pragmatic concerns have shaped the current international tax system, and they will undoubtedly influence its development in the future. The history of international income taxation attests to this. As explained in chapter 2, although the economic allegiance theory provided a foundation for international tax law, it has not been fully implemented. The League of Nations model conventions were developed by tax administrators who relied more on previous bilateral tax treaties (which were, of course, negotiated by tax administrators) than on the economic allegiance theory or the recommendations of the League of Nations economists.⁵¹ When the OECD took over the work on bilateral treaties in 1956, it relied on previous models and the recent treaty practices of its member countries in order to develop the OECD model.⁵² A worldwide reliance on source withholding tax as a means of taxing investment income earned by non-residents is also explained by the fact that withholding tax is easier to enforce.

Uniform Withholding Tax

The proposed UWT is intended to perform two duties: protect the source country's tax base and curb international tax avoidance through the use of tax haven intermediaries. Its design draws from the writings by Richard Doernberg,⁵³ Avi-Yonah,⁵⁴ the eComTaxpert Group of India,⁵⁵ and some others.⁵⁶ Salient aspects of this proposal are discussed below.

Tax Base: Portfolio Income

The proposed UWT would be imposed on portfolio income. Portfolio income typically includes dividends, interest, rents, royalties, and capital gains earned by taxpayers from portfolio investment (as opposed to direct foreign investment). Payments of dividends, interest, rents, or royalties between related corporations would not be treated as giving rise to portfolio income, but rather as business profits subject to the GPS method.⁵⁷

The source of portfolio income could be based on either the base-erosion test or the residence-of-payer test. The base-erosion test⁵⁸ sources portfolio income to the country whose tax base is reduced by the deduction of the payment of the income. The domestic source rules in Canada and Singapore adopt this approach in certain cases.⁵⁹ The OECD model adopts this approach in respect of interest payments borne by a permanent establishment. In most cases, payers of portfolio income are entitled to deduct the payment in computing their income from business or property and, therefore, a payer's country of residence would be the source country. However, in cases where a payer is not entitled to deduct the payment—as in the case of payments made by individual customers, government bodies, or tax-exempt entities—the base-erosion approach fails to assign the source of portfolio income to the payer's country of residence.

The residence-of-payer test sources portfolio income to the payer's country of residence. This is preferable in the context of the proposed UWT, because it is broader than the base-erosion approach. Most payers are businesses that deduct the payments, but are also government institutions, non-profit institutions, and individual consumers. The residence-of-payer approach is also the predominant method under existing treaty law and domestic laws for sourcing investment income. It generally coincides with the place-of-customer rule as proposed by Avi-Yonah.⁶⁰

The compliance concern with imposing the withholding obligation on non-business payers is a legitimate one, but only in respect of individual customers, because institutional payers generally have a withholding mechanism in place (if nothing else, payroll withholding). Determining the residence of individuals and institutions would generally be straightforward. If the residence of business payers is difficult to establish, the base-erosion approach could be used as a backup.

Rate

Because the proposed UWT is designed not only to protect source taxation but also to prevent the shifting of portfolio income to tax haven intermediaries, the

tax rate should be set to approximate the level of taxation in the taxpayer's country of residence. Because taxes in residence countries are imposed on a net basis and the proposed UWT is a gross-basis tax, the UWT rate should be much lower than the standard tax rate in residence countries. This rate would be reduced by tax treaties so that both residence and source countries can share the taxation of portfolio income. International overtaxation would be avoided through foreign tax credit mechanism in the residence country. In cases where the profit margin is slim and the gross-basis source withholding tax would result in excessive taxation, tax treaties could allow the taxpayer to elect to pay source-country tax on a net basis.⁶¹

Advantages and Disadvantages

The proposed UWT has at least four advantages over the current system. The first advantage is that it is theoretically correct. The UWT on portfolio income can be justified under the benefit theory because the earning of income benefits from the public services provided by the source country (including a market base and legal framework). It is also consistent with the economic allegiance theory because portfolio income could be viewed as originating, at least in part, in the source country. This argument is strengthened, moreover, by the fact that payments of interest, rent, and royalties are generally deductible by corporate payers in computing their profits and thereby reduce the corporate tax base of the payer's country.

The second advantage is that the UWT has the potential to curb international tax avoidance and tax evasion. It removes the tax incentives for using tax haven intermediaries, since capital is actually used in "real countries" and, thus, the income from capital would be taxed at least once in the source countries. To earn decent returns without incurring excessive risk, investors must use the markets in the European Union, the United States, Japan, China, and other countries. Stopping tax avoidance at the source level seems to be the most sensible and effective method.⁶² Moreover, the imposition of withholding tax at source on all forms of portfolio income would reduce opportunities for tax arbitrage by taxpayers through the use of hybrid or derivative financial instruments. In other words, if only certain types of portfolio income, such as dividends, are subject to withholding tax at source, taxpayers can use cross-border securitizations or derivative financial instruments to circumvent the tax by converting dividends into capital gains or interest.⁶³

The third advantage is that the UWT promotes inter-nation fairness by allowing both residence and source countries to share the taxation of portfolio income. If the country of residence adopts the foreign tax credit mechanism for double taxation relief, portfolio income would be taxable in that country to the extent that its tax level exceeds the source withholding tax. If the residence country adopts the tax-exemption mechanism, the withholding tax would be the only tax imposed on portfolio income. The bias against source countries under the current international tax system would be eliminated. More important, the proposed UWT would help residence countries that have the jurisdiction to tax

foreign portfolio income but have found it increasingly difficult to exercise this jurisdiction effectively. Because portfolio income is already taxed at source and this tax is creditable in the residence country, taxpayers would gain little tax advantage from non-reporting in the residence country.

The fourth advantage of the UWT lies in its effective enforcement. The UWT is better than other forms of tax collection because it can be efficiently administered. This is particularly attractive to developing countries, which often have limited tax administration and collection resources. All countries have experience with withholding tax. It is the only viable method of tax collection in cases where the taxpayer is physically out of the source country and has no assets located in the source country.

The UWT may, however, be challenged by arguments against traditional source withholding taxes imposed by individual countries. The first argument is that the UWT could result in excessive taxation. Excessive taxation occurs when a gross-basis withholding tax in the source country exceeds a net-basis tax in the residence country. This is true when profit margins are very small—for example, where interest is earned by financial institutions or portfolio income is earned by investors who finance the investment with borrowed money. This disadvantage could be addressed through treaty reduction of withholding tax rate and a net-basis election.

It has also been argued that source withholding taxes are economically inefficient on the grounds that they are “tariffs on cross-border investment” and interfere with marketplace efficiency by “raising the cost of imported capital in the country above the world market cost of such capital.”⁶⁴ This argument assumes that the incidence of withholding tax is borne by the payer rather than the recipient. However, this assumption is not true where the pre-tax rates of return are invariant with respect to withholding tax rates and investors/lenders expect to obtain full offsetting tax credits in the residence country. In this case, the incidence of withholding taxes falls entirely on the treasury in the residence country. The economic inefficiency criticism is valid, however, in the extreme case where pre-tax rates of return are grossed up one for one with the withholding tax and the incidence of the withholding tax is borne entirely by the payer of portfolio income.⁶⁵ Moreover, “no one claims that taxation in any form, source or residence, is a boon to economic activity.”⁶⁶ Source withholding tax on a gross basis is especially cumbersome and it is understandable why financial market participants often inveigh against such tax. However, this problem can be solved either by abolishing withholding taxes⁶⁷ or by imposing the proposed UWT at a reasonable rate. Assuming that the marketplace takes the tax into account, the advantages of the UWT vastly outweigh any irritants to cross-border capital movement.

Capital flight and tax competition concerns have also been raised as reasons for imposing no source withholding taxes on portfolio income. Indeed, Avi-Yonah found that “the principal reason for the lack of withholding taxes in most of the countries [including the United States] is the fear that if such taxes were imposed, capital would swiftly move to other locations that do not impose

a withholding tax.”⁶⁸ In the meantime, however, if source withholding taxes are adopted multilaterally and fully implemented by all countries (that is, if the proposed UWT is adopted), a source-based system with equal effective rates in all countries would, by definition, prevent tax competition and capital flight.⁶⁹ The “if” in the last sentence is a big one. Many transitional issues need to be resolved first.

Transitional Issues

There are three types of transitional issues that must be addressed before the UWT can be implemented: technical difficulties, a race to the bottom in tax policy, and political obstacles.

Technically, the proposed UWT would require modifications both to tax treaties and to domestic law. Conceptually, these modifications would be relatively easy. For example, the existing provisions in the OECD model concerning dividends, interest, and royalties could be consolidated into a single provision for portfolio income subject to source withholding tax. Practically speaking, however, amending each of some 2,000 bilateral tax treaties would be extremely difficult and time-consuming. To simplify the matter, the OECD could persuade its member countries to uniformly implement the measures and revise their treaties accordingly. Since the lion’s share of the world’s portfolio income is derived from OECD countries by residents of OECD countries, uniform adoption by these countries would be a marked improvement over the current situation.

A race-to-the-bottom type of tax competition among source countries will continue to be a big concern. Although OECD countries have acted in concert against “harmful” tax competition practices of non-OECD countries (mostly tax havens), OECD countries themselves are engaged in a race to the bottom in respect of exempting portfolio interest and royalties from source taxation. Such a race also occurs among non-OECD countries. If the United States were unwilling to abolish the exemption, others would certainly not change their policy for fear of capital flight. For this reason, uniform adoption of the proposed system would be unlikely in the absence of US support. Given that OECD countries are the world’s biggest source countries and the proposed UWT would benefit these countries the most, they may be persuaded to raise their withholding taxes on all forms of portfolio income to a standard rate of say, 25 percent (like Canada) and apply reduced rates where there is a treaty. Non-OECD countries may realize that imposing the withholding tax would not result in capital flight and may agree to follow suit. That should benefit net capital-importing countries, most of which are poorer countries that are afraid of raising their taxes in case they lose out in the competition for investment.

Traditional tax havens do not matter, because they do not have treaties and portfolio income paid into holding companies located in these havens would be subject to the proposed UWT at the standard rate. Treaty havens, such as Barbados, are problematic. These countries have treaties and offer “preferential tax regimes” (using OECD’s term)⁷⁰ and are used in treaty-shopping schemes. What

the world community could do is tell treaty havens either to remove their offshore regime or to agree to revise their treaties so that reduced treaty rates do not apply. Otherwise, OECD countries would terminate the treaties.

Finally, the non-taxation of portfolio income has been politically popular with three powerful allies: business enterprises seeking cheaper capital, the financial institutions that run the withholding system, and the increasingly large group of tax minimizers (evaders or avoiders) who supply much of the money.⁷¹ Bird wrote in 1988:

Change will not come easily, or soon, in the face of such opposition. But it must, in the end, occur—perhaps through a reassertion of the source principle—if anything like the present income tax is to continue to exist in this increasingly integrated world.⁷²

Global Profit Split: Major Design Issues

The proposed GPS method would allocate an MNE's global business profits to members of the MNE group by applying predetermined criteria.⁷³ The method is based on the existing profit-split methods and some elements of the traditional formulary apportionment method used by a number of US states⁷⁴ and Canadian provinces.⁷⁵ Major design issues in respect of the GPS are discussed in this section and tax policy and transitional issues are discussed in the two subsequent sections.

Basic Features

The proposed GPS method would treat an economically integrated business as a single entity for tax purposes. In this sense, it is similar to the "unitary system" used in California and some other US states. The GPS method would differ from the unitary system in the design of factors used to determine the profit split. Another difference relates to semantics. The unitary system, largely for political reasons, has a bad international reputation.⁷⁶ It does not illustrate the inadequacy of the worldwide allocation approach, but rather the non-viability of any approach that increases taxes on internationally mobile capital and is applied in only a few jurisdictions.⁷⁷ However, because the "word [unitary] alone makes other countries apoplectic,"⁷⁸ its use is deliberately avoided in this proposal.

The proposed GPS method differs from the existing profit-split methods in five ways:

- 1) The GPS method would use an explicit fractional apportionment method, rather than a case-by-case functional analysis approach. Although arbitrary, the GPS would be more certain. The factors chosen would represent the economic factors that contribute to the production of profit.
- 2) The GPS method would not be a transaction-based method, as that term is used in the OECD transfer-pricing guidelines, and thus it would avoid

the problems associated with the transactional approach. It would be necessary to define “integrated business,” but arriving at a definition would likely be no more difficult than finding the often non-existent “comparable transactions.”

- 3) The GPS method would directly allocate a firm’s total profit, as opposed to the current use of the profit split to establish arm’s-length prices, which are in turn used to determine profit. The GPS would thus reflect the purpose of article 9(1) of the OECD model in allocating profit among countries.
- 4) The GPS method would not require that an integrated business of an MNE group be compared with the business of independent firms. Consequently, it would reflect the unique nature of intrafirm transactions and would eliminate the practical difficulties of finding comparables. Profit would be allocated on the basis of contributions made internally by each participant in the business. The base of the allocation would be the total profit from the globally integrated business.
- 5) Given that all participants would be treated the same, the GPS method would apply equally to branches and subsidiaries.

Because of the expected opposition to the proposed GPS method on technical grounds—the devil is in the details—it is to these details that we now turn. The following discussion draws from the existing literature, especially writings by Bird,⁷⁹ Jerome Hellerstein,⁸⁰ Walter Hellerstein,⁸¹ Langbein,⁸² McDaniel,⁸³ McIntyre,⁸⁴ McLure,⁸⁵ Pomp,⁸⁶ and Weiner.⁸⁷

Scope of Application

“Integrated Business”

The definition of “integrated business” is critical to the proposed GPS method because it draws a circle around the total profit to be split. Bearing in mind that the main objective of the GPS is to ensure a fair allocation of the global profit from an MNE’s integrated business, the definition of “business” and “integrated business” should capture the economic value of integration and allocate it according to the formula. As in the case of “global dealing operations” in the proposed US regulations, what matters is an entity’s participation in the integrated business, not the legal form of the entity.

The term “business” may be defined on the basis of standard industrial classification categories or by reference to recognized lines of business. In defining the term “integrated business,” some useful lessons may be learned from the tests used for defining “unitary business” for the purposes of US state corporate income taxation.⁸⁸ These tests include the control test, the flow-of-value test, and the operational-interdependence test.

The control test could be based on legal ownership of equity or on de facto control of the business operations of a controlled entity. A bright-line legal

ownership test is perhaps easier to administer.⁸⁹ The control test may be used as the sole test because once an entity is considered to be under common control, all of its active income is deemed to be income from an integrated business. This test is arguably justified on the ground that unless an entity benefits from the economies of scale or contributes to the synergy of the whole MNE, it will likely be spun off and replaced by an outside supplier. Alternatively, the control test could be used in combination with the flow-of-value test or the operational-interdependence test.

Under the flow-of-value test, a business is integrated if there is a flow of value among the units under common control.⁹⁰ Under the operational-interdependence test, “a business is not unitary unless interdependent basic operations are carried on to a substantial extent in different states by the branches or subsidiaries that constitute the controlled enterprise.”⁹¹ “Interdependence” is determined by the flow of tangible goods, services, and, in some cases, intangibles. This test reflects the interdependence of the basic operations of units of an MNE. For administrative ease in implementing this test, a threshold could be required—say, one-third or one-half of the value of the flow of goods, services, or intangibles among units.⁹²

Both the flow-of-value test and the operational-interdependence test seem to involve a high degree of factual determination. MNEs are typically engaged in a variety of activities, some of which are part of an integrated business and some of which are not. Caution needs to be exercised in defining which activities are parts of an integrated business. Guidance may be drawn from countries’ experience in defining qualifying “cost-contribution arrangements,” “global trading,” or even the businesses covered by advance pricing agreements (APAs).

“Global Profit”

The definition of “global profit” determines the size of the pie to be divided among the participants in an integrated business, and hence the countries involved. Currently, there is no international agreement on the computation of profit. In general, however, global profit from each integrated business would be the excess of revenues over expenses allocable to the business. The measurement of the global tax base is not a problem unique to global formulary apportionment. Miller notes that it also exists under a residency system—in particular, in the implementation of the tax credit regime.⁹³

Global profit could be defined on the basis of financial accounting. MNEs that have their shares listed in multiple jurisdictions must now comply with financial reporting requirements in the listing jurisdictions. Current practices may provide guidance for the definition of global profit for GPS purposes. The definition might also be developed from certain principles that are commonly applied in the taxation of business income.⁹⁴ For example, revenues from the sale of goods and services are generally recognized on an accrual basis, and business expenditures, such as labour compensation, depreciation, interest, and purchased goods and services, are generally deductible in computing taxable income.

In computing the amount of revenues for the purposes of the global profit definition, only receipts from independent third parties in respect of sales of goods or services, or royalties from licences, should be included; intrafirm transactions should be ignored. With respect to expenditures, it would be necessary to decide whether all operating expenses incurred by all participants in carrying on the integrated business should be aggregated and deducted, or whether instead certain expenses should be dealt with separately. If all expenses are aggregated, global expenses would be divided under the profit-split formula. Although this approach is simple to administer, it may force one country to allow deductions for local day-to-day operating expenses incurred by a related party in another country, and some tax authorities may find this practice unacceptable.⁹⁵ Alternatively, “local expenses” might be excluded from the aggregate calculation and deducted by the relevant entity once a global profit has been allocated to each location. Local expenses could be defined as those expenses that are incurred locally and are not fungible. One example of a local expense is rent for office space.

Interest expenses are difficult to deal with because the existing rules on interest deduction vary from country to country, and the treatment for a branch may differ from that for a subsidiary. To allow for such differential treatment, interest expenses would be excluded from the computation of global profit and from the subsequent allocation among participating entities.⁹⁶ The disadvantage of this approach is that it would encourage MNEs to book interest in high-tax countries.

Finally, global profit would include not only business income derived from the integrated business, but also investment income attributable to the activities of that integrated business. Article 7 of the OECD model allows investment income to be taxed as business profits if it is attributable to a permanent establishment.

Formulary Allocation of Profit

Once global profit from a globally integrated business has been determined, the next step is to allocate the profit to each participant in the business by using an allocation formula. Factors in the formula may include payroll, sales, tangible assets, and intangibles. These factors have been used, to varying degrees, in traditional formulary allocation methods (discussed below). In addition, they are implicitly recognized in articles 5 and 7 of the OECD model. In article 5, the notion of permanent establishment is essentially defined as a place of business consisting of human capital and capital assets.⁹⁷ In article 7, the attribution of profit is based on the revenue (from sales of goods or services) and expenses arising from the business activities of the permanent establishment. The factors of human capital (indicated by payroll), assets (tangible and intangible), and revenue from sales thus underlie the current regime of taxing business profits earned through a permanent establishment.

Each participant in an integrated business would be allocated an appropriate percentage of the global profit. The appropriate percentage would be calculated

as the aggregate of payroll, sales, tangible property, and intangibles in the participant's taxing jurisdiction *divided by* the worldwide payroll, sales, tangible property, and intangibles.⁹⁸

These factors could be equally weighted, or perhaps more weight could be given to some factors than to others. For example, it may be considered that sales deserve more weight. Currently, some US states that apply formulary apportionment use sales as a single factor in the formula.⁹⁹ Economically speaking, "sales, if anything, are the more or most important factor in indicating the 'relative contribution' of a component to an enterprise's group profit."¹⁰⁰ A modified formula may apply to specified industries, such as financial services and transportation, among others.

The Factors

The design of the formula raises serious technical challenges. Each factor needs to be defined and sourced to a particular jurisdiction. Ideally, each factor should be readily quantifiable and locatable, economically justifiable as a determinant of tax liability, and not subject to artificial manipulation.¹⁰¹

Payroll

The payroll factor would reflect the cost of labour compensation. The formula could use total cost of labour compensation irrespective of legal form (for example, employer-provided insurance, pensions, and other social benefits, as well as contract employment).

The physical location of this factor could be the place where a worker works or has his or her base of operations. If a worker has no particular base of operations, the worker's country of residence could be used as the location of the payroll factor. If a worker has a base of operations in more than one country, payroll expense would be allocated to each country on the basis of the time spent in each country. For the purposes of the formula, the location of the employer is irrelevant because all workers work for the integrated business.¹⁰²

Sales

The sales factor would reflect the sales of products or services to parties that are not participants in the integrated business. It would also include transfers of property or services from an integrated business to non-integrated units of the same MNE. Such transfers would be treated as deemed sales at fair market value. In the case of intangibles (discussed further below), valuation may be very difficult. A "profit-sharing" or "superroyalty" type of rule may be necessary to ensure that research and development businesses fully participate in sharing the economic benefits resulting from the research and development.

The location of sales may be:

- for sales of goods, the place of “origin” (the seller) or the place of “destination” (the customer);
- for services, the place of the customer or the place where services are rendered; and
- for intangibles, the place of origin or the place of the payer.

In light of the threat to source taxation and contributions made by market jurisdictions to the earning of global profit, the use of place of origin as a sole test is not recommended. The place of destination may be used either as a sole test or in combination with the place-of-origin test. In the latter case, sales would be apportioned between the place of the customer and the place of the seller or provider.

Tangible Property

Tangible property is probably the most reliable factor in the GPS formula. It is reasonably easy to quantify and to locate geographically. The jurisdiction where tangible assets are located generally provides legal protection and infrastructure and is thus entitled to tax a portion of the income derived through the use of these assets. In determining the cost of the tangible assets of each component, in addition to the actual cost, each component may be allowed a “location savings” for the net production cost savings realized from operating in its jurisdiction.¹⁰³

Intangibles

Intangible assets are often difficult to quantify, much less value, and they are also very slippery to locate.¹⁰⁴ At the same time, much of the residual profit of integrated businesses may be derived from intangibles. They are the “crown jewels” of MNEs. Therefore, the treatment of intangibles is crucial to the design of the proposed GPS method. Intangibles are not identified as a separate factor under traditional formulary apportionment.

The definition of “intangibles” for the purposes of the proposed GPS method could be based on the existing definition in chapter VI of the OECD transfer-pricing guidelines.¹⁰⁵ Thus, the term would include commercial intangibles, such as patents and copyrights, and marketing intangibles, such as trademarks and trade names.

Both commercial intangibles and marketing intangibles may be measured by cost.¹⁰⁶ For commercial intangibles, cost would include expenditures on research and development and the cost of obtaining legal protection of the intangibles. For marketing intangibles, it would include the cost of advertising and marketing. However, using cost as a measurement of intangibles may be problematic for two reasons. First, there is no necessary link between cost and value.¹⁰⁷ Second, historic costs may be difficult to determine since valuable intangibles (especially marketing intangibles) may be created over a period of

years.¹⁰⁸ While the value of intangibles may alternatively be based on fair market value, this is difficult to establish on an annual basis.

The cost method has the virtue of being simple to apply. To some extent, the fair market value of intangibles is expected to be reflected in the sales factor. Proprietary technology used for the production of a product or the creation of a valuable trademark will be reflected in market prices fetched by the product made with such technology or bearing the trademark. Thus, it is arguable that using both the sales factor and the cost-of-intangibles factor in the formula would account for the lion's share of the contribution of intangibles to the profitability of the integrated business. It would also attribute this profitability to both the "production" jurisdiction (where cost is incurred) and the "destination" jurisdiction (where products or services are sold).

With respect to the location of intangibles, commercial intangibles could be sited to the country where research and development occurred, and marketing intangibles could be sited to the country where products or services are marketed. In many cases, the site will be the country where the cost is incurred and recognized for tax purposes. Therefore, the country where research or marketing is performed would receive some taxing capacity because that jurisdiction supported the people and property that produced the resulting intangible assets. Also, for the same reason, countries that grant intellectual property protection to those assets should receive taxing capacity.

In some cases, it would be very difficult to locate research and development cost when it is embodied in human capital or mobile assets. Consider, for example, the following case.¹⁰⁹ X Corp does research in the United States, where a Hungarian immigrant has a bright idea, and China, where Chinese scientists turn this idea into something potentially useful. Development is done in India, where computer whizzes and "cheap" engineers manage to develop a marketable product. The design is then sent to a Thai factory for further development by process engineers (who come from several different countries), and the final product is "developed" by Thai workers and managers. Finally, the product is manufactured in Nicaraguan and Moroccan factories for eventual sales in NAFTA and EU countries. What portion of the research and development cost should be allocated to each jurisdiction?

Similar difficulties exist with respect to locating the cost of marketing intangibles. Charles McLure explains the problem as follows:

Consider, for example, the value of intangibles such as the trademarks for a soft drink or the endorsement of sporting equipment by an American sports star. Should these intangible assets be attributed to (for purposes of calculating the property factor), primarily, the country in which the trademark was originally developed or in which the athlete performed, and not to the place where products are sold? Does it matter how much advertising is conducted in the market country? Does it matter that the product enjoys a monopoly position in the local market, perhaps because of government policy? In other words, is there a difference between intangibles based on R & D and those based simply on reputation and advertising (or on monopoly power)?¹¹⁰

Because of these difficulties, some proponents of formulary apportionment, such as McLure, conclude that since it is impossible to determine the situs of intangibles, perhaps intangibles should be ignored as a factor.¹¹¹ Otherwise, “if one wants to determine the location, as well as the value of intangible assets, one is likely to be forced into analysis similar to that under the separate accounting standard.”¹¹² Hellerstein also has argued against including intangibles in the formula, for two reasons: first, because intangibles are nebulous, with respect to location, benefits and protections furnished by the state, and social costs incurred; and second, because their inclusion could prove highly distorting.¹¹³

If intangibles were not a separate factor in the formula, the value of intangibles would be allocated on the basis of payroll, sales, and tangible property. This approach is still an improvement over the current system, because the residual profit would not be assigned to the “owner” of intangibles alone, but also to jurisdictions where payroll cost is incurred, sales are made, and tangible property is located. Often, commercial intangibles have only a notional existence, as ideas in people’s heads, or they are inherent in the capabilities of machines.¹¹⁴ To some extent, the cost of research and development would be reflected in the salaries paid to engineers, scientists, managers, and workers who participated in the research and development, as well as in expenditures on equipment purchased to carry out the research and development or the value of products produced with the intangibles. In the case of marketing intangibles, the cost would be reflected through increased sales.

Obviously, the treatment of intangibles is worthy of more study. At present, this author leans toward the inclusion of intangibles as a factor in the formula for the main reason that it would give technology-exporting countries specific recognition. As discussed in a later section, the current use of cost-sharing arrangements by some MNEs may offer practical assistance in tracing and valuing the cost of intangibles. Intangibles would be valued on the basis of cost and sited to the location where research and development activities occur. The market value of intangibles would be included in the sales factor. Possibly, the mobility issue mentioned earlier could be partially addressed by the payroll and tangible property factors.

“Throwout” Factors

In cases where factors are located in countries that have no jurisdiction to tax the global profit of an integrated business, or in countries that do not impose any income tax (such as traditional tax havens), these factors could be thrown out (omitted) from the formula.¹¹⁵ The profit that would otherwise be attributable to these jurisdictions would be captured by the formula and allocated to other participants.

Jurisdiction To Tax Global Profit

The proposed GPS method aims to allocate income from an integrated business between taxing jurisdictions that have a connection with the earning of the

income. In other words, income is earned in a jurisdiction because some or all of the factors are located in that jurisdiction. In a treaty context, the threshold of a permanent establishment can be retained. However, in order to enable market countries to tax profits from the electronic sale of goods or services to domestic customers, the concept of permanent establishment would be redefined to include not only a “physical presence,” but also an “economic presence” based on the level of sales (for example, \$1 million or some other amount agreed to by treaty partners). A computer server should not be considered to constitute a permanent establishment because servers are mobile and multiple servers can be used.

The GPS method described above draws ideas from existing profit-split and traditional formulary apportionment methods. It is aimed at achieving “rough approximation, not precision.”¹¹⁶ It is recognized that further study is required to make the GPS method workable in the real world. Nevertheless, the GPS is superior to the existing system in the ways described below, under the heading “Global Profit Split: Advantages and Disadvantages.” Even more important, it can be implemented because it is part of an evolutionary process started before the rise of electronic commerce.¹¹⁷

Global Profit Split: An Evolutionary Approach

This section of the chapter argues that the proposed GPS method can be implemented on the basis that the law of evolution is on its side. The GPS represents incremental changes to the existing system and is not “radical” or “revolutionary.”¹¹⁸ The discussion that follows shows that the proposed method evolves from the historical development of the arm’s-length principle and from current applications of formulary allocation in various circumstances. As will be explained, these and other factors support the possibility that an international consensus can be developed on implementation of the GPS.¹¹⁹

Historical Development of the Arm’s-Length Principle

Article 9 of the OECD model codifies the arm’s-length principle. As argued in chapter 12, under the heading “Questionable Interpretation of Article 9(1) of the OECD Model,” article 9(1) does not strictly require the comparable transactional pricing approach. This interpretation is borne out by the historical development of the arm’s-length principle and by the gradual movement toward formulary allocation.¹²⁰ In order to cope with the reality of integrated businesses, as discussed below, the separate-accounting approach is giving way to the apportionment of profit on a more formulary basis.

The Early Years

At the beginning of the 20th century, few countries had introduced rules for the allocation of cross-border corporate income.¹²¹ In the 1920s, the League of Nations appointed expert groups to study the problem of double taxation and the allocation of income. In 1927, a committee of technical experts drafted a convention for the prevention of double taxation,¹²² which was intended as a model

bilateral treaty. Article 5 of the 1927 model convention provided principles for allocating income of a corporation among permanent establishments in different countries but did not recommend a specific allocation method. In 1928, the United States enacted the predecessor of current section 482 of the Internal Revenue Code.¹²³ The original section provided no particular method for determining the permitted allocation of income.

In 1933, the League of Nations commissioned a study to survey the methods of allocation of income used in various countries. The report was begun by Thomas S. Adams of Yale University and completed in 1933 by his assistant, Mitchell Carroll, after Adams's death. Carroll visited 27 countries and made an extended study of their tax systems.¹²⁴

The Carroll report stated that there was little legislation or jurisprudence concerning the allocation of income and that it was thus necessary to study the practices followed by the various administrations. He found that both separate accounting and formulary apportionment were practised in various countries, but recommended separate accounting exclusively. Carroll contended that "the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation."¹²⁵ Carroll's recommendation was adopted in the 1933 draft convention,¹²⁶ which called for adjustments of accounts of associated enterprises to reflect arm's-length prices.¹²⁷ The 1933 draft convention clarified that the use of formulary apportionment as a fallback method was permissible with respect to allocations to permanent establishments, but did not mention whether it was permissible with respect to allocations to associated enterprises. This is also the origin of article 9 of the current OECD model.¹²⁸

The United States first adopted the arm's-length standard in 1935 by introducing regulations under the predecessor of Code section 482. The standard was very simple: in determining the "true net income of each controlled taxpayer . . . [t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."¹²⁹

The Formative Years

From 1935 to the mid-1960s, the number of multinational corporations was small. Consequently, the arm's-length principle had little international impact. It was not until 1968 that specific transfer-pricing methods were introduced.¹³⁰ In 1968, the US Treasury began refining and elaborating on the section 482 regulations, a process that has continued to the present day. The 1968 regulations attempted, for the first time, to establish rules for applying the arm's-length standard to specific types of transactions, but with sufficient flexibility to accommodate the unique character of multinational business. The determination of a fair arm's-length price for intercompany sales of tangible property was a central issue. The regulations recognized three methods that could be used in valuing the property, as well as an unspecified default method. The preferred choice was the comparable uncontrolled price (CUP) method. Because this method required the availability of comparable transactions, where these could

not be found, prices were determined by applying either the resale-price method or the cost-plus method. Where none of these methods could reasonably be applied under the facts and circumstances of a particular case, some other appropriate method was to be used.¹³¹ No specific method was identified for the pricing of services.¹³² In respect of intangibles, the regulations anticipated the lack of comparables; instead of setting forth any specific method, they listed 12 factors to be taken into account, without establishing any priority or relative weight among them.¹³³ Overall, the legislative guidance on transfer pricing under the 1968 regulations focused on a transactional approach that relied heavily on comparability with dealings—whether actual or hypothesized—between independent parties.

The OECD commenced a study of transfer pricing in 1976, which culminated in the 1979 report of the Fiscal Committee, proposing detailed transfer-pricing guidelines for adoption by OECD member governments.¹³⁴ Drawing heavily on the US regulations, the OECD report reflected a broadly similar approach to the use of transfer-pricing methods. Like the United States, the OECD favoured the CUP method as best reflecting the arm's-length principle. The OECD also agreed with the use of the resale-price and cost-plus methods where comparables were not available. Overall, the OECD 1979 report was substantially the same as the US regulations.

As multinational businesses evolved, it became apparent that the transfer-pricing methods set out in the 1968 US regulations and the 1979 OECD report were inadequate to deal with many types of intrafirm transactions. Specifically, comparables were either difficult to find or non-existent for transactions that involved intangible property and/or services. Although national tax authorities and the OECD have been generally steadfast in their commitment to the arm's-length principle, major modifications have been made to the manner in which the principle is applied. Again, the United States has taken the lead in reformulating the rules.

Recent Modifications

The main trend of the modifications was the gradual weakening of the traditional arm's-length methods. The trend began with the 1986 amendment to Code section 482. The revised section 482 requires that the income recognized by a transferor of an intangible be "commensurate with the income attributable to the intangible."¹³⁵ In passing this amendment, the US Congress noted¹³⁶ that the legislation still left many important and difficult transfer-pricing issues unresolved. It instructed the Internal Revenue Service (IRS) to undertake a comprehensive study of the issues and to consider carefully whether the regulations should be modified. The IRS responded by issuing a white paper in 1988,¹³⁷ proposed regulations in 1992, temporary regulations in 1993, and final regulations in 1994.¹³⁸

The 1992 proposed regulations recognized transfer-pricing methods (comparable profits method [CPM] and profit-split method) that were radically different

from those in the earlier regulations and the 1979 OECD report. Under the traditional transactional approach, transfer prices were set solely on the basis of the facts and circumstances relating to individual transactions, without regard for the profit position of the parties. The proposed CPM and profit-split method established prices by working backward from the relative profits that taxpayers earned from intercompany transactions. These proposed methods relied much less heavily on comparables and focused more on achieving arm's-length results by adopting profit-split methodology applied where functions were highly inter-related and could not be readily evaluated on a separate or an independent basis.

The OECD and foreign governments vigorously opposed the American proposals, initially on the ground that they were inconsistent with the arm's-length principle. The OECD went so far as to issue two reports that strongly criticized various aspects of these proposals.¹³⁹ The OECD particularly commented on issues arising from the dominant role given to the CPM as a basis for determining transfer prices.¹⁴⁰

Both the OECD and the US government were, however, well aware of the vital importance of being more or less in step. The subsequent release of the US final regulations (1994)¹⁴¹ and the OECD transfer-pricing guidelines (1995),¹⁴² and their similar approaches to transfer-pricing methodologies, suggest that the OECD and the United States agreed to a compromise position. The United States reduced its emphasis on the use of profit-based methodologies and agreed that traditional transaction-based methods would continue to be important techniques for setting transfer prices. While still according the traditional methods priority, the OECD agreed that profit-based approaches could be useful in certain circumstances. Furthermore, the OECD, with the apparent support of the United States, firmly rejected formulary apportionment as a valid method of determining income in an international setting.

Nevertheless, there are signs that national tax authorities are no longer convinced that article 9 of the OECD model requires exclusive use of the comparable transactional pricing approach. As discussed below, while national governments recite their conceptual opposition to formulary apportionment, they allow its use in practice. Moreover, a joint communiqué issued in 1992 by the IRS and the tax authorities of France, Germany, and the United Kingdom endorsed the arm's-length principle in general but also conceded the applicability of formulary apportionment in appropriate cases.¹⁴³

Current Uses of Formulary Allocation

As mentioned earlier, there has been a steady drift toward formulary allocation.¹⁴⁴ Current uses of formulary allocation methods are discussed below.

APAs

APAs are considered to be the "most successful approach to the transfer pricing problem."¹⁴⁵ Some APAs are based on formulary apportionment. An example is the use of global apportionment in the context of APAs involving global trading

of commodities and financial products.¹⁴⁶ In other contexts, the profit-split method used in APAs relies on allocation factors such as expenses and fixed assets to determine how the profits should be split, and thus would be an application of formulary apportionment.¹⁴⁷

According to the annual APA report (2000) released by the US Treasury department,¹⁴⁸ a wide range of pricing methods were used in the APAs executed in 2000 in the United States. The CPM was used in virtually all of them, either as the primary method or as a means of testing the results obtained under other methods.¹⁴⁹ The profit-level indicators used, in accordance with the CPM, included the following: return on assets or capital employed, operating margin, gross margin, the Berry ratio (the ratio of gross profit to operating expenses), markup on total costs, and net margin. These indicators can be interpreted as single-factor formulas.

An interesting aspect of the US APA program is that foreign-owned US subsidiaries accounted for the large majority (74.6 percent) of the APAs approved in 2000. There are good practical reasons for this: for the past several years, the IRS has specifically targeted such entities under its audit program. These companies use APAs as a way of avoiding contentious audits or, perhaps more important, of settling these audits in a forward-looking manner to cover open tax years. Most of the foreign parents of these US subsidiaries are located in US treaty countries. Presumably, these companies did not invoke article 9 of the applicable treaty to contest the use of CPM, possibly for reasons of expediency or, more significantly, because of implicit acceptance of the compatibility of CPM and the arm's-length approach.

Profit Split in Global Trading

Profit split is the preferred method for allocating profit from global trading operations under both the OECD draft global trading report¹⁵⁰ and the US proposed regulations.¹⁵¹ It is possible to use a three-factor approach to the splitting of profit—trader compensation, back-office compensation, and risk.¹⁵² It is also possible to use trader compensation as the sole factor.¹⁵³ The use of a single-factor formula in allocating combined income may lack economic validity in most cases; but since many taxpayers are more concerned with a predictable outcome than with economic purity, a single-factor approach may well suit their purposes.¹⁵⁴

Cost-Contribution Arrangements

Formulary allocation is often used in cost-contribution arrangements (the term used in the OECD transfer-pricing guidelines and by many OECD member countries) or cost-sharing arrangements (the term used in the United States) in respect of research and development and other activities.¹⁵⁵ A qualified cost-contribution arrangement is not subject to transfer-pricing adjustment.

The arm's-length principle requires that each participant's contribution be consistent with that which an arm's-length party would have agreed to contribute

under comparable circumstances, given the benefit it would have reasonably expected to derive from the arrangement. Various approaches may be used to estimate the benefits expected to be obtained by each participant. They include:

- estimation on the basis of anticipated additional income that will be generated or costs that will be saved as a result of entering into the arrangement; and
- the use of an appropriate allocation key, on the basis of sales; units used, produced, or sold; gross or operating profits; numbers of employees; capital invested; or alternative factors.¹⁵⁶

In essence, this is a formulary allocation approach.

Thin Capitalization

Canada, Japan, the United States, and many other countries have enacted thin capitalization rules that deny the deduction of interest on “excessive” debt.¹⁵⁷ Some countries use a fixed debt-to-equity ratio in determining the amount of excessive debt (hence excessive interest).¹⁵⁸ Article 9 of the OECD model arguably does not apply to thin capitalization situations but applies only to the rate of related-party loans.¹⁵⁹ However, the OECD’s position is that thin capitalization rules are consistent with the arm’s-length principle “insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm’s length situation.”¹⁶⁰

It is naïve to argue that the fixed ratio always represents the arm’s-length ratio of debt to equity from industry to industry. However, there have been no cases in Canada in which a taxpayer has challenged the validity of the thin capitalization rules on this basis.¹⁶¹ The use of a fixed ratio has been accepted in practice.

Attributing Profit to a Permanent Establishment

Formulary allocation has been applied in attributing profit to a permanent establishment under both treaties and domestic law. Under treaty law, article 7(4) of the OECD model specifically permits countries to attribute profit to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts if apportionment is customary.¹⁶² The OECD commentary on article 7(4) lists three factors that may be used in determining the allocation:¹⁶³

- 1) *Turnover or receipts*. This factor can be used by enterprises that provide services or produce proprietary articles. For example, an insurance enterprise may make an apportionment of total profits by reference to premiums received from policyholders in each of the countries concerned.
- 2) *Expenses*. This factor can be used by enterprises that manufacture goods with a high raw material cost or high labour content.

- 3) *Capital structure*. This factor can be used by banking and other financial enterprises.

Thus, according to the OECD commentary, the use of formulary apportionment in the context of a branch is not always inconsistent with the arm's-length principle.¹⁶⁴ The recent OECD discussion draft on the attribution of profit to permanent establishments suggests, however, that article 7(4) is fundamentally inconsistent with the arm's-length principle and should be disregarded for the purposes of the proposed working hypothesis.¹⁶⁵ This is an astonishing suggestion, because it questions the integrity of the OECD model in upholding the arm's-length principle.¹⁶⁶ Meanwhile, the proposed working hypothesis in the discussion draft has itself been criticized as a departure from the arm's-length principle.¹⁶⁷

In addition, as Scott Wilkie argues, when the definition of “permanent establishment” under article 5 and the profit attribution rules under article 7 are examined together, it is apparent that “the OECD model convention has always reflected a formulaic aspect that effectively frames an allocative approach to measuring and attributing enterprise income.”¹⁶⁸ He notes that “a typical tax treaty may be analyzed to reflect a kind of simple three-factor formula—namely, plant and equipment, salaries and wages (or people), and revenue, which establish the principal touchstones of income measurement in relation to a jurisdiction.”¹⁶⁹ This view is historically correct, since formulary apportionment was used concurrently with the separate-accounting approach in attributing profits to permanent establishments, and has been suggested as a backup method in earlier model tax conventions.¹⁷⁰

As discussed in chapters 4 and 9,¹⁷¹ the Canadian and US domestic laws allow the use of formulas in allocating interest deductions to branches of foreign banks. US taxpayers have challenged this domestic law as being contrary to the arm's-length principle and have won in court.¹⁷² For example, in *Natl. Westminster Bank v. US*,¹⁷³ the US Court of Federal Claims held that US regulations requiring the allocation of interest based on a formula are inconsistent with the “separate enterprise” requirements of article 7 of the US-UK treaty because the regulations rely on a formula and are not based on a deemed arm's-length relationship between the US branch and the UK head office.¹⁷⁴ The US-UK treaty was subsequently amended to adopt the approach recommended by the OECD discussion draft.¹⁷⁵

Chinese domestic tax laws permit the use of deeming methods in computing profit attributable to Chinese establishments of foreign enterprises.¹⁷⁶ These methods may be based on cost, gross sales, or commissions. China also permits the use of formulary allocation in computing the profit of foreign branches in China.

Formulary Allocation of Global Profit

As discussed above, the taxable profit of a permanent establishment is determined, at least in some cases, by apportioning the total profits of the enterprise on the basis of such factors as turnover and cost. In the extreme situation where

an enterprise carries on business activities outside its home jurisdiction solely in the form of branches, the formulary allocation method would be applied to its global income. This is particularly true if a corporation carries on business activities in the form of a branch in a foreign jurisdiction where formulary allocation is customarily used. In addition, formulary apportionment is already being practised with respect to the taxation of internal trading in financial flows—the most mobile of all factors—within multinational banks that span the whole world and all time zones.¹⁷⁷

Formulary Determination of “Cost”

Defining cost base for the purposes of the cost-plus method is crucial. Cost is identified directly if a direct charge exists, or indirectly by using an appropriate allocation formula.¹⁷⁸ The OECD guidelines identify several factors on which cost allocation may be based, including turnover, staff employed, capital applied, time spent to perform a task, and income-producing unit.¹⁷⁹ Some national tax authorities allow the use of a global formula to apportion costs on the basis of gross turnover of the worldwide group.¹⁸⁰

Other Uses Under Domestic Law

Formulary allocation is currently used at different stages in determining a taxpayer's income tax liability under domestic laws. First of all, formulary allocation is used to define the source of income. For Canadian income tax purposes, for example, income from employment services rendered both inside and outside Canada may be apportioned between Canada and the other jurisdiction on the basis of the time spent in each jurisdiction.¹⁸¹ For US tax purposes, Code section 863 authorizes the formulary determination of the source of specified types of taxable income in order to allocate that income partly to the United States and partly to foreign jurisdictions. Examples are income from the sale of goods produced in the United States and sold abroad, and vice versa, income from transportation, and income from communications. The Income Tax Act of Singapore¹⁸² allows the use of a formula in determining domestic-source income from international shipping.

Formulary allocation is also used to determine the amount of expenses to be deducted in the computation of taxable income. Examples (discussed above) are the limitation of interest expense deductions in the case of thin capitalization and branch interest allocation rules in Canada, China, and United States.

Moreover, formulary allocation is used in computing tax (not profit). For example, in Canada, formulary allocation is used to determine the amount of the manufacturing and processing tax credit.¹⁸³ Many countries use formulas to impose limitations on the amount of foreign tax credit.¹⁸⁴

Formulary Allocation and the Arm's-Length Principle

The OECD transfer-pricing guidelines do not seem to reject the use of formulary allocation in the circumstances described above. According to the guidelines,

profit-split methods are different from global formulary apportionment because they “compare, on a case-by-case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances.”¹⁸⁵ Formula-based APAs are consistent with the arm’s-length principle because the formula “is derived from the particular facts and circumstances of the taxpayer.”¹⁸⁶ The formulary allocation methods for attributing profits to permanent establishments under article 7(4) of the OECD model are consistent with the arm’s-length principle because “the method of apportionment adopted shall . . . be such that the result shall be in accordance with the principles contained in . . . Article [7].”¹⁸⁷ These attempts show that “the OECD accepts the existing provisions of the model as untouchable and, as a result, it bends them out of shape to accommodate new developments.”¹⁸⁸ They may also indicate that the OECD’s traditional interpretation of article 9 was too rigid in the first place and that the drift toward formulary allocation is inevitable.

Global Profit Split: Advantages and Disadvantages

Advantages

In addition to the argument that the proposed GPS method is consistent with the arm’s-length approach embodied in article 9(1) of the OECD model, the GPS is superior to the existing system in the following ways:

- it promotes inter-nation fairness,
- it is consistent with economic theories,
- it can overcome the tax haven problem, and
- it respects the principle of simplicity.

Consistency with the Arm’s-Length Principle

Article 9(1) of the OECD model was intended to allocate the income of an MNE among countries in which the MNE conducts its business operations. As argued in chapter 12, under the heading “Questionable Interpretation of Article 9(1) of the OECD Model,” the traditional interpretation of this provision to require the use of the comparable transactional pricing approach is not warranted either by its object and purpose or by its wording. Although an arm’s-length price is one means of satisfying an arm’s-length principle, it is not the only means. Allocation of profit on the basis of formulas in the circumstances described under the heading “Current Uses of Formulary Allocation” has been largely accepted as being consistent with the arm’s-length principle. Therefore, a strong argument can be made that article 9(1) does not compel the use of comparable pricing methodologies to the exclusion of formula-based methods. The comparable transactional pricing approach and formulary allocation should not be viewed as polar extremes; rather, both should be viewed as part of a continuum of methods, designed to implement the arm’s-length principle. The GPS method is

thus arguably consistent with the arm's-length principle as stated in article 9(1) of the OECD model.

Inter-Nation Fairness

The proposed GPS method would achieve a more equitable allocation of income among jurisdictions. Market countries that provide a consumer base and countries that provide a manufacturing base, as well as capital-exporting and technologically advanced countries, could all share in the taxation of the global profit (including the residual profit) of MNEs. The factors of the GPS formula could be designed to recognize the contributions made by all these countries. Residual profit would not be allocated solely to the country where intangibles are "owned" (often a tax haven) or "developed" (usually a developed country).¹⁸⁹

Moreover, developing countries that typically have limited resources to apply the complex existing transfer-pricing methods could receive a share of global profit without incurring extra expenses. They could rely on the tax base computed by another country and compute an appropriate percentage based on the information available locally. This approach is not perfect, but it would be an improvement over current practice.

Theoretical Correctness

The main advantage of the proposed GPS method over the existing arm's-length methods is that it is economically logical. It would be a conceptual improvement over the status quo because it recognizes economic reality: MNEs' businesses are globally integrated, and the whole is greater than the sum of its parts.¹⁹⁰ The proposed method can fairly allocate the residual profit of an MNE to all participants in an integrated business. It is thus superior to existing methods, which either cannot account for residual profit (in the case of transactional methods) or cannot fairly allocate it. Even the OECD transfer-pricing guidelines, while rejecting "global formulary apportionment" as an alternative to the arm's-length principle on mainly political and pragmatic grounds, seem to admit that formulary allocation is more in keeping with economic reality.¹⁹¹

The proposed GPS method would also be justified on the grounds of economic allegiance or benefit theory. The idea of "formula split" was raised by Georg von Schanz in 1892, when he suggested a 75:25 split between source and residence countries on the basis of benefit theory.¹⁹² Thirty years later, economists appointed by the League of Nations suggested that two countries might agree by treaty to develop reciprocal rules of origin or source for specific classes of income and to reciprocally apply only a percentage of their normal rates of tax to such income.¹⁹³ The goal of this proposal was to effect a division of the tax revenue from international income approximating that which would occur if each country's economic interest in the income could be quantified using an economic allegiance analysis. Subsequent developments under the auspices of the League of Nations and the OECD were essentially an attempt to find conceptual and pragmatic hooks upon which to hang what the participants

recognized to be an acceptably fair split along these lines.¹⁹⁴ The proposed GPS seeks to apportion the taxpayer's income from an integrated business among jurisdictions according to a formula designed to measure the substantiality of the connection between the income and each jurisdiction with a legitimate claim to tax that income. It is thus supported by well-accepted theories of international taxation.

Overcoming the Tax Haven Problem

The proposed GPS method would eliminate the attractiveness of traditional tax havens, because no profit would be allocated to them. This feature of the GPS is particularly important in respect of intangibles¹⁹⁵ and in an e-commerce context. In an electronic commerce environment, not only are the existing transfer-pricing methods inadequate to prevent the shifting of income to tax haven entities, but existing anti-avoidance rules (such as the CFC rules) also are ineffective.¹⁹⁶ The main reason is that the character of e-commerce transactions blurs the distinction between "active business income," which is not subject to the CFC rules, and "passive income" or "base company income," which is the target of such measures.¹⁹⁷ Under the GPS method, income from integrated business activities would be allocated in accordance with the formula. Because traditional tax havens typically have no consumer base, manufacturing facility, or research and development activities, no profit would be allocated to entities in these countries. Even if sales or other factors could be sited to tax havens, the throwout rule would exclude tax haven entities from the allocation of global profit.

In the case of the so-called production havens where the corporate tax rate is low (for example, China, Singapore, and Ireland), the GPS would allocate a portion of the global profit to such jurisdictions. This result would be consistent with benefit theory and the principle of inter-nation fairness, since there are genuine economic connections between these jurisdictions and the earning of the global profit. It would also respect the sovereign rights of these jurisdictions to impose tax on income earned within their borders, at whatever rates they choose to adopt.

Simplification

A transition from the current comparable transactional pricing methods to the proposed GPS method would inevitably involve some complexity. Once the transition is over, the GPS system would greatly simplify the international tax system, for the following reasons:

- 1) The GPS would replace the existing complex transfer-pricing methods and eliminate subjectivity and the case-by-case approach required by those methods.
- 2) The GPS would not totally depend on the determination of the residence of MNEs. Because the concept of corporate residence is elusive, taxing the income of MNEs under the GPS would provide more certainty and simplicity.

- 3) The built-in anti-tax-haven mechanism of the GPS, applied in combination with the proposed source withholding, would virtually eliminate the need for CFC rules. Since these rules are a main cause of complexity, their removal would undoubtedly simplify the tax system.
- 4) The GPS would tax the income of an integrated business in the source country and provide strong policy reasons for the residence country (to the extent that the residence of corporations remains relevant) to adopt the exemption method in taxing foreign active income. The combination of GPS and the exemption method would be much simpler than the current system in providing relief for double taxation.
- 5) The GPS would simplify the determination of “permanent establishment” and profit attribution to a permanent establishment. Once a permanent establishment is found to exist, the amount of income allocated to it would be determined in accordance with the formula.¹⁹⁸

A further advantage of the GPS is that the consequent simplification of the tax system would likely reduce compliance costs. This feature should make the GPS attractive to MNEs. While the GPS may impose significant reporting requirements on integrated businesses, these requirements may be less onerous than those imposed under the existing methodologies. For example, the traditional methods require the derivation of hypothetical prices for each of perhaps a multitude of cross-border transactions, assuming that these are the “right” prices and then assuming that the reported taxable income in each country as adjusted for these prices constitutes the correct amount of taxable income for that country. Even aside from the problem of determining the “right” price for each transaction, the focus on the propriety of individual transactions, as opposed to the proper amount of taxable income, multiplies substantially the number of questions that must be answered and, correspondingly, the resources required to determine the ultimate result. By contrast, the GPS method directly allocates global income among the jurisdictions in which an integrated business operates, on the basis of objective factors that each enterprise could ascertain for itself. Finally, with regard to the expense of maintaining records for the proposed GPS method, with the increasing capacity of computer technology and worldwide accounting firms that service MNEs, and the computerization of accounting records, compliance with formulary apportionment requirements on a worldwide basis is not the formidable task it once was.

It is possible that administrative costs under the proposed GPS system would rise as a result of the need to audit members of an MNE group that are not taxable in particular jurisdictions under the existing system. The additional burden created by the increased audit coverage would be offset, however, by the elimination of the need to pursue costly and complex investigations to monitor planning opportunities under the existing transfer-pricing regime.

To conclude, the proposed GPS method enjoys several advantages over the existing system for allocating international income. The GPS would be more equitable in allocating income among jurisdictions and be more consistent with both economic theory and the economic reality of how MNEs conduct their

business. It could also help reduce tax incentives for shifting profit to tax havens. In terms of the overall structure of the international tax system, the GPS, in combination with the proposed UWT, would simplify the system by reducing the need for other anti-avoidance rules that were designed to deal with problems unresolved by the transfer-pricing approach. As Alex Easson has noted, there are only two major issues in international taxation: transfer pricing and the rest.¹⁹⁹ However, as discussed below, the GPS has some disadvantages that must be thoroughly examined and, it is hoped, overcome before the method is adopted.

Disadvantages

Traditional formulary apportionment has been criticized as being arbitrary on the ground that predetermined formulas cannot reflect the particular circumstances of each MNE, and thereby cause double taxation.²⁰⁰ Transitional difficulties have often been raised as a major disadvantage. Similar arguments may be made against the proposed GPS. The merits of these arguments are discussed below.

Arbitrary Allocation

It has been argued that the use of predetermined factors makes formulary apportionment inconsistent with article 9 of the OECD model, since it may result in the allocation of profits to a country in which profits were not earned.²⁰¹ Although this objection is valid, it is hardly persuasive. A thoughtful design of the formula would ensure at least a fairer and more accurate allocation of profits, whereas the present methods are inherently inadequate because they allow profits to be sheltered from full taxation.²⁰² Moreover, opponents of formulary apportionment assume that the existing arm's-length methods "correctly" allocate profits from integrated business. This assumption is incorrect. Benjamin Miller writes:

Both the OECD and [opponents of the global formulary apportionment] hold global formulary apportionment to the standards of a theoretical world while absolving the arm's-length method from not only a perfect world, but also a real world, evaluation. In their eyes, it is apparently enough that most nations pay lip service to the existence of an arm's length standard.²⁰³

Potential Double Taxation

In theory, under the proposed GPS method, there is a mathematical certainty of no double taxation.²⁰⁴ In practice, double taxation could occur if countries could not reach a consensus on the definition of "integrated business" and "global profit," or on the measurement and location of the factors in the formula. Even in such cases, however, the problem could be dealt with by improving uniformity, whereas the double taxation that is inherent under existing methods cannot be eliminated through uniformity in implementation. As discussed in chapter 12,

the purported current international consensus on the implementation of the arm's-length principle is very superficial. In fact, countries may apply different methods to a transaction, producing different results and causing double taxation of income.²⁰⁵

Transition Difficulties

The key to any satisfactory solution to the problem of international taxation is international consensus. The proposed GPS method is unlikely to be adopted as an international norm unless it is accepted by both capital-importing countries (typically developing countries) and capital-exporting countries (typically developed countries.)

First of all, there must be sufficient political will among participating countries to make the transition. Countries will move to the new system only if they think that it will bring better results. Obtaining broad acceptance of the GPS method would be a major task, especially given that international taxation is a zero-sum game. The GPS will not be accepted if countries perceive that its adoption will put them in a losing position. This problem is even more significant if the United States and the EU countries are likely to be worse off under the GPS. MNEs that stand to lose under the GPS also would oppose it, and they often have significant lobbying power. The present system allows MNEs to manipulate transfer prices to reduce their international tax liabilities. These taxpayers, who may see their scope to avoid tax reduced by the GPS, would need to be persuaded of the overriding benefits of the new system (such as simplification, certainty, and lower compliance costs). This would not be an easy task.

Assuming that international consensus could be achieved, making the transition from the current system to the proposed GPS would involve some difficulties. Both domestic legislation and administrative practices would need to be amended. The question of national fiscal sovereignty and the legal mechanism for countries to cooperate must be addressed. In addition, the accounting and reporting systems of MNEs would need to be modified and improved in terms of their transparency and reliability so that the type of fraud carried out by Enron²⁰⁶ would be prevented. Nevertheless, there are several factors that would help smooth the transition.

First, the profit-split method and other current applications of formulary allocation should provide some precedents. Countries that impose income tax on the worldwide income of domestic corporations and provide relief for foreign tax have experience with the translation of currencies and conversion of accounting conventions. Such experience is directly applicable to the proposed GPS method. More important, the implementation of formulary apportionment by subnational governments in the United States and Canada may provide some useful experience in designing and administering such a system.

A second factor is the trend toward global harmonization of accounting standards. Profit from integrated businesses can be computed with a high degree of uniformity among jurisdictions. Before the advent of electronic commerce,

the harmonization of accounting standards had already become an important factor in the capital market decisions of many companies. The boards of the International Accounting Standards Committee and the International Organisation of Securities Commissions had agreed to develop common accounting standards by 1998.²⁰⁷ Accounting conventions in the EU are standardized. In addition, the Financial Accounting Standards Board is exploring areas in which Canada, Mexico, Chile, and the United States can harmonize their accounting standards.²⁰⁸ In terms of accounting for financial products, the rules have become more or less global.²⁰⁹ It is clear that globalization in capital markets has encouraged the internationalization of accounting rules.

A third factor that would smooth the transition to GPS is the movement toward the standardization of transfer-pricing documentation. For example, the Pacific Association of Tax Administrators (PATA) released a uniform transfer-pricing documentation package to assist taxpayers in the efficient preparation and maintenance of useful transfer-pricing documentation, and the timely production of such documentation upon request to PATA member tax administrations.²¹⁰ PATA members agree that an MNE will satisfy each member country's documentation requirements by complying with all of the principles contained in this package. The package itself is based on the principles set forth in the OECD transfer-pricing guidelines.²¹¹

Finally, the fact that the proposed GPS method enhances inter-nation fairness and represents incremental changes from existing methods should help build international support for its adoption. If formulary apportionment were adopted across the EU,²¹² other countries would certainly be more likely to adopt it. This said, forging a worldwide consensus on the use of GPS would be a formidable task. Fortunately, to the optimists at least, the time has come for the next advance in the search for the optimal method of allocating and taxing international income.

Developing an International Consensus

As is the case for the existing transfer-pricing methods, implementation of the proposed GPS method requires a strong international consensus. At present, such a consensus does not exist. However, there is no reason to believe that international agreement could not be secured and maintained. On the contrary, as discussed below, there seem to be sufficient political, technical, and institutional conditions to foster such consensus.

The GPS is not radically different from the current profit-split method. The only major differences are that the former is an explicit formulary allocation method, which uses defined factors, whereas the latter is implicit and uses flexible factors. The profit-split method has been accepted and applied in Canada, Japan, the United States, and other countries. There is also evidence that competent authorities are actually using profit-split procedures with some frequency and success in resolving transfer-pricing disputes.²¹³ These precedents bode well for the eventual international acceptance of the proposed GPS method.

Both developed and developing countries have an interest in accepting the proposed method. Under the GPS method, residual profit would be allocated to the country where intangibles are developed (usually capital-exporting countries) as well as to the country where products and services are sold (capital-importing countries). By comparison, the existing methods allocate residual profit mainly to capital-exporting countries. Therefore, the GPS favours destination-based taxation by allocating a portion of residual profit to countries of sale. As noted by Avi-Yonah, a rule that favours destination-based taxation is the most likely candidate to gain international acceptance.²¹⁴

Capital-exporting countries would also obtain a fair share of residual profit.²¹⁵ In theory, they may not get as much as they do under the existing system, since a portion of the profit would be allocated to market countries and production countries. However, the GPS would allocate income that is currently artificially shifted to tax havens back to the countries where income-earning activities occur. The recovered income would be allocated, at least substantially, to countries where intangibles are developed and produced.

There has been a gradual and steady movement toward greater international cooperation on taxation issues. The need for it has been well identified and appreciated. Some commentators have called for the establishment of a multinational tax organization. The OECD has assumed the role of an international tax body, especially in the areas of transfer pricing and electronic commerce. It has also recently invited non-members to participate in its work. The OECD might be persuaded to change its current stance on transfer pricing and take the initiative in exploring the implementation of the GPS.

The historical development of the arm's-length principle suggests a path toward achieving consensus on this issue: the United States takes the lead, the OECD and its members reach a compromise, and the rest of the world follows the OECD. In fact, the United States may have already taken the lead by introducing the global dealing regulations. The EU has also opened the debate on the use of formulary allocation as a means of eliminating tax obstacles for EU-based companies. If the United States and the EU were in agreement, the OECD would soon follow. It is only hoped that the world of international taxation will not have to wait too long to catch up with the world of international business.

Conclusions

In order to deal with the fundamental problems inherent in the present system of (not) taxing income from cross-border transactions, this chapter has proposed a system consisting of a UWT on portfolio income and a GPS method of allocating profits of integrated businesses. The proposed system is guided by the principles of inter-nation fairness and single taxation. It would be naïve to believe that the proposed system is problem-free. One big problem is that formulary allocation is unlikely to be adopted worldwide, or by OECD countries in the near future—though it will be interesting to see what happens in the EU.²¹⁶ In the meantime, the proposed UWT and GPS are not necessarily interdependent

in their implementation, and each could be adopted on its own. The UWT could be relatively easy to get agreement on and could, in any event, be introduced unilaterally. In contrast, the proposed GPS is difficult to introduce unilaterally. Even if there were general agreement about its superiority, it might be impossible to achieve consensus on the formula. It is worth emphasizing, however, that the proposed UWT need not be rejected simply because adoption of the proposed GPS proves unlikely in the near future.

Notes

- 1 See the discussion under the heading "History of International Taxation" in chapter 2.
- 2 Richard M. Bird, "Shaping a New International Tax Order" (1988) vol. 42, no. 7 *Bulletin for International Fiscal Documentation* 292-99, at 293 and 295.
- 3 Jack M. Mintz, "National Tax Policy and Global Competition" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1285-1302.
- 4 Jack M. Mintz and Duanjie Chen, "Will the Corporate Income Tax Withers?" in *Report of the First World Tax Conference: Taxes Without Borders*, 2000 World Tax Conference Report (Toronto: Canadian Tax Foundation, 2000), 45:1-16.
- 5 David R. Tillinghast, "The Impact of the Internet on the Taxation of International Transactions" (1996) vol. 50, no. 11/12 *Bulletin for International Fiscal Documentation* 524-26, at 526.
- 6 Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1357-1448, at 1362.
- 7 See the discussion under the heading "Justifications for Claiming Tax Jurisdiction" in chapter 2.
- 8 Organisation for Economic Development and Co-operation, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model").
- 9 Ibid.
- 10 See Thomas S. Adams, "The Taxation of Business," in *Proceedings of the Eleventh Annual Conference on Taxation*, National Tax Association, 1917 (New York: National Tax Association, 1918), 185-94, at 192.
- 11 A related theory is the entitlement theory, which argues that a country is entitled to tax corporate income when the corporation avails itself of the productive resources or the market of that country. See Charles McLure Jr., "Source-Based Taxation and Alternatives to the Concept of Permanent Establishment," in the 2000 World Tax Conference Report, *supra* note 4, 6:1-15, at 6:4.
- 12 Reuven S. Avi-Yonah, "International Taxation of Electronic Commerce" (1997) vol. 52, no. 3 *Tax Law Review* 507-55, at 517.
- 13 For further discussion of international double taxation and undertaxation, see the discussion under the headings "International Double Taxation" and "International Undertaxation" in chapter 3.
- 14 According to Bird and Mintz, "fair shares" for all relevant claimants to the international tax pie are an essential element of any acceptable (and hence sustainable)

- international tax system. See Richard Bird and Jack Mintz, "Sharing the International Tax Base in a Changing World" (unpublished as of July 2002; on file with the author), 4.
- 15 See discussions under the heading "Unsatisfactory Policy Results" in chapter 12.
- 16 *Longman Dictionary*.
- 17 Ontario, *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto: University of Toronto Press in cooperation with the Ontario Fair Tax Commission, 1993), 7 (co-chaired by Neil Brooks and Robert Couzin). The commission further notes, at 7: "For the public, tax fairness is a multidimensional concept reflected in different ways in the tax system and in discussions of tax policy. Tax fairness encompasses the overall level of taxes, the perceived value of the services that are funded from tax dollars, the fair distribution of the tax burden based on individuals' ability to pay, the appropriate linkage for the individual between a tax and the service it pays for, and the accessibility of the tax policy process."
- 18 For example, Peggy Musgrave defines "inter-nation equity" as "a standard applicable to countries of source and involves the concepts of a fair division of tax base and reciprocity of tax rates." See Peggy B. Musgrave, "Taxing International Income: Further Thoughts" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1477-80, at 1479.
- 19 For more analysis of inter-taxpayer equity, see Ontario Fair Tax Commission, *supra* note 17, at 9-10; Louis Kaplow, "Horizontal Equity: Measures in Search of a Principle" (1989) vol. 42, no. 2 *National Tax Journal* 139-54; Paul R. McDaniel and James R. Repetti, "Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange" (1993) vol. 1, no. 10 *Florida Tax Review* 607-22; and Martin J. McMahon Jr. and Alice G. Abreu, "Winner-Take-All Markets: Easing the Case for Progressive Taxation" (1998) vol. 4, no. 1 *Florida Tax Review* 1-81.
- 20 See, for example, Michael A. Livingston, "Blum and Kalven at 50: Progressive Taxation, 'Globalization,' and the New Millennium" (2000) vol. 4, no. 11 *Florida Tax Review* 731-68.
- 21 See, for example, Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) vol. 113, no. 7 *Harvard Law Review* 1573-1676, at 1649.
- 22 Peggy B. Musgrave, "Fiscal Coordination and Competition in an International Setting," in Lorraine Eden, ed., *Retrospectives on Public Finance* (Durham, NC: Duke University Press, 1991), 276-305; Richard A. Musgrave and Peggy B. Musgrave, "Inter-Nation Equity," in Richard M. Bird and John G. Head, eds., *Modern Fiscal Issues: Essays in Honor of Carl S. Shoup* (Toronto: University of Toronto Press, 1972), 63-85, at 68; Peggy B. Musgrave, "Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union," in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000), 46-77; and Peggy B. Musgrave, "Sovereignty, Entitlement, and Cooperation in International Taxation" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1335-56.
- 23 Musgrave, "Interjurisdictional Equity in Company Taxation," *supra* note 22, at 59.
- 24 For example, Bird and Mintz, *supra* note 14, who recommend that international tax policy issues be governed by inter-nation equity, do not seem to include the

- redistribution aspect. Similarly, Nancy Kaufman, a self-labelled “equity freak,” argues that inter-nation equity should be the foundation of an equitable international tax system, but did not expand the concept to include inter-country redistribution: see Nancy H. Kaufman, “Equity Considerations in International Taxation” (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1465-70, at 1465. See also Nancy H. Kaufman, “Fairness and the Taxation of International Income” (1998) vol. 29, no. 2 *Law and Policy in International Business* 145-203.
- 25 Graetz, *supra* note 6, at 1372.
- 26 *Ibid.*, at 1372-73.
- 27 *Ibid.*, at 1373. In this respect, Graetz cites John Rawls, *The Law of Peoples*, with “The Idea of Public Reason Revisited” (Cambridge, MA: Harvard University Press, 1999) and F.H. Hinsley, *Power and the Pursuit of Peace: Theory and Practice in the History of Relations Between States* (Cambridge, UK: University Press, 1963).
- 28 Bird and Mintz, *supra* note 14, at 24. See also Michael J. McIntyre, “The Design of Tax Rules for the North American Free Trade Alliance” (1994) vol. 49, no. 4 *Tax Law Review* 769-93, at 772 (“I do not take capital import neutrality seriously as a national tax policy goal”).
- 29 See, for example, comments by Stanford Ross during a symposium: “Discussion Transcript” (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1611-19, at 1617-18 (noting that subpart F rules were concerned with equity); and David P. Hariton, “International Tax Policy: Capital vs. Labor” (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1471-75 (noting the subpart F rules were the result of political compromise between capital and labour).
- 30 Bird and Mintz, *supra* note 14, at 23.
- 31 United Nations Model Double Taxation Convention Between Developed and Developing Countries, UN publication no. ST/ESA/102, 1980 (herein referred to as “the UN model”).
- 32 See Graetz, *supra* note 6, at 1371-92.
- 33 See the discussion under the heading “Other Anti-Deferral Rules” in chapter 4.
- 34 See the discussion under the heading “Other Anti-Deferral Rules” in chapter 9.
- 35 Joseph H. Guttentag, “Key Issues and Options in International Taxation: Taxation in an Interdependent World” (2001) vol. 55, no. 11 *Bulletin for International Fiscal Documentation* 546-56, at 554.
- 36 For a detailed account of this threat, see Charles E. McLure Jr., “Globalization, Tax Rules and National Sovereignty” (2001) vol. 55, no. 8 *Bulletin for International Fiscal Documentation* 328-41. See also Arthur J. Cockfield, “Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests” (1998) vol. 34, no. 1 *Stanford Journal of International Law* 39-69; Luc Hinnekens, “New Age International Taxation in the Digital Economy of the Global Society” (1997) vol. 25 no. 4 *Intertax* 116-19; Jack Mintz, “Is National Tax Policy Viable in the Face of Global Competition?” (1999) vol. 19, no. 1 *Tax Notes International* 99-107; Jeffrey Owens, “Taxation Within a Context of Economic Globalization” (1998) vol. 52, no. 7 *Bulletin for International Fiscal Documentation* 290-96; H. David Rosenbloom, “Sovereignty and the Regulation of International Business in the Tax Area” (1994) vol. 20 *Canada-United States*

- Law Journal* 267-72; Ian Spence, "Globalization of Transnational Business: The Challenge for International Tax Policy" (1997) vol. 25, no. 4 *Intertax* 143-47; and John P. Steines Jr., "Income Tax Implications of Free Trade" (1994) vol. 49, no. 4 *Tax Law Review* 675-89.
- 37 Paul McDaniel, "Reflections on International Taxation for the 21st Century," in the 2000 World Tax Conference Report, *supra* note 4, 20:1-4.
- 38 Guttentag, *supra* note 35, at 555.
- 39 This is quoted by Guttentag, *ibid*.
- 40 For example, Mitsuo Sato and Richard M. Bird, "International Aspects of the Taxation of Corporations and Shareholders" (1975) vol. 22, no. 2 *International Monetary Fund Staff Papers* 384-455; Peter A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (Amsterdam: International Bureau of Fiscal Documentation, 1996); Hugh J. Ault, "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices" (1992) vol. 47, no. 3 *Tax Law Review* 565-608; and Alvin C. Warren Jr., "Alternatives for International Corporate Tax Reform" (1994) vol. 49, no. 4 *Tax Law Review* 599-614.
- 41 Arthur J. Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) vol. 85, no. 5 *Minnesota Law Review* 1171-1266 (Internet solutions may be available to facilitate exchanges of information, identify the location of taxpayers, or establish an international online tax clearing house). See also Duncan Bentley and Patrick Quirk, "A Proposal for Electronic Transactions Tax Collection (ETTC) in the Context of Tax-Driven Reform of Banking Laws" (1999) vol. 14, no. 10 *Journal of International Banking Law* 327-41; Duncan Bentley, "A Model for Electronic Tax Collection" (1999) vol. 1, no. 11 *Tax Planning International E-Commerce* 15-29; and Glenn P. Jenkins, ed., *Information Technology and Innovation in Tax Administration* (The Hague: Kluwer Law International, 1996).
- 42 For a discussion of the administration issues, see Richard L. Doernberg, Luc Hinnekens, Walter Hellerstein, and Jinyan Li, *Electronic Commerce and Multi-jurisdictional Taxation* (The Hague: Kluwer Law International, 2001), 388-93. For a discussion of administration questions, especially those raised by electronic commerce, see Organisation for Economic Co-operation and Development, *Report by the Technology Technical Advisory Group (TAG)* (Paris: OECD, December 2000) (available in PDF at <http://www.oecd.org/pdf/M000015000/M00015516.pdf>); Organisation for Economic Co-operation and Development, *Report by the Professional Data Assessment Technical Advisory Group (TAG)* (draft) (Paris: OECD, December 2000) (available in PDF at <http://www.oecd.org/pdf/M000015000/M00015523.pdf>); and Organisation for Economic Co-operation and Development, *Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities*, a report from the Forum on Strategic Management to the Committee on Fiscal Affairs (draft) (Paris: OECD, February 2001) (available in PDF at <http://www.oecd.org/pdf/M000015000/M00015523.pdf>).
- 43 This usage came from Guttentag, *supra* note 35, at 551.
- 44 These categorizations are borrowed from Richard M. Bird and J. Scott Wilkie, "Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?" in Clossen, *supra* note 22, 78-109, at 99.

- 45 See, for example, David F. Bradford, "Blueprint for International Tax Reform" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1449-63.
- 46 Avi-Yonah, *supra* note 21.
- 47 M.A. King, "Tax Systems in the 21st Century," paper presented to the International Fiscal Association, Geneva, September 1996.
- 48 Many have raised the possibility of a "GATT for taxes" or "general agreement on taxes" (GATaxes). An international tax organization, analogous to the World Trade Organization, would perhaps be needed to oversee the implementation of such an agreement. For further discussion, see Frances M. Horner, "Do We Need an International Tax Organization?" (2001) vol. 24, no. 2 *Tax Notes International* 179-87; Charles E. McLure Jr., "Tax Policies for the XXIst Century," in International Fiscal Association, *Visions of the Tax Systems of the XXIst Century*, vol. 21d, proceedings of a symposium held in Geneva in 1996 during the 50th Congress of the International Fiscal Association (The Hague: Kluwer Law International, 1997), 9-52, at 36; Jack M. Mintz, "Globalization of the Corporate Income Tax: The Role of Allocation" (1999) vol. 56, no. 3/4 (new series) *FinanzArchiv* 389-423; John V. Surr, "Intertax: Intergovernmental Cooperation in Taxation" (1966) vol. 7, no. 2 *Harvard International Law Journal* 179-237; Vito Tanzi, "Is There a Need for a World Tax Organization?" in Assaf Razin and Efraim Sadka, eds., *The Economics of Globalization: Policy Perspectives from Public Economics* (Cambridge, UK: Cambridge University Press, 1999), 173-86; and Victor Thuronyi, "International Tax Cooperation and a Multilateral Treaty" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1641-81.
- 49 United Nations, *Report of the High-Level Panel on Financing for Development* (available in PDF at http://www.un.org/reports/financing/full_report.pdf). This report was released on July 6, 2001. It calls for the examination of the creation of an economic security council and an international tax organization (ITO). The powers of the ITO would include helping to strengthen tax administration and to curb international tax evasion, tax avoidance, and harmful tax competition. For comments, see Bruce Zagaris, "U.N. Report Calls for New Spirituality: The Creation of Two Organizations To Aid International Tax Enforcement" (2001) vol. 23, no. 4 *Tax Notes International* 508-16.
- 50 Bird and Mintz, *supra* note 14.
- 51 For a more detailed account of the historical development, see the discussion under the heading "History of International Taxation" in chapter 2.
- 52 Jacques Sasseville, "The Future of the Treaty Rules for Taxing Business Profits," in the 2000 World Tax Conference Report, *supra* note 4, 5:1-14, at 5:3. See also Stanford G. Ross, "International Tax Law: The Need for Constructive Change," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley & Sons, 1988), 87-100, at 98, stating that the key to sound international tax reform is a prudent balance of theory and reality.
- 53 Richard L. Doernberg, "Electronic Commerce and International Tax Sharing" (1998) vol. 16, no. 13 *Tax Notes International* 1013-22; and Richard Doernberg, "Electronic Commerce: Changing Income Tax Treaty Principles a Bit?" (2000) vol. 21, no. 21 *Tax Notes International* 2417-30.
- 54 Avi-Yonah, *supra* note 21; and Avi-Yonah, *supra* note 12.

- 55 eComTaxpert Group, *Taxation of Electronic Commerce in India*, report presented to the Central Board of Direct Taxes, India (Mumbai: eComTaxpert Group, June 2002) (available in PDF at <http://www.lawthinktank.com/Final-Ecomtaxpert.pdf>).
- 56 For example, see Arthur J. Cockfield, "Balancing National Interests in the Taxation of Electronic Commerce Business Profits" (1999) vol. 74, no. 1 *Tulane Law Review* 133-217.
- 57 Income from personal services would be characterized as either portfolio income or business profits under the proposal. The source withholding tax mechanism can be extended to income from personal services. An example of such provision is found in article 14(1) of the Convention Between Canada and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Santiago on January 21, 1998, which reads: "Income derived by an individual who is a resident of a Contracting State in respect of professional services or other activities of an independent character performed in the other Contracting State may be taxed in that other State but the tax so charged shall not exceed 10 per cent of the gross amount of that income unless the individual has a fixed base regularly available in that other State for the purpose of performing the activities. If the individual has or had such a fixed base, the income may be taxed in the other State in accordance with the law of that State, but only so much of it as is attributable to that fixed base."
- 58 This is supported by Doernberg, *supra* note 53; and the eComTaxpert Group of India, *supra* note 55.
- 59 See the discussion under the heading "Source Rules" in chapter 4 and chapter 8.
- 60 Avi-Yonah, *supra* note 21; and Avi-Yonah, *supra* note 12.
- 61 Such net-basis election is allowed by section 216 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").
- 62 See Charles E. McLure Jr., "International Aspects of Tax Policy for the 21st Century" (1990) vol. 8, no. 2 *The American Journal of Tax Policy* 167-85, at 179; Howell H. Zee, "Taxing Capital Income in a Globalized World" (2002) vol. 27, no. 11 *Tax Notes International* 1185-1211, at 1206; and Howard H. Zee, "Taxation of Financial Capital in a Globalized Environment: The Role of Withholding Taxes" (1998) vol. 51, no. 3 *National Tax Journal* 587-99, at 592-94.
- 63 For more discussion on this issue, see Jeffrey M. Colon, "Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads" [1999] no. 3 *University of Illinois Law Review* 775-844; H. David Rosenbloom, "Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions" (1996) vol. 50, no. 3 *University of Miami Law Review* 597-615; Willys H. Schneider, "Selected United States Tax Issues in Cross-Border Securitizations" (1998) vol. 8, no. 2 *Duke Journal of Comparative & International Law* 453-68; and Frans J. Vanistendael, "Reinventing Source Taxation" (1997) vol. 6, no. 3 *EC Tax Review* 152-61, at 158.
- 64 Robert H. Dilworth, Carol A. Dunahoo, Peter R. Merrill, Melody Pan, and Anastasia M. Parker, "Zero Withholding on Direct Dividends: Policy Arguments for a New U.S. Treaty Model" (2000) vol. 20, no. 10 *Tax Notes International* 1113-31, at 1124. Similar arguments are made by others; see, for example, Jack

- M. Mintz, "Withholding Taxes on Income Paid to Nonresidents: Removing a Canadian-US Border Irritant," *C.D. Howe Institute Backgrounder* 48 (Toronto: C.D. Howe Institute, March 5, 2001); and Jack M. Mintz, Larry Chapman, Nick Pantaleo, Peter R. Merrill, Cathy Koch, and Carol A. Dunahoo, "Canada-U.S. Treaty Interest Withholding Rates: Revenue and Policy Considerations" (1999) vol. 18, no. 18 *Tax Notes International* 1805-35, at 1818-21.
- 65 For a more detailed analysis of the incidence of withholding tax, see Harry Huizinga, "International Interest Withholding Taxation: Prospects for a Common European Policy" (1994) vol. 1, no. 3 *International Tax and Public Finance* 277-91, at 280-85.
- 66 Rosenbloom, *supra* note 63, at 606.
- 67 This was recommended by Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches" (1990) vol. 47, no. 5 *Tax Notes* 581-91, at 587.
- 68 Reuven S. Avi-Yonah, "Memo to Congress: It's Time To Repeal the U.S. Portfolio Interest Exemption" (1998) vol. 17, no. 23 *Tax Notes International* 1817-26, at 1820.
- 69 McLure, *supra* note 62, at 180.
- 70 See the discussion under the heading "International Undertaxation" in chapter 3.
- 71 Bird, *supra* note 2, at 298.
- 72 *Ibid.*
- 73 The description and evaluation of the GPS method have been included in an article by the author: Jinyan Li, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) vol. 50, no. 3 *Canadian Tax Journal* 823-83.
- 74 In the United States, all states that levy corporate taxes adopt the formulary apportionment method. This method applies to the income of a "unitary business." The three-factor formula (payroll, property, and sales) adopted by the Uniform Division of Income for Tax Purposes Act (UDITPA) is used by many states. UDITPA is a model statute that was adopted in 1957 by the National Conference of Commissioners of Uniform State Laws, incorporated into the Multistate Tax Compact, and "substantially adopted" by over 25 states. This formulary apportionment has been offered as an alternative to the arm's-length principle. See, for example, United States, General Accounting Office, *Tax Policy and Administration: California Taxes on Multinational Corporations and Related Federal Issues*, GAO/GGD-95-171 (Washington, DC: United States, General Accounting Office, July 11, 1995) (available on the Web at <http://www.gao.gov/>); Eric J. Coffill and Prentiss Willson Jr., "Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?" (1993) vol. 59, no. 8 *Tax Notes* 1103-17; and Benjamin F. Miller, "None Are So Blind as Those Who Will Not See" (1995) vol. 66, no. 7 *Tax Notes* 1023-35. However, there are many problems with the formulary apportionment method. The unsatisfactory treatment of intangibles and the uncertain definition of "unitary business" are two such problems. McLure describes the method used by the states as "insane" and "chaotic": see Charles E. McLure Jr., "U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles" (1997) vol. 14, no. 10 *Tax Notes International* 859-71.

- 75 For further discussion of the Canadian formulary apportionment approach, see Ernest H. Smith, "Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved" (1976) vol. 24, no. 5 *Canadian Tax Journal* 545-71; and Geoffrey S. Turner, "Interprovincial Income Allocation: The Permanent Establishment Threshold in the E-Commerce World," paper given at a Strategy Institute conference on "Taxing Electronic Commerce," December 1, 1998.
- 76 When California and other US states applied "unitary taxation" to MNEs, US major trading partners such as Canada, Japan, and EU countries filed complaints with the US government. The United Kingdom even threatened to retaliate. See Li, *supra* note 73, at 875, note 129.
- 77 Bird, *supra* note 2, at 297.
- 78 Charles I. Kingson, "Taxing the Future" (1996) vol. 51, no. 4 *Tax Law Review* 641-62, at 658.
- 79 Richard M. Bird, "A View from the North" (1995) vol. 49, no. 4 *Tax Law Review* 745-57, at 752.
- 80 Jerome R. Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business" (1968) vol. 21, no. 4 *National Tax Journal* 487-503, at 501-2; Jerome R. Hellerstein, "Allocation and Apportionment of Dividends and the Delineation of the Unitary Business," Special Report (1982) vol. 14, no. 4 *Tax Notes* 155-68; Jerome Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment" (1993) vol. 60, no. 10 *Tax Notes* 1131-45; and Jerome Hellerstein and Walter Hellerstein, *State Taxation*, 3d ed. (Boston: Warren, Gorham & Lamont) (looseleaf).
- 81 Hellerstein and Hellerstein, *supra* note 80; Walter Hellerstein, "State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon, and H.R. 5076" (1980) vol. 79, no. 1 *Michigan Law Review* 113-71; Walter Hellerstein, "State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond" (1993) vol. 48, no. 4 *Tax Law Review* 739-879; and Walter Hellerstein, "State Taxation of Electronic Commerce" (1997) vol. 52, no. 3 *Tax Law Review* 425-505.
- 82 Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length" (1986) vol. 30, no. 7 *Tax Notes* 625-81, at 643-44; Stanley I. Langbein, "Transaction Cost, Production Cost, and Tax Transfer Pricing" (1989) vol. 44, no. 12 *Tax Notes* 1391-1413; and Stanley I. Langbein, "A Modified Fractional Apportionment Proposal for Taxing Transfer Pricing" (1992) vol. 54, no. 6 *Tax Notes* 719-30.
- 83 Paul R. McDaniel, "Formulary Taxation in the North American Free Trade Zone" (1995) vol. 49, no. 4 *Tax Law Review* 691-744, at 736.
- 84 Michael McIntyre, "Design of a National Formulary Apportionment Tax System," in *Proceedings of the Eighty-Fourth Annual Conference on Taxation* (Columbus, OH: National Tax Association, 1992), 118-24; McIntyre, *supra* note 28; and Michael J. McIntyre, Paull Mines, and Richard D. Pomp, "Designing a Combined Reporting Regime for a State Corporate Income Tax: A Case Study of Louisiana" (2001) vol. 61, no. 4 *Louisiana Law Review* 699-761.
- 85 Charles E. McClure Jr., "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws" (1997) vol. 52, no. 3 *Tax Law Review* 269-423, at 418; McClure, *supra* note 74; and Charles McClure Jr., "Defining a

- Unitary Business: An Economist's View," in *Economics Perspectives on State Taxation of Multijurisdictional Corporations* (Arlington, VA: Tax Analysts, 1986), 47-90.
- 86 Richard D. Pomp, "Issues in the Design of Formulary Apportionment in the Context of NAFTA" (1994) vol. 49, no. 4 *Tax Law Review* 795-820; and McIntyre, Mines, and Pomp, *supra* note 84.
- 87 Joann M. Weiner, *Using the Experience in the U.S. States To Evaluate Issues in Implementing Formula Apportionment at the International Level*, OTA Paper 83 (Washington, DC: Department of the Treasury, Office of Tax Analysis, April 1999) (available in PDF at <http://www.ustreas.gov/offices/tax-policy/library/ota83.pdf>).
- 88 For a summary of the tests used under the traditional formulary apportionment method, see Weiner, *ibid.*, at 29-34. They include majority ownership; legal and effective control; the three-unities test (unity of ownership, unity of operation, and unity of use); dependency or contribution; operational interdependence; the three-stage test (common control, shared expenses, economies of scale or scope, and substantiality requirement); flow of value; and an activity test.
- 89 Miller, *supra* note 74, at 1025-27.
- 90 The flow-of-value test was recommended in McLure, "Defining a Unitary Business," *supra* note 85. This test has been accepted by US courts. See, for example, *Container Corp. v. Franchise Tax Bd.*, 463 US 159 (1983).
- 91 This test was first proposed by Jerome Hellerstein in 1968, which he defined in terms of a substantial flow of goods. See Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business," *supra* note 80. At that time, a flow-of-goods requirement would provide a reasonable and workable bright-line test for unitary business. Both Jerome Hellerstein and Walter Hellerstein, his co-author of *State Taxation*, *supra* note 80, section 8.09[4][b], at 8-121, now believe that a "definition of a unitary business based on flows of 'tangible' products is too confining." See *ibid.*, where they write: "While we do not mean to suggest that we embrace all the expansive holdings of courts—including the holding in *Container* [*supra* note 90] itself—which have found businesses to be unitary under an unrestrained 'flow of value' standard, we do acknowledge that there are many businesses which should be characterized as unitary based on the interdependence of basic operations, even though that interdependence may be reflected in the flow of services or intangible values rather than a flow of goods."
- 92 Hellerstein and Hellerstein, *supra* note 80.
- 93 Miller, *supra* note 74, at 1026.
- 94 Mintz, *supra* note 48, at 409-10.
- 95 Joseph L. Andrus and Robert H. Dilworth, "Proposed Transfer Pricing and Source of Income Regulations Applicable to Global Trading in Financial Markets" (1998) vol. 27, no. 6 *Tax Management International Journal* 267-78, at 271.
- 96 Brian J. Arnold, "General Report," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 79a, *Deductibility of Interest and Other Financing Charges in Computing Income* (Deventer, the Netherlands: Kluwer Law and Taxation Publishers, 1994), 491-541.
- 97 See J. Scott Wilkie, "A Canadian Perspective on Related-Party Transactions," in the 2000 World Tax Conference Report, *supra* note 4, 12:1-34. In the case of an

agency permanent establishment, the agent employs the capital assets and human capital factors in carrying out the activities.

98 The formula is expressed as

$$\frac{\text{in-country sales}}{\text{total sales}} + \frac{\text{in-country tangible property}}{\text{total tangible property}} + \frac{\text{in-country intangible}}{\text{total intangibles}} + \frac{\text{in-country payroll}}{\text{total payroll}}$$

Note that the intangible element may or may not be included.

99 See Kirk J. Stark, “The Quiet Revolution in U.S. Subnational Corporate Income Taxation,” February 25, 2002, reproduced in *State Tax Today* (Arlington, VA: Tax Analysts) (electronic database), 2002-5244.

100 Langbein, “A Modified Fractional Apportionment Proposal,” supra note 82, at 729. Avi-Yonah suggested a single sales factor in splitting residual profit: Reuven Avi-Yonah, “Slicing the Shadow: A Proposal for Updating U.S. International Taxation” (1993) vol. 58, no. 11 *Tax Notes* 1511-37. However, a sales-only apportionment method may violate the international trade rules of the World Trade Organization: see Charles E. McLure Jr. and Walter Hellerstein, “Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules?” (2002) vol. 27, no. 11 *Tax Notes International* 1315-23.

101 Brian E. Lebowitz, “Transfer Pricing and the End of International Taxation” (1999) vol. 19, no. 13 *Tax Notes International* 1201-9, at 1202 and 1207.

102 In most cases, a worker works in the country where the employer is resident. In the case of “telecommuters” who live in one country and work “remotely” over the Internet on a foreign employer’s computer network, the base of operations may be different from the place of the employer. See Doernberg, Hinnekens, Hellerstein, and Li, supra note 42, at 302.

103 Langbein, “A Modified Fractional Apportionment Proposal,” supra note 82. This amount would be determined by establishing an appropriate cost-comparison base, which would ordinarily be the costs the MNE would have incurred by locating facilities at or near its “home” jurisdiction, which would ordinarily be the place where its existing facilities are situated.

104 Hellerstein, “Federal Income Taxation of Multinationals,” supra note 80, at 1142, argues that intangibles “are far more nebulous [than tangible assets], both as to ‘locus’ and benefits and protections furnished by the state and social costs incurred.” Miller, supra note 74, at 1030, also acknowledges these difficulties: “Intangible property obviously presents some special, nagging problems both as to valuation and location for property factor and receipts factor purposes.” For a thorough discussion of the treatment of intangibles for US state corporate tax purposes, see Hellerstein, “State Taxation of Corporate Income from Intangibles,” supra note 81. For more discussion of accounting and valuing intangibles, see Michael Stirling, “Intangibles—Accounting, Economic and Legal Perspectives” (2002) vol. 3, no. 1 *Tax Planning International Transfer Pricing* 17-20; and Michael Stirling, “Perspectives on Intangibles—Part 2” (2002) vol. 3, no. 2 *Tax Planning International Transfer Pricing* 17-21.

105 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf) (herein referred to as “the OECD transfer-pricing guidelines”).

106 This is used as a factor under US transfer-pricing rules. See J. Roger Mentz and Linda E. Carlisle, “The Tax Ownership of Intangibles Under the Arm’s-Length

- Principle” (1997) vol. 15, no. 18 *Tax Notes International* 1495-1506; and Elizabeth King and Scott D. Newman, “Taxonomy of Pricing Problems Involving Intangibles and Their Treatment Under the Old and New §482 Regulations” (1994) vol. 9, no. 24 *Tax Notes International* 1851-60.
- 107 The OECD transfer-pricing guidelines, *supra* note 105, at paragraph 6.27.
- 108 Coffill and Willson, *supra* note 74, at 1109, note: “Historic costs often would be impossible to determine in any meaningful way, and the difficulty of determining the present fair market value of intangibles is apparently one of the driving forces behind seeking an alternative to the present federal approach under section 482.”
- 109 This example is credited to Richard Bird during his comments on an earlier draft of this book.
- 110 McLure, *supra* note 74, at 867.
- 111 *Ibid.*; and McLure, “Taxation of Electronic Commerce,” *supra* note 85, at 417.
- 112 McLure, *supra* note 74, at 868.
- 113 Hellerstein, “Federal Income Taxation of Multinationals,” *supra* note 80, at 1141-42.
- 114 Lebowitz, *supra* note 101, at 1208.
- 115 This is based on the “throwout” solution proposed by McIntyre, “Design of a National Formulary Apportionment Tax System,” *supra* note 84. The solution is to throw out from the formula sales or other factors that occur in a country with no jurisdiction to tax.
- 116 This is the controlling score of the US apportionment system. See Hellerstein, “State Taxation of Corporate Income from Intangibles,” *supra* note 81, at 751.
- 117 Robert J. Peroni, “Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules” (1997) vol. 51, no. 4 *University of Miami Law Review* 975-1011, at 1006.
- 118 For example, Stanley I. Katz, “International Taxation of Electronic Commerce: Evolution Not Revolution” (1997) vol. 52, no. 4 *Tax Law Review* 655-72.
- 119 This is the position of the OECD transfer-pricing guidelines, *supra* note 105, at paragraphs 3.58-3.74. Some have argued that the United States could adopt a formulary apportionment system without violating existing treaty provisions. See Dale W. Wickham and Charles J. Kerester, “New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?” (1992) vol. 56, no. 3 *Tax Notes* 339-61; Louis M. Kauder, “Inter-company Pricing and Section 482: A Proposal To Shift from Uncontrolled Comparables to Formulary Apportionment Now” (1993) vol. 58, no. 4 *Tax Notes* 485-93; and Hellerstein, “Federal Income Taxation of Multinationals,” *supra* note 80, at 1144. Others have argued the opposite: see Coffill and Willson, *supra* note 74, at 1116. Some have expressed doubt on this issue: see McDaniel, *supra* note 83, at 736.
- 120 Jeffrey Owens of the OECD defends the arm’s-length principle and challenges proponents of alternatives to the arm’s-length principle not only to show that they are better in theory but also that they are also capable of achieving an international consensus. See Jeffrey Owens, “Tax Administrations in the New Millennium” (2000) vol. 20, no. 1 *Tax Notes International* 95-105, at 99.
- 121 Brian D. Lepard, “Is the United States Obligated To Drive on the Right? A Multi-disciplinary Inquiry into the Normative Authority of Contemporary International

- Law Using the Arm's Length Standard as a Case Study" (1999) vol. 10, no. 1 *Duke Journal of Comparative & International Law* 43-190, at 60.
- 122 "Draft of a Bilateral Convention for the Prevention of Double Taxation," in League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations document no. C.216.M.85.1927.II. (Geneva: League of Nations, April 1927), 10-18 (source: Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions*, vol. 4 (Washington, DC: US Government Printing Office, 1962), 4111-47, at 4124-32).
- 123 Internal Revenue Code of 1986, as amended (herein referred to as "the Code").
- 124 Mitchell B. Carroll, *Methods of Allocating Taxable Income*, vol. 4 of League of Nations, *Taxation of Foreign and National Enterprises*, Studies of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country, League of Nations document no. C.425(b).M.2176(b).1933.II.A. (Geneva: League of Nations, 1933), 5 volumes (herein referred to as "the Carroll report").
- 125 *Ibid.*, at 177.
- 126 "Draft Convention Adopted for the Allocation of Business Income Between States for the Purposes of Taxation," in League of Nations, *Report Presented by the Fiscal Committee to the Council on the Work of the Fourth Session of the Committee*, League of Nations document no. C.399.M.204.1933.II.A. (Geneva: League of Nations, 1933), 3-7 (source: *Legislative History of United States Tax Conventions*, supra note 122, 4241-47, at 4243-47) (herein referred to as "the 1933 draft convention").
- 127 Article 5 of the 1933 draft convention, *ibid.*
- 128 A provision identical to the current article 9(1) of the OECD model, supra note 8, was included in the first OECD 1963 model (Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963)), which in turn was based on an article in both the London model (1946) and the Mexico model (1943). The London/Mexico model (League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations document no. C.88.M.88.1946. II.A. (Geneva: League of Nations, November 1946) (source: *Legislative History of United States Tax Conventions*, supra note 122, 4319) incorporated article 5 of the 1933 draft convention, supra note 126.
- 129 Article 45-1(c) of regulation 86 (1935) (Revenue Act of 1934). The arm's-length standard was adopted into the first American tax treaty—Convention Concerning Double Taxation, signed April 27, 1932, 49 Stat. 3145, 3146-47 (1935).
- 130 Langbein, "The Unitary Method and the Myth of Arm's Length," supra note 82.
- 131 IRC reg. section 1.482-2(e).
- 132 IRC reg. section 1.482-2(b)(3). The regulations simply recited the arm's-length standard.
- 133 IRC reg. section 1.482-2(d)(2).
- 134 Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs* (Paris: OECD, 1979), 95-96.

- 135 This approach was to be applied in respect of outright transfers of ownership by way of sale or contribution, as well as licences and other arrangements. Under this method, consideration must be given to the actual profit gained following the transfer. The division of income between related parties should reflect on a going-forward basis, the relevant economic activity undertaken by each party. It was thought that this approach totally disregarded arm's-length licences that might have been entered into by US corporations as appropriate comparative standards.
- 136 HR rep. no. 841, 99th Cong., 2d sess. II-638 (1986).
- 137 United States, Department of the Treasury and Internal Revenue Service, *A Study of Intercompany Pricing Under Section 482 of the Code*, Notice 88-123, 1988-2 CB 458.
- 138 IRC reg. section 1.482.
- 139 Organisation for Economic Co-operation and Development, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations* (Paris: OECD, 1993); and Organisation for Economic Co-operation and Development, *Intercompany Transfer Pricing Regulations Under US Section 482 Temporary and Proposed Regulations* (Paris: OECD, 1993).
- 140 The OECD also expressed strong reservations on provisions for periodic adjustments under the commensurate-with-income test in respect of intangible property.
- 141 *Supra* note 138.
- 142 Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, rev. ed. (Paris: OECD, 1995).
- 143 The communiqué stated (Kauder, *supra* note 119, at 492): "The use of formulae should not, however, be entirely ruled out. In some industries and in some circumstances the use of a formula might be appropriate assuming that the formula attempted to approximate an arm's-length result. . . . Each one of us has expressed varying levels of support for using carefully tailored formulae in specific situations. The United States sees considerable advantages in this approach in particular cases. Germany and the United Kingdom have agreed to consider the use of such formulae in those cases where they are involved as Competent Authorities." See "Report of Agreed Discussions Between the Tax Administrations of France, Germany, the United Kingdom, and the United States," in United States, Internal Revenue Service, *Report on the Application and Administration of Section 482* (Washington, DC: Internal Revenue Service, April 1992), appendix E, at 7, cited by Kauder, *supra* note 119, at 491-92.
- 144 For a review of the historical developments of the arm's-length principle, see the discussion under the heading "Historical Movement Toward Formulary Allocation" earlier in this chapter.
- 145 Lawrence Lokken, "Marking Up the Blueprint" (2001) vol. 26, no. 4 *Brooklyn Journal of International Law* 1493-1508, at 1503.
- 146 See Notice 94-40, 1994-1 CB 351, at 352. See also Jerome B. Libin, "Formulary Apportionment for 'Global Trading' in the Manufacturing Industry: Can It Work?" (1995) vol. 11, no. 21 *Tax Notes International* 1375-78; and Robert S. Ackerman, "Negotiating Advance Pricing Agreements for Financial Institutions" (1998) vol. 16, no. 22 *Tax Notes International* 1713-24.

- 147 Valerie Amerkhail, "Arm's Length or Formulary Apportionment? Sometimes the Best Choice Is Both" (1999) vol. 8, no. 3 *Tax Management Transfer Pricing Report* 94-104.
- 148 Announcement 2000-35, 2000-1 CB 922 (herein referred to as "the US 2000 APA report").
- 149 Deloris R. Wright, "Transfer Pricing in the United States: Recent Events and Expectations for the Future" (2001) vol. 55, no. 9/10 *Bulletin for International Fiscal Documentation* 417-26, at 421-22.
- 150 Organisation for Economic Co-operation and Development, *The Taxation of Global Trading of Financial Instruments: A Discussion Draft* (Paris: OECD, January 1, 1997) (available in PDF at <http://www.oecd.org/pdf/M000014000/M00014133.pdf>) (herein referred to as "the OECD draft global trading report").
- 151 US prop. reg. section 1.482-8.
- 152 *Ibid.* These regulations do not prescribe specific factors to be used in the formula, because the appropriateness of any one factor will depend on all the facts and circumstances associated with the global dealing operation. The regulations require that the multifactor formula take into account all of the functions performed and risks assumed by a participant, and attribute the appropriate amount of income or loss to each function. The OECD draft global trading report, *supra* note 150, uses the factors of compensation for marketers, risk, and support in the profit-split formula. Presumably, this approach was influenced by Notice 94-40, *supra* note 146.
- 153 A single-factor profit-split formula based exclusively on trader or front-office compensation is acceptable in at least some situations. US prop. reg. section 1.482-8(e)(8), example 1.
- 154 Andrus and Dilworth, *supra* note 95, at 273.
- 155 The OECD transfer-pricing guidelines, *supra* note 105, suggest that the most likely area in which cost-contribution arrangements will arise will relate to the development of intangible property. Other areas may include centralized management services or the development of campaigns common to the participants' markets (at paragraphs 8.6 and 8.7).
- 156 The OECD transfer-pricing guidelines, *ibid.*, at paragraph 8.19; and Canada Customs and Revenue Agency, *Information Circular* 87-2R, "International Transfer Pricing," September 27, 1999.
- 157 Detlev J. Piltz, "General Report," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 81b, *International Aspects of Thin Capitalisation* (The Hague: Kluwer Law International, 1996), 83-139.
- 158 For example, the Canadian thin capitalization rules adopt a fixed-ratio approach. Where the debt-to-equity ratio of a Canadian corporation is more than 3:1, the thin capitalization rules of subsection 18(4) of the Act deny the deduction of interest paid on the excessive debt. In the 2000 federal budget (February 28, 2000), the federal government proposed to change the ratio to 2:1.
- 159 Jinyan Li and Daniel Sandler, "The Relationship Between Anti-Avoidance Legislation and Tax Treaties" (1997) vol. 45, no. 5 *Canadian Tax Journal* 891-958, at 929.
- 160 The OECD model, *supra* note 8, commentary on article 9, at paragraph 3(a). This conclusion stems from the OECD's 1987 report on thin capitalization: Organisation

for Economic Co-operation and Development, "Thin Capitalisation," in *Thin Capitalisation/Taxation of Entertainers, Artists and Sportsmen*, Issues in International Taxation no. 2 (Paris: OECD, 1987), 8-36, at paragraphs 48-50.

161 Li and Sandler, *supra* note 159, at 930.

162 *Ibid.*

163 The use of these methods is specified in OECD Business Profits Technical Advisory Group, *Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions*, a discussion paper from the Technical Advisory Group Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (Paris: OECD, February 2001) (available in PDF at <http://www.oecd.org/pdf/M000015000/M00015525.pdf>); and OECD Committee on Fiscal Affairs (CFA), *Discussion Draft on the Attribution of Profits to Permanent Establishment* (Paris: OECD, February 8, 2001) (available in PDF at <http://www.oecd.org/pdf/M000015000/M00015495.pdf>) (herein referred to as "the OECD discussion draft").

164 However, the OECD model, *supra* note 8, commentary on article 7, at paragraph 25, states that a formulary apportionment method is generally "not as appropriate" as a method that looks only to the activities of the permanent establishment. The commentary also makes it clear that a formulary apportionment method "should only be used where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory."

165 The OECD discussion draft, *supra* note 163, at paragraph 180.

166 Another way of explaining this might be that formulary apportionment had been customarily used in countries before the arm's-length principle became the principle. See the discussion under the heading "Historical Movement Toward Formulary Allocation," *supra*.

167 See, for example, the Institute of International Bankers, "Comments on the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments" (2001) vol. 23, no. 4 *Tax Notes International* 477-507, at 480.

168 Wilkie, *supra* note 97, at 12:15.

169 *Ibid.*

170 See the discussion under the heading "Historical Movement Toward Formulary Allocation," *supra*.

171 See the discussion under the heading "Source Rules" in chapters 4 and 9.

172 For example, in *The North West Life Assurance Co. of Canada* (1996), 107 TC 363, the court held that the use of a formulary method of determining attributable profits to the taxpayer's branch in the United States was contrary to article 7 of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, and March 17, 1995, which is materially identical to article 7 of the OECD model, *supra* note 8. In *Ostime v. Australian Mutual Provident Society*, [1960] AC 459 (HL), the court held that the UK domestic law that attributed profits to a permanent establishment on the basis of insurance premiums received was against the arm's-length principle.

173 99-2 USTC 50,654 (Ct. Fed. Cl.).

- 174 The court quoted at length from the OECD commentary and found that the intention of the contracting parties was to follow the terms of the treaty as interpreted by the commentary. The Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on December 31, 1975, did not include article 7(4) of the OECD model, *supra* note 8. One view about article 7(4) is that it addresses only formulary allocation of the *total* profits of the enterprise, and not a formulary method that refers only to factors specific to the permanent establishment without regard to the rest of the enterprise. Therefore, article 7(4) does not, by its terms, rule out the latter type of formula.
- 175 Lee Sheppard, "NatWest Revisited in the New British Treaty" (2001) vol. 23, no. 13 *Tax Notes International* 1499-1510.
- 176 See the discussion under the heading "Source Taxation" in chapter 5.
- 177 See Jill C. Pagan and J. Scott Wilkie, *Transfer Pricing Strategy in a Global Economy* (Amsterdam: International Bureau of Fiscal Documentation, 1993); Charles T. Plambeck, H. David Rosenbloom, and Dian M. Ring, "General Report," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 80b, *Tax Aspects of Derivative Financial Instruments* (The Hague: Kluwer Law International, 1995), 653-90; and Sylvain Plasschaert, "An EU Tax on the Consolidated Profits of Multinational Enterprises" (1997) vol. 37, no. 1 *European Taxation* 2-13.
- 178 For a practical analysis of these methods, see Tim Brierley, "Charging Globally for Management Services" (1997) vol. 24, no. 11 *Tax Planning International Review* 13-20.
- 179 The OECD transfer-pricing guidelines, *supra* note 105, at paragraph 7.25.
- 180 For example, the New Zealand transfer-pricing guidelines, paragraph 539, allow the following formula:
- $$\frac{\text{New Zealand gross sales}}{\text{Worldwide group's gross sales}} \times \text{Costs to be allocated}$$
- (Source: New Zealand, Inland Revenue, "Appendix: Transfer Pricing Guidelines" (October 2000) vol. 12, no. 10 *IRD Tax Information Bulletin* (available in PDF at <http://www.ird.gov.nz/library/newsletters/tib/vol12/apx12-10.pdf>.)
- 181 Jinyan Li, "Rethinking Canada's Source Rules in the Age of Electronic Commerce: Part 1" (1999) vol. 47, no. 5 *Canadian Tax Journal* 1077-1125, at 1090-91.
- 182 Chapter 134.
- 183 The formula for computing the amount of manufacturing and processing profits is as follows:
- $$MP = ABI \times \frac{MC + ML}{C + L}$$
- where *MP* is Canadian manufacturing and processing profits, *ABI* is adjusted business income, *MC* is cost of manufacturing and processing capital, *C* is cost of capital, *ML* is cost of manufacturing and processing labour, and *L* is cost of labour. Regulations 5200-5204 of the Income Tax Regulations.
- 184 For example, section 126 of the Act and section 904 of the Code.

- 185 The OECD transfer-pricing guidelines, *supra* note 105, at paragraph 7.25.
- 186 *Ibid.*
- 187 Last sentence in article 7(4) of the OECD model, *supra* note 8.
- 188 Brian J. Arnold and Marc Darmo, “Summary of the Proceedings of an Invitational Seminar on the Attribution of Profits to Permanent Establishments” (2001) vol. 49, no. 3 *Canadian Tax Journal* 525-52.
- 189 As pointed out by Peggy Musgrave and others, the principle of inter-nation equity demands “[c]ommon source rules employing consistent methods of unitary combination and uniform formulary apportionment.” See Musgrave, “Sovereignty, Entitlement and Cooperation,” *supra* note 22, at 1345; Musgrave, “Interjurisdictional Equity in Company Taxation,” *supra* note 22; and Kaufman, “Equity Considerations in International Taxation,” *supra* note 24.
- 190 Daniel Sandler, “Slicing the Shadow—The Continuing Debate over Unitary Taxation and Worldwide Combined Reporting” [1994] no. 6 *British Tax Review* 572-97, at 592.
- 191 The OECD transfer-pricing guidelines, *supra* note 105, at paragraph 3.61.
- 192 Klaus Vogel, “Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part 1)” [1988] no. 8-9 *Intertax* 216-29.
- 193 League of Nations, Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp*, League of Nations document no. E.F.S.73.F.19. (Geneva: League of Nations, 1923), 42, 48 (source: *Legislative History of United States Tax Conventions*, *supra* note 122, 4003-55, at 4046 and 4052).
- 194 Bird and Mintz, *supra* note 14, at 22.
- 195 For a discussion of the offshore migration of intangibles under the existing transfer-pricing regime, see Avi M. Lev, “Offshore Migration of U.S. Intellectual Property: An Unintended Effect of Transfer Pricing Regulations” (2002) vol. 28, no. 3 *Tax Notes International* 285-98.
- 196 For a survey of these rules, see Brian J. Arnold and Patrick Dibout, “General Report,” in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 86b, *Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends* (The Hague: Kluwer Law International, 2001), 21-89.
- 197 See Doernberg, Hinnekens, Hellerstein, and Li, *supra* note 42, at 320-36.
- 198 From a policy perspective, this is the correct approach since both the permanent establishment issue and the arm’s-length principle aim at measuring and allocating income among jurisdictions. See Wilkie, *supra* note 97, at 12:14-15. This would also address the concern raised by David Ward that the permanent establishment definitional issue and the profit attribution issue should be concerned together: David A. Ward, “Dependent Agency Permanent Establishments,” in the 2000 World Tax Conference Report, *supra* note 4, 4:1-11.
- 199 Alex Easson, “The Importance of Transfer Pricing” (1998) vol. 8, no. 8 *Canadian Current Tax* 80-81.
- 200 The OECD transfer-pricing guidelines list the following reasons for rejecting global formulary apportionment as an “alternative” to the arm’s-length principle:

it is difficult to implement in a manner that both protects against double taxation and ensures single taxation; the transition to a global formulary apportionment system would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic in the field of international taxation; predetermined formulas are arbitrary and disregard market conditions; the formula cannot adequately deal with the movement of exchange rates; compliance costs would be intolerably high; valuation of assets, especially the valuation of intangible property, would be difficult; and formulary apportionment does not provide a complete solution to the allocation of profits of an MNE group unless it is applied on the basis of the whole enterprise. For comments on the difficulties with formulary apportionment, see Frank Church and Richard D. Pomp, "The Unitary Method: Thirteen Questions and Answers" (1980) vol. 10, no. 24 *Tax Notes* 891-97; and William J. Wilkins and Kenneth W. Gideon, "Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment" (1994) vol. 65, no. 10 *Tax Notes* 1259-65.

- 201 This is one of the reasons raised in the Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* ("the Ruding report") (Luxembourg: Office for Official Publications for the European Communities, 1992), 130.
- 202 Bird, *supra* note 79.
- 203 Miller, *supra* note 74, at 1023-24.
- 204 *Ibid.*, at 1026.
- 205 It is noteworthy that Stanley Surrey highlighted the problems stemming from the general lack of clear international norms of any sort, not the particular shortcomings of formulary apportionment or other allocation methods. See Langbein, "The Unitary Method and the Myth of Arm's Length," *supra* note 82, at 643. See also William Hellmuth and Oliver Oldman, eds., *Tax Policy and Tax Report: 1961-1969: Selected Speeches and Testimony of Stanley S. Surrey* (Chicago: CCH, 1973), 380-88.
- 206 Steven Harris and Paul Burns describe Enron as follows: "Enron Corporation came into being in 1985 as the result of a merger of two natural gas pipeline operators. Over the next 15 years, the company grew exponentially and transformed itself into something very different from its utility company roots. It became a global trading behemoth, developing products and making markets in commodities ranging from natural gas and electricity to Internet bandwidth and exotic derivatives, even dealing with the weather. One observer called the company "in effect, a hedge fund with a gas pipeline on the side." See Steven Harris and Paul Burns, "Transfer Pricing in the Post-Enron World" (2002) vol. 30 *International Tax Review* 30-34, at 30. Enron's published financial statements made it difficult for investors and most financial analysts to determine its true financial condition until the Enron web had already begun to unravel. In the wake of a series of adverse disclosures in the fall of 2001, its stock price collapsed. Enron could not finance its operations and filed for bankruptcy. Enron's auditor, Arthur Andersen, was also dragged down for its involvement. Ripple effects from Enron's collapse have been felt throughout the US financial system. The US Congress, the Securities and Exchange Commission, and the accounting profession are expected to bring in new financial reporting standards.

- 207 Weiner, *supra* note 87, at 26-27.
- 208 *Ibid.*
- 209 Shawn D. Porter and Kenneth J.A. Vallillee, "Tax and Accounting Aspects of Treasury Operations," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 20:1-51.
- 210 PATA members include Australia, Canada, Japan, and the United States.
- 211 The OECD transfer-pricing guidelines, *supra* note 105, at chapter 5.
- 212 See the discussion under the heading "Erosion of Residence Country's Tax Base" in chapter 12.
- 213 Lebowitz, *supra* note 101, at 1205.
- 214 Avi-Yonah, *supra* note 12, at 549.
- 215 Douglas Shackelford, "The Revenue Consequences of Using Formula Apportionment To Calculate U.S. and Foreign-Source Income: A Firm-Level Analysis" (1998) vol. 5, no. 1 *International Tax and Public Finance* 41-59 (estimating, in the absence of behavioural responses, that shifting to an equal-weighted, three-factor formula would have increased MNEs' US tax liabilities by 38 percent, with an 81 percent increase for oil and gas firms). Compare that with Michael S. Schadewald, "Global Apportionment: How Would It Affect the Largest U.S. Corporations?" (1996) vol. 13, no. 2 *Tax Notes International* 131-39 (finding that the use of formulary apportionment would not have had a substantial effect on the 1994 US income tax liabilities of the firms under study).
- 216 The recent EU debate on reforming the corporate tax system by introducing formulary allocation and other reforms was discussed under the heading "Alternative: Formulary Allocation" in chapter 12.