Formulary Apportionment—Myths and Prospects

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Structure of the Presentation

• Introduction

• Explaining and distinguishing our proposal

• Assessing the proposal

• Concluding remarks, Q&A, and real-world examples for Discussion
Introduction
Main Argument: Taking the Middle Path

• A radical reform to a unitary tax system is not the only way to deal with the shortcomings of the arm’s length standard’s (ALS).

• Policymakers could *internalize* formulary alternatives into current tax arrangements and generate *better* (though not perfect) international tax policies if the tradeoffs of formulary arrangements were better understood.
Essence of the Proposal

• There is a need to distinguish formulary alternatives from unitary regime alternatives.

• Setting a hybrid regime in which:
  – ALS is applied when there are adequate market comparables (including comparable profit methods)
  – formulary solutions are applied when the ALS does not provide satisfactory results (primarily with respect to intangible assets).
Main Points

• While every unitary setting requires an allocation formula, formulary arrangements do not necessitate a consolidated unitary framework.

• Formulary arrangements have certain key advantages:
  – they constrain income shifting
  – they promote transparent and consistent treatment of intra-group transactions

• Many of the problems associated with adopting formulary arrangements have been misunderstood and exaggerated.

• The baseline to evaluating the merits of the proposal is the current ALS transfer pricing regime, which is highly dysfunctional (at least with respect to intangibles).
Part I: Explaining and Distinguishing the Proposal
Current Methods & Proposals

• Current transfer pricing methods are based on separate accounting of each entity and:
  – focus on transactions and activities
  – use market indicators to allocate profits
  – apply separate accounting conventions

• Unitary Proposals
  – focus on unity of multinational enterprises (MNEs)
  – require income consolidation
  – use formula to allocate income

• Formulary Arrangements?
Formulary v. Unitary

• Formulary Arrangements:
  – focus on transactions and activities
  – use formula to allocate income generated (only) by *certain* transactions and activities
  – apply separate accounting conventions

• When compared to unitary arrangements, formulary solutions:
  – do not provide MNEs with consolidation benefits
  – require substantially less international cooperation and coordination because they can be applied unilaterally (e.g., U.S. interest allocation rules)
Using Formulary Solutions

• They could be applied *selectively* (almost as if they were just another transfer pricing method) instead of to all income generated by MNEs.

• They should be used *alongside current* transfer pricing arrangements and applied only when these traditional methods are unsatisfactory.

• They should be seen as a default arrangements, leaving tax authorities with the discretion to allow taxpayers to come up with advanced pricing arrangements (APAs) in unique cases.
First Tier: Ordinary ALS Transfer Pricing Rules

Applied in (the majority of) transactions where there is an easy-to-observe market price indicator

Second Tier: Formulary Arrangements for the hard to source/price income sources

Applied namely with respect to income generated from intangibles where there is no easy to observe market price (namely: intangibles)

Third Tier: Unique pre-negotiated arrangements
Benefits of FAs

• Reduce MNEs’ ability to engage in income shifting (primarily with respect to intangibles).

• Reduce administrative and compliance costs associated with documenting and monitoring intra-group transactions that lack easy-to-observe market comparables.

• Promote transparency and consistency with respect to sensitive issues in tax administration.
Part II: Assessing the proposal
Key Arguments Against Integrating FAs

• (1) Associating FAs with unitary solutions and, as a result, exaggerating the difficulties

• (2) Requiring an unrealistically high standard:
  • FAs cannot provide perfect solutions
  • however, they may provide incrementally better solutions than those currently in place
1. Are FAs arbitrary?

• Myth: The FA is a crude averaging device because the formulas used are alienated to market realities about how MNEs generate their incomes.

• Answer (2): The FA is not fundamentally different from the ALS:
  – Market prices, like formulary factors, are both reasonable proxies that lack any inherent “correctness.”
  – Market prices do not try to determine the firm-specific sources of profitability.

• Conclusion: As proxies both FA and ALS are means to an end, as long as they promote sensible policies.
2. Do FAs require unattainable tax harmonization?

• Myth: FAs could only be applied after fundamental aspects of existing tax regimes have been harmonized.

• Answer (1):
  – This confuses FAs with unitary arrangements.
  – As mentioned, FAs:
    • should be applied only towards hard-to-source (primarily intangibles-related) transactions and activities
    • require no consolidation
    • could be applied unilaterally
2. Do FAs require unattainable tax harmonization? (cont.)

- Myth: FAs require harmonization. Without it, categorization and valuation problems would render the arrangements impractical.

- Answer (2):
  - Problems of categorization and valuation with respect to intangibles exist today in the ALS separate accounting systems; the shift toward FAs would not aggravate them.
  - The FA concept detaches questions of valuation from questions of location and:
    • provides improvement with respect to the latter
    • aligns we with the proposal’s goal of incremental improvement
3. Are FAs alienated to business practices?

• Myth: FAs do not reflect how MNEs structure their business affairs and would lead to inefficiencies.

• Answer: FAs would not prohibit practices—they just deny some of their tax benefits.

• Answer (2): Even if at some point a FA averaging-allocation reaches unintuitive results:
  – it would reduce shifting and, therefore, arbitrariness of current ALS practices
  – it would still have (limited) APA options that would provide flexibility
4. Would FAs be easy to plan against?

- Myth: MNEs can easily adjust their behavior to allocate formulary factors in low tax jurisdictions.

- Answer (1): MNEs may not respond to tax planning incentives because of:
  - high (constant) non-tax costs of shifting
  - relatively low profits for shifting in a hybrid regime
  - relatively low profits in a multi-factored FA

- Answer (2): In terms of income shifting, FAs would likely provide a significant improvement when compared to current ALS arrangements.
5. Do FAs require new international conventions?

- Myth: FAs are inconsistent with current international tax arrangements.

- Answer (2): Today there is not just one method, but 180+ methods that adhere to the same name but may have little substantive content in common.

- Answer (1+2): FAs are not fundamentally different from current transfer pricing profit methods.
  - Both do not rely on market prices, apply separate accounting and focus on transactions and activities.
  - This suggests they could be under the OECD framework.
5. Do FAs require new international conventions? (cont.)

- Myth: FAs require excessive coordination to avoid problems of double taxation. Experience shows this type of coordination is unrealistic.

- Answer (1):
  - There is no need for unanimous agreement, FAs could be applied unilaterally.
  - It is unrealistic and unnecessary to try to buy out tax havens’ agreement to any FAs.

- Answer (2):
  - As in the ALS framework, coordination between major economies could help smooth double-taxation problems
  - Today, because of low-tax-haven jurisdictions, the problem if of double-non-taxation
6. Would FAs increase effective tax rates on MNEs?

- Myth: FAs would allocate more income to high-tax jurisdictions and, as a result, shift investments to low-tax jurisdictions.

- Answer:
  - FAs would allocate more income to high-tax jurisdictions, but have no necessary impact on the average or marginal tax rates of MNEs.
  - Countries could (and probably should) provide (tax or non-tax) direct subsidies to MNEs that conduct otherwise underprovided activities.
  - Income shifting has only negative externalities; countries should therefore avoid subsidizing MNEs engaging in the practice.
Concluding Remarks, Q&A, and Real World Examples for Discussion