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Taxation of Multinational Banks

Using Formulary Apportionment to Reflect Economic Reality (Part 1)

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Formulary apportionment does not attempt to undertake a transactional division of a highly integrated multinational entity; rather, it allocates income to the jurisdictions based on an economically justifiable formula. This article argues that the unitary taxation model is superior to the current arm's-length model for the taxation of multinational banks despite significant implementation, compliance, and enforcement issues.

Part 1 of this article below gives some background on the taxation of multinational banks, followed by a discussion of their uniqueness, and the theoretical benefits of the unitary tax model for multinational banking. Part 2 in a forthcoming issue will cover the practical implications of accepting formulary apportionment as an “optimal” regime for taxing multinational banks.

1. Background

The taxation of multinational banks is currently governed by general principles of international tax. However, there are characteristics exclusive to multinational banks that may warrant consideration of a separate taxing regime, as the current system does not produce a result that accurately reflects the economic source of the income or the location of the economic activity. The suggested alternative is unitary taxation using global formulary apportionment.

[pg. 48]Formulary apportionment does not attempt to undertake a transactional division of a highly integrated multinational entity. Rather, it allocates income to the jurisdictions based on an economically justifiable formula. An optimal regime, for purposes of this article, is one that distributes the taxing rights equitably between the relevant jurisdictions,¹ while simultaneously allowing decisions of the international banks to be tax neutral. In this sense, neutrality is viewed as an economic concept and equity as a legal concept.² A neutral tax system is one in which tax rules do not affect economic choices about commercial activities. Neutrality will ideally be across jurisdictions as well as across traditional and non-traditional industries. The primary focus of this article is jurisdictional neutrality.

A system that distributes taxing rights equitably between the relevant jurisdictions ensures that each country receives its fair share of tax revenue. Given the increase in multinational banking, jurisdictions should be concerned that they are receiving their fair share. Inter-nation equity is concerned with redetermining the proper division of the tax base among countries.³ Richard and Peggy Musgrave argue that sharing of the tax base by source countries should be seen as a matter of inter-nation equity requiring international cooperation.⁴ The rights of the jurisdiction of residency will also be at issue. To this extent, while it is generally agreed that inter-nation equity is an essential attribute of an international tax regime, there is no universal agreement on how to achieve it. The current system attempts to achieve such equity through a combined residency and source regime, with the transfer pricing rules used to apportion income between the relevant jurisdictions. However, this article suggests that, as an alternative to the current regime, inter-nation equity would be achieved through formulary apportionment.

Opposition to formulary apportionment is generally based on the argument that it is not a theoretically superior (or optimal) model because of the implementation difficulties. Yet these are two separate issues. Thus, this article examines both (1) the theoretical soundness of the formulary apportionment model, concluding that it is theoretically superior to the arm's-length pricing requirement of the traditional transfer pricing regime (Part 1 of the article); and (2) the practical implications of accepting formulary apportionment as an optimal model with a view to disclosing the issues that arise when a formulary apportionment regime is adopted (Part 2 of the article). While this article demonstrates the application of formulary apportionment to multinational banks, many of the arguments (particularly in relation to its theoretical soundness of formulary apportionment) may suggest that it is a superior model for all multinational entities. Consequentially, a broader approach is adopted in Part 1 of the article.

2. Uniqueness of Multinational Banks

The conclusion that the unitary taxation model may be theoretically superior to the current arm's-length model that applies to multinational banks, despite significant implementation, compliance, and enforcement issues, is based on the unitary taxation model providing greater

alignment with the unique features of these banks. In accordance with generally accepted theory, multinational banks are considered in theoretical terms as a subset of multinational entities, rather than an extension of the functions of domestic banks.⁵ While being a subset of multinational entities, multinational banks have special features that may result in the appropriate tax treatment being different from that of multinational entities generally. The features that distinguish multinational banks from traditional multinational entities are (1) the unique services and consequent products, and (2) the non-traditional organizational structure.

The first unique feature of multinational banks relates to the services and consequent products supplied—the innovative financial instruments developed to meet client's global demand.⁶ The intangibility and seamlessness of these services and products challenge the suitability of the traditional tax system to not only the supplier and the user of the service, but also to the bank itself, especially when these services are provided across jurisdictions. The essential difference between a multinational bank and its more traditional counterpart (a non-banking multinational) is that the bank offers an intermediary service.⁷ In doing so, the service may be offered in a location different from where the product is supplied to the client, whether borrower or lender. It is this ability to perform services for clients anywhere in the world, while providing the product in a low-tax jurisdiction, that leads to tax minimization for multinational banks. When the current source rules are applied, the jurisdiction where the services are performed may fail to receive any tax revenue.⁸ The interjurisdictional allocation of service costs can also lead to distortion. For example, the jurisdiction providing the services may charge the location where the product is supplied to the client a service fee above or below the arm's-length price.

Adding to the distinctiveness of the services and consequent products are the synergistic gains unique to multinational banks. Rather than [pg. 49]expanding internationally to meet the needs of a new market, multinational banks are expanding internationally to meet the needs of existing clients.⁹ Multinational banks can expand either by offering their current client base new financial “products” or by acquiring new clients. In contrast, traditional multinationals are usually capable of only the latter.¹⁰ The externalities provided by being an information-based firm thus avail multinational banks of more synergies than tangibles-based multinationals. Another problem associated with transfer pricing arrangements is that the client database (a valuable asset in its own right) can be shared between elements of the entity. Placing a value on the use of that client list for transfer pricing purposes is difficult given that it is firm specific and, therefore, has no arm's-length value.

The second unique feature of multinational banks, also a by-product of the aim to meet client global demand, is the non-traditional organizational structure that introduces issues previously not recognized in a traditional taxation regime. The theory of internalization of the firm, specifically motivation and structure, can explain this structural difference.¹¹ This theory is

based on the banks following their customers overseas because of the banks' knowledge advantage. This knowledge advantage arises from the client-banking relationship and becomes a public good within the firm that can be best exploited by expanding offshore. (A "public good" in this context is one that can be used by the entity as a whole and to its advantage without consumption.) As stated by Plummer, "[i]nternalisation is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimised for the sector as a whole by bringing interdependent activities under common ownership and control."¹²

The unique organizational structure also involves a consideration of the types of trading models adopted by multinational banks. This allows an appreciation of the generally highly integrated nature of the multinational bank as contrasted with the traditional multinational entity. The three types of trading models, recognized by the Organization for Economic Co-operation and Development (OECD) and represented along a continuum, are the "integrated trading model," "centralized product management model," and "separate enterprise model."¹³

The integrated trading model has traders in separate international jurisdictions trading off the same portfolio of positions. This is known as a "book," the responsibility for which is passed from one location to the next as the market closes in one jurisdiction and opens in another.¹⁴ The integrated trading model is a true global trading model.¹⁵ The primary concern of the multinational bank operating under the integrated trading model is the time zone. Essentially, all functions can be performed in any of the multinational bank's locations and, at any given time, will be performed where the market is open. At one time, this type of model was regarded as the exception rather than the norm, but it is now becoming the more prevalent mode of operation for banks.¹⁶

The centralized product management model has a central location accepting and managing all risk associated with a particular product, with separate branches managing separate products.¹⁷ Various commercial factors, such as market liquidity, ease of hedging, competition, business strategy, location of customers, and skilled staff, influence the location of the centralized trading site,¹⁸ which is essentially a head office into which all other parts of the entity report.

[pg. 50]The separate enterprise model has each location operating as if it were a separate profit center. Under this model, each location, whether a subsidiary or branch, has its own marketers and traders and its own books reflecting the activities of that location. Provided that the branch or subsidiary does not trade outside its trading limits, the central committee will not control any transactions undertaken by the individual locations.

These trading models not only distinguish the multinational bank from its more traditional counterpart, that is, traditional multinational entities, but also raise unique tax problems. Again, both source and transfer pricing issues arise. Given the three alternate trading models, the legal source (while easy to ascertain) is unlikely to be the economic source of the income. Further, because of the highly integrated nature of the models and the lack of comparable independent third-party transactions, transfer pricing is problematic.

No matter which model is adopted, global trading operations within financial intermediaries perform four general functions: trading, sales, management, and support. These four elements of the structure introduce their own unique qualities. Trading is divided into product groups, rather than geographical locations, with traders being rewarded on profitability as a whole. Management, on the other hand, may have responsibilities restricted to product, clients, economic sectors, or particular markets. Sales staff will generally be responsible for a portfolio of clients and so are cross-jurisdictional. Finally, the support teams are responsible for the integrated entity as a whole, primarily offering support to ensure that global transactions are accomplished.

A new approach is the answer to the problems associated with taxing multinational banks, and not multinational entities in general. A global solution is needed in relation to multinational banking transactions if the tax regime is to keep pace with the economic reality of the multinational banks undertaking such transactions.¹⁹ The OECD describes global formulary apportionment:²⁰

Global formulary apportionment would allocate the global profits of an MNE [multinational enterprise] group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. There would be three essential components to applying a global formulary apportionment method: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

Unitary taxation is the taxation of the worldwide income of a multinational entity, and is normally based on a formulary apportionment method, which allocates income to the relevant jurisdictions based on a percentage of the worldwide profits of the multinational entity.²¹ Formulary apportionment and unitary taxation are regularly treated as being interchangeable terms. However, this is not accurate. As Joann Weiner explains:²²

Formula apportionment is often referred to as unitary taxation, but the terms are not entirely equivalent. Apportionment refers to the process of using a formula to assign a portion of the total income of a company and its branches that operate in several locations to each individual location. Unitary taxation refers to the process of combining the functionally integrated operations of a multiple-entity affiliated corporate group that operates as a single economic enterprise into a single unit for purposes of determining the taxable unit. The group's combined income is then calculated, with internal transactions excluded, and apportioned by formula, with the income and factors of all of the unitary businesses combined into a single return. The use of the term "formula apportionment" may refer to its application to a single entity or to a multiple entity, whereas the term "unitary taxation" refers to the process of combining the operations of a group of corporations that are engaged in a unitary business into a single unit for tax purposes.

[pg. 51]Adopting a formulary apportionment process as the method of unitary taxation means that the profits are allocated to respective jurisdictions based on a pre-determined formula. The implementation of this methodology involves a three-step determination of (1) the unit to be taxed; (2) the tax base to be apportioned; and (3) the formula to be used for distributing the tax base. These steps are investigated later in the article.

Before considering the implementation difficulties, however, it is necessary to examine why unitary taxation based on global formulary apportionment is a more theoretically sound model for determining the jurisdiction to tax and the allocation of profits of multinational banks.

3. Theoretical Benefits of Unitary Tax Model for Multinational Banking

When the unitary tax model based on global formulary apportionment is applied to multinational banks, it has several interrelated theoretical advantages over the existing arm's-length model. The most significant advantage to global formulary apportionment is that because multinational banks are highly integrated, unitary taxation has greater consistency with economic reality. Unitary taxation also conforms to the aim of efficient operations within the multinational bank, providing the advantage of consistency between bank policy (to maximize group profit) and tax policy. Further, formulary apportionment has the theoretical advantage of aiming to find an equitable profit split between the jurisdictions, which ultimately should be the overall goal of any taxation regime.²³ There are also consequential practical advantages arising out of the implementation of unitary taxation based on formulary apportionment. Each is examined below.

3.1 Unitary taxation reflecting economic reality of multinational banking.

Underlying formulary apportionment is the assumption that each part of the multinational entity contributes to the overall profits of the entity. The focus is not on the individual transactions entered into but the contribution made by the separate parts of the entity. This model concentrates on the practical question of how much each jurisdiction gets, rather than dealing with issues like theoretical prices.²⁴ In this sense, formulary apportionment looks to the economic activity rather than the enterprise. The OECD, while not supporting global formulary apportionment, recognizes the “economic reality” argument put forth by proponents of this model. It states:²⁵

These advocates also take the position that global formulary apportionment is more in keeping with economic reality. They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.

[pg. 52]Economic interdependence by multinational banks has two effects on the economic reality of the entity as a whole. The first is that multinational banks are so highly integrated that the entity cannot be divided into any smaller component parts with any degree of accuracy. This is particularly relevant where the multinational bank is undertaking global trading, as the integrated parts of the entity “are not susceptible to further functional division.”²⁶

The second effect of economic interdependence is that there are advantages to multinational entities because of their very existence in a foreign direct investment form, explained by internalization theory.^{26.1} The consequence of this is that the modern multinational entity as a whole is greater than the sum of its parts, because of economies of scope and scale.²⁷ Even more than this, the multinational entity is “an indivisible whole rather than a mere sum of its separate parts.”²⁸

3.2 Reflecting integration.

It was argued above that multinational banks are so highly integrated that it is effectively impossible to divide the entity into smaller parts with any accuracy. The advantage of formulary apportionment is that it recognizes this economic reality and does not attempt to divide the entity into separate parts. The arm's-length standard does attempt such a division, which is one of its fundamental flaws.²⁹ While the arm's-length standard may have reflected economic reality in the past, when it is applied to highly integrated multinational banks, it is conceptually wrong.³⁰ The arm's-length approach requires a dissection of the entity, whereas the unitary taxation model reflects economic reality by treating multinational entity groups on a consolidated basis.

By doing so, the fundamental nature of the modern multinational entity is recognized. This economic reality is reflected in the integrated nature of the group as a whole, and the underlying rationale that the modern “multinational entity is, as a rule, unitary in character.”³¹ This economic reality is supported by an examination of a multinational entity, which will most often reveal a structure very similar to that of a single entity. As Joann Weiner explains:³²

The rationale for using formula apportionment is that despite separate corporate entities, related companies may have collectively many of the characteristics found in a single corporate entity. For example, affiliates may be under common ownership and have shared management and expenses, economies of scale, and functional integration. These characteristics make it difficult to draw a line between integrated parts of the corporation for purposes of computing income earned by the various pieces of the company.

By ignoring the separate parts of the multinational entity, the formulary apportionment model also ignores the entity's legal structure, making the structure adopted meaningless for tax purposes, just as it is meaningless for purposes of management decisions. Instead, the formulary apportionment model looks to the economic substance of the multinational entity and, in this sense, adopts a substance-over-form approach. The fundamental nature of this model is not to distinguish between a head office with affiliated branches and a parent company with multiple subsidiaries as the traditional model does; rather, it examines the location of [pg. 53]the economic activity undertaken by the entity as a whole and allocates based on that activity. It recognizes, therefore, that branches and subsidiaries are integrated and part of the one unitary business.³³ The model then considers which factors contribute to the income of the entity as a whole and incorporates this into the allocation formula, thereby recognizing that the income is generated by the factors that the multinational entity uses.³⁴

Formulary apportionment further recognizes the impossibility of using arm's-length pricing for economically interdependent multinational entities.³⁵ The need for comparables is also a fundamental flaw in the application of the arm's-length standard. Economic interdependence of vertically integrated multinational entities, such as multinational banks, also often means that there are no comparable transactions.³⁶ Even where comparable transactions do exist, the level of vertical integration may mean that the comparable prices do not reflect the contributions by the component parts of the entity. The continued globalization and integration of multinational entities mean that the problem of determining comparables will only worsen.³⁷ Formulary apportionment recognizes that related-party transactions are not undertaken on arm's-length terms and removes the need for any such comparables.³⁸

The current source and transfer price regime attempts to assign a geographical source to income by looking at the location of the income-producing activities.³⁹ Because of the legal

principles that have developed, however, the geographical source to which the income is allocated may not be the location of the income-producing activities. For example, parts of the multinational bank will often be allocated along functional lines, such as certain jurisdictions having the responsibility for trading when the market is open. Further, the traditional regime fails to recognize the economic reality that the component parts are “dependent upon or contributory to” each other.⁴⁰ The formulary apportionment model does not attempt to apply this legal perspective of economic activity; rather, it is based on the economic perspective that all of the activities of the multinational entity contribute to the profits. Where the income of a multinational has its source in the integrated operations of the entity as a whole, it is economically inaccurate to characterize the income as being from one specific geographic source.

3.3 Reflecting internalization.

Internalization theory also supports the use of global formulary apportionment for multinational banks as a theoretically superior model. Internalization theory means that the arm's-length standard does not accurately represent why an entity becomes multinational. This same theory may be used to demonstrate that the unitary tax model is consistent with economic reality. One proponent of this argument is Stanley Langbein, who relies on internalization theory to posit an alternative to the arm's-length price.⁴¹ His suggested model does not discard the arm's-length price altogether; rather, it is a more liberal approach to the current [pg. 54]regime, combined with a formula apportionment methodology, which may accord with current economic thinking.

Langbein's model, proposed over a decade ago, attempts to dispel the myth that the arm's-length method and unitary taxation cannot work together. Instead, he postulates a pricing regime that involves a two-step process. The first step is an allocation of adequate return to components, consisting of a recoupment of cost and a profit margin, the profit margin being determined by reference to an appropriate rate of return. The second step involves the residual profit being allocated according to a formula-based method, using assets and sales factors. Langbein suggests that this approach is a modified fractional apportionment approach, because the first step, by allowing a market rate of return on assets, uses an accepted feature of the current arm's-length approach to the allocation of profits.

The model that Langbein proposed is founded on the notion that “multinational integration occurs to obviate certain hazards.”⁴² The hazards obviated are those external to the firm such as quality control, security of information, reputation debasement, and hold-ups. Commenting on his hazard analysis, Langbein states:⁴³

This exegesis of the origin of multinational firms, and of the “integration economies” they effect, suggests the futility of constructing a transfer pricing

regime based on the identification of “inputs” to the productive process and the association of profit with particular inputs. It suggests, rather, that allocations seek to provide profits among the components of a multinational group according to the relative contributions of the components to the group profit. And the development of the “hazard” analysis of the MNE suggest[s] a crude, but logical method for asking what the relative contribution of a component is.

Internalization means that there are factors that contribute to the overall profitability of the multinational entity that are not taken into account when allocating income under the arm's-length model. For example, “functional integration, centralization of management and economies of scale are simply not reflected in any 'transactions' between entities in a corporate group, but arguably do impact on the profitability of the various aspects of a multinational's business.”⁴⁴ Savings in transaction costs and economies of scale, both of which multinational banks experience and are part of the motivation for becoming multinational, are also important features of a vertical integrated multinational entity, which contribute to the efficiency of the entity as a whole. Many multinational entities in general may contain these features. However, multinational banks will clearly always benefit from these characteristics.

The economic reality of multinational banks cannot be reconciled with the underlying assumptions of the arm's-length pricing model that an entity can be divided into component parts with an accurate allocation of profits attributable to those parts. On the other hand, formulary apportionment does accurately reflect these factors inherent in global trading, and avoids the problems of economic interdependence not being recognized by the current model.

The overall approach of global formulary apportionment is to recognize the “economic reality of the integrated, interdependent, yet expansive, business enterprise.”⁴⁵ Most importantly, formulary apportionment recognizes not only the highly integrated nature of multinational banks, but also the advantages gained by operating via foreign direct investment. Consequently, by recognizing the economic reality of the highly integrated multinational entity and the internalization advantages, there is consistency between the taxation model and corporate management philosophy. This is the second theoretical advantage to the formulary apportionment model.

3.4 Consistency between unitary taxation and aim of efficient operations within the multinational bank.

Unitary taxation conforms to the aim of efficient operations within multinational banks by providing the advantage of consistency between bank management policy and tax policy. The aim of any multinational bank is profit maximization, and it is the responsibility of management to ensure that this occurs, so resources will be allocated to the location that ensures this profit

[pg. 55]maximization. Consequently, a tax model that allocates income consistently with management policy is economically sound and theoretically superior. Formulary apportionment allocates income to the place of the economic activity by recognizing the factors that contribute to the overall profits of the entity, consistent with management policy.

Not only are the business decisions within the multinational bank reflected in the formulary apportionment model, but also the decision to become multinational. As previously discussed, internalization theory suggests that multinational banks come into existence due to their ability to reduce costs and transact more efficiently than they would have with an independent third party. The current arm's-length model requires a recharacterization of transactions, which does not accord with the efficient nature of the multinational bank and the factors that initially brought it into existence. This need for examination and recharacterization of international transactions is no longer necessary for formulary apportionment.

The OECD holds the contrary view that there is inconsistency between unitary taxation and the aim of the multinational entity. It expresses the concern “that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management's own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction.”⁴⁶ There are several key problems with this statement. Foremost is that where it is difficult to use a traditional arm's-length method such as the comparable uncontrolled price method, it is accepted that transactional methods are suitable. Yet, it is the use of a formula through a transactional method (for example, the profit split approach) that is arbitrary, not the use of one under a unitary tax regime. To the contrary, formulary apportionment provides a model that has the rationale of consistency between similar multinational entities, such as multinational banks, with the formula designed to factor in market conditions.

This statement by the OECD is further flawed when management's own allocation of resources is taken into account, as this is the very essence of formulary apportionment. The resources are the factors in the formula, weighted according to relative importance and reflecting management's decisions to allocate those resources to a particular jurisdiction. The formula used for unitary taxation purposes represents the allocation of resources by the multinational entity to a particular jurisdiction, thereby again reflecting the economic decision of the firm.

There is justification for the OECD's statement that the allocation may bear no sound relationship to the specific facts surrounding the transaction, as formulary apportionment is not (and does not purport to be) a transactional method. It recognizes that to attempt a division based on the transactions of the multinational entity is a fiction, unlike the arm's-length transactional model. Arm's-length pricing, which does purport to bear a relationship to the specific facts surrounding transactions, often fails in this goal, especially for multinational

banking transactions where it becomes practically impossible. The claim of formulary apportionment is that it allocates income based on an economically justifiable formula. The process will still be somewhat contrived, but because the model is founded in an economic solution, the result is not the fiction under the present regime.

When corporate tax differentials are disregarded, internal transactions are meaningless to management, as it is the entity's overall aim to minimize expense and maximize profits as a whole, not of the separate parts at the expense of another part of the entity. Yet, inconsistently with this rationale, arm's-length pricing takes into account these transactions and assumes that each part of the entity is a separate profit center. This is generally not overall management strategy. Consequently, formulary apportionment, which ignores all of the internal transactions, is consistent with the aim of the efficient operations of the multinational entity.

The OECD also expresses the concern that “a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g., dollar, euro, yen) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group.”⁴⁷ This statement necessarily [pg. 56]assumes that the functions, assets, risks, and efficiencies are significant to the overall profits of the entity, but that they are not taken into account in determining the formula. A formula does not have to be based on costs, assets, payroll, and sales, and such a formula would be unsuitable for multinational banks where the significant factors are likely to be value, risk, and activity.⁴⁸ Consequently, a formula for multinational banks would take into account the differences in functions, assets, risks, and efficiencies by adopting a formula that is representative of these factors. When this is done, factors considered significant to management would also be reflected in the tax model.

The OECD states that by abandoning the separate-entity approach, important geographical differences would be ignored, as would separate-company efficiencies and other subgroup specific factors. The OECD concern specifically relates to loss or profit centers, which it believes will not be adequately recognized under a formulary apportionment regime.⁴⁹ Yet again, this approach is contrary to the overall aim of management to maximize the profits of the entity as a whole. Every part of the entity is integral to this profit and so contributes. Unlike the arm's-length model, the formulary apportionment model recognizes this contribution.

The way that formulary apportionment allocates income to a particular jurisdiction is in direct contrast to the arm's-length model. Inconsistent with management policy, the transactional approach attempts to allocate income based on the geographical source of income. Formulary apportionment, which is consistent with management policy, apportions income according to economic or business activity undertaken in a particular jurisdiction.⁵⁰ It may be argued, therefore, that formulary apportionment contains the characteristics of an optimal regime.

3.5 Distributing taxing rights through an equitable model.

A system that distributes taxing rights equitably between the relevant jurisdictions ensures that each country receives its fair share of tax revenue. A jurisdiction will receive its fair share when the tax model reflects the economic activity undertaken in a jurisdiction. The economic activity undertaken in a jurisdiction is reflected under a formulary apportionment model via the specific factors in the formula, along with the relative weighting.

That formulary apportionment operates in a vacuum, by considering only firm-specific information, is suggested as a reason why this method fails to distribute the taxing rights equitably. Yet, the economic reality of multinational banks is that they do operate in a vacuum. It is only the income or loss of the individual multinational bank that is relevant to determine the income or loss to be attributed to each jurisdiction in which that entity operates. The industry in which the multinational bank operates does not determine the profit or loss of the individual bank.⁵¹ The formulary apportionment model accepts that the market does not dictate the profits of individual multinational banks, and seeks “a 'fair' or 'proper' division of the overall profits regardless of how the marketplace would operate.”⁵²

The formulary apportionment model also recognizes the reality that modern multinational entities, such as multinational banks, are highly integrated and does not attempt a fiction by trying to separate that entity into component parts. Where this is not recognized, there is a failure to acknowledge the true nature of the situation. A model that ignores this reality may necessarily lack the attributes of efficiency, equity, and achievability.

Neutrality, in all forms, is also an essential feature of an equitable tax regime. A unitary model based on global formulary apportionment has the potential to achieve both jurisdictional and taxpayer neutrality.⁵³ Jurisdictional neutrality requires a taxpayer's decision to invest in one jurisdiction over another to be neutral, while taxpayer neutrality means that all taxpayers are treated the same, whether resident or nonresident. Jurisdictional neutrality is achieved through the provision of a single formula for calculating tax liability. While differing corporate tax rates between jurisdictions may mean that there are still differences between jurisdictions, this is not a product of the unitary tax model. Further, a successful formulary apportionment model makes the use of havens pointless, as there is no longer the opportunity to have income sourced within that jurisdiction unless formula factors are present there. The use of tax havens by multinational banks is one of the reasons why there is such a distortion in the allocation of profits compared with economic activity. This distortion would be limited under a formulary apportionment regime.

The unitary tax model, focusing on taxpayer activity rather than taxpayer location, also achieves taxpayer [pg. 57]neutrality. As Benjamin Miller points out, “[i]t levels the playing field for all

business competitors by basing taxes on what they actually earn on an overall basis, not on the basis of whether they are domiciled in the United States or another country, or the skill of their tax compliance staff in manipulating the rules.”⁵⁴ The model would focus on the substance rather than the form of the multinational bank.

An equitable model is also one where each taxpayer pays its fair share of tax. A global formulary apportionment model may assist in this goal by reducing tax evasion and avoidance by a multinational entity. This occurs due to the extent of reorganization that a multinational entity would have to undertake to avoid tax. While the incentive would still be there, it would be reduced by the physical movement required, rather than the simple book transactions that achieve tax avoidance under the current regime. To avoid tax under a formulary apportionment model, the taxpayer would have to shift formula factors to the low-tax jurisdiction. It is unrealistic to believe that such movement would not take place. This type of avoidance, however, would occur less frequently than under the traditional regime because multinational entities would have to undertake actual movement and alter their real business operations to effect any tax changes.

The outcome of an analysis of the current regime and the economic realities of modern multinational entities, such as the multinational bank, is that “it would seem that some form of fractional apportionment regime represents the optimum way to reflect the economic realities of modern multinationals in an allocation scheme.”⁵⁵ As Daniel Sandler points out, “[i]f the primary purpose of international co-operation in taxation is to achieve an equitable division of the international corporate income tax base amongst the various competing nations, it is rationally more sound and more consistent with economic reality to tax a highly integrated multinational as a single unit, rather than as a group of separate entities acting at arm's-length.”⁵⁶

Consequently, it may be argued that the unitary tax model based on global formulary apportionment is theoretically superior to the current arm's-length pricing method for the taxation of multinational banks. The most significant advantage of unitary taxation based on global formulary apportionment is that it reflects the location of the economic activity undertaken by the multinational bank, so intermediary services are reflected. This means that it reflects the decisions of management and produces an optimal result. Because of the theoretical superiority, there are several key practical advantages to the regime, considered below.

3.6 Consequential advantages to unitary taxation model.

A formulary apportionment regime may provide such practical benefits as greater certainty, improvement of tax compliance due to increased simplicity, reduction in avoidance, and

reduction in double taxation. Given the uniqueness of multinational banks, these benefits have even greater significance to the unitary tax model being optimal for taxing the banks.

Currently, unless the taxpayer enters into an advance pricing agreement, and despite the taxpayer's best intentions, the relevant tax authority may at any time undertake a transfer pricing audit and substitute an arm's-length price for one that the taxpayer has used. In addition, the tax authority will be privy to competitor information, to which a taxpayer will not have access, thereby allowing the tax authority to more accurately determine an arm's-length price due to a greater database of comparables. A unitary tax regime alleviates this uncertainty and so long as there is compliance with the formula, there is little chance of the tax authority amending an assessment.⁵⁷

Certainty is also increased where formulary apportionment is applied uniformly to corporate groups and on an international scale. Further, the information required to administer the formulary apportionment model has greater objectivity and is grounded in more reality than the information required to determine the hypothetical arm's-length price under the current transfer pricing regime.

It may also be argued that formulary apportionment encourages greater compliance through a reduction in compliance costs and increased simplicity.⁵⁸ In its most extreme form, formulary apportionment is a very straightforward model. It simply takes the income from the unitary business and divides it between the relevant jurisdictions based on a [pg. 58]predetermined formula, unlike the current arm's-length approach, which is inherently complex in its application.⁵⁹ Formulary apportionment removes a large percentage of the complexity associated with the arm's-length model,⁶⁰ as transfer prices, determined on a transactional basis, would no longer need to be ascertained.

This simplicity results in a reduction of compliance costs, and where compliance costs are reduced, tax compliance may be improved. This reduction in complexity and increased compliance will be at its greatest level where there is international implementation of a formulary apportionment model, and agreement on all relevant issues. The requisite international agreement is generally the argument used to support the view that a formulary apportionment regime introduces increased compliance costs and complexity.⁶¹ This view is based on the premise that it would be difficult to reach international agreement on the elements of the formulary appointment model, particularly the relevant tax base to be used. The OECD opposes formulary apportionment based partially on this argument:⁶²

Contrary to the assertions of its advocates, global formulary apportionment may in fact present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and

presented in each jurisdiction on the basis of the currency and the book and tax accounting rules of that particular jurisdiction. Thus, the documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle. The costs of a global formulary apportionment would be further magnified if not all countries could agree on the components of the formula or on the way the components are measured.

There is some belief that multinational entities themselves also hold this view. It has been stated that “the view of business is that the documentation and compliance requirements under a unitary approach would be more burdensome than under the separate entity approach.”⁶³ While this may still be true of traditional multinational entity businesses, it is not so for multinational banks. That multinational banks are entering into advance pricing agreements emulating a formulary apportionment model suggests that this statement may not apply to the international banking sector, and that banks may be receptive to an allocation method that openly accepted a formulary basis for profit distribution.

Although there is still some complexity associated with formulary apportionment, it is a comparison between the current and proposed models that must be drawn. To this extent, “[a] comparison of the administrative and compliance burdens involved in preparing a combined report and computing the income derived from a particular jurisdiction by formula accounting with those involved in rigorous arm's-length examination must inevitably lead to the conclusion that the former is superior.”⁶⁴

The theoretical advantage of formulary apportionment offering an equitable regime because taxpayers pay their fair share of tax is juxtaposed with the practical advantage of the reduction in the opportunity for income shifting. By reducing the need to determine transfer prices based on an arm's-length methodology, the opportunity for income shifting is also reduced. As stated earlier, while a formulary apportionment model introduces the incentive to move formula factors to lower-tax jurisdictions, this is not as easy as transfer price manipulation due to the need to relocate economic activity to those locations.

A final advantage to formulary apportionment, which is also a consequence of this model achieving greater inter-nation equity, is the elimination of double taxation.⁶⁵ The possibility of double taxation is removed when a formulary apportionment model is adopted globally and implemented uniformly. Double taxation then becomes impossible, as the tax base to be divided between the relevant jurisdictions is never more than 100% of taxable profits.

The advantages of a consolidated corporate tax base may be real and substantial. Potentially, compliance costs are reduced, many of the transfer pricing problems largely disappear

rendering the tax regime simpler, and there is less opportunity for over- or under-taxation. Further, businesses can undertake a comprehensive consolidation of profits and losses, and a restructuring is simplified.⁶⁶ Multinational banks would no longer have to rely on advance price arrangements to gain any certainty in their pricing allocation of income.

Part 2 of this article will pick up with practical implications of accepting formulary apportionment as an "optimal" regime for taxing multinational banks.

¹ Peggy Musgrave refers to this as interjurisdictional equity. Musgrave, "Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union," in Crossen (ed.), *Taxing Capital Income in the European Union—Issues and Options for Reform* (Oxford U. Press, 2000), page 46.

² Vogel, "Worldwide vs. Source Taxation of Income—A Review and Re-evaluation of Arguments (Part 1)," 16:8-9 *Intertax* 216 (1988), page 216.

³ Avi-Yonah, "Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State," 113:7 *Harvard L. Rev.* 1573 (2000), page 1616.

⁴ Musgrave and Musgrave, "Inter-nation Equity," in Bird and Head (eds.), *Modern Fiscal Issues* (U. of Toronto Press, 1972), page 68. See also Musgrave, "Sovereignty, Entitlement, and Cooperation in International Taxation," 26:4 *Brooklyn J. Int'l Law* 1335 (2001); Musgrave, "The Treatment of International Capital Income," in Head (ed.), *Taxation Issues of the 1980s* (Australian Tax Research Foundation, 1983), page 279.

⁵ Williams, "Positive Theories of Multinational Banking: Eclectic Theory Versus Internalization Theory," 11:1 *J. Economic Surveys* 71 (1997), pages 71-72.

⁶ Colon, "Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads" 3 *Illinois U. L. Rev.* 775 (1999), page 777.

⁷ Plambeck, "Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives," *Taxes* (1996), page 1131.

⁸ Noren, "Commentary: The U.S. National Interest in International Tax Policy," 54:3 *NYU Tax Rev.* 337 (2001), page 337.

⁹ Ferguson, "Foreign Banks in Australia—A Strategic Reassessment," 9:3 *Economic Papers* 1 (1990).¹⁰ It may be argued that other modern types of multinational entities can do both (Microsoft, for example).

¹¹ Casson, *The Organization of International Business* (Edward Elgar, 1995), page 22; fns. 6 and 7; page 777; Plambeck, "The Taxation Implications of Global Trading," 44 *Bulletin for Int'l Taxation* 527 (IBFD, 1990), page 529; Langbein, "Transaction Cost, Production Cost, and Transfer Pricing," 44 *Tax Notes* 1391 (1989), page 1402. Internalization theory draws on the Coasian theory of the firm. See Coase, "The Nature of the Firm," 4:16 *Economica* 386 (1937).

¹² Casson, *id.*, page 22.

¹³ OECD, *Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading)* (December 2006) ("OECD Report 1"), page 124, para. 27; OECD, *The Taxation of Global Trading of Financial Instruments* (1998) ("OECD Report 2"), page 19, para. 48.

¹⁴ OECD Report 1, page 124, para. 28.

¹⁵ White, "Global Trading—Carving Up the Profit Cake," 24:4 *Tax Planning Int'l Rev.* 21 (1997), page 22.

¹⁶ Snyder, "Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology," 48:4 *Tax Lawyer* 1057 (1995), page 1058.

¹⁷ OECD Report 1, page 125, para. 30.

¹⁸ OECD Report 2, page 55, para. 20.

¹⁹ Spence, "Globalization of Transnational Business: The Challenge for International Tax Policy," 25:4 *Intertax* 143 (1997), page 146.

²⁰ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) ("OECD Guidelines"), para. 1.17.

²¹ Eden, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto U. Press, 1998), page 36.

²² Weiner, "Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level," 13 *Tax Notes Int'l* 2113 (1996), page 2118.

²³ Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises," 79:1 *Cornell L. Rev.* 18 (1993), page 67.

²⁴ Bird and Wilkie, "Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?," in Crossen (ed.), *supra* note 1, page 99.

²⁵ OECD Guidelines, para. 1.19.

²⁶ Plambeck, *supra* note 11, page 537.

^{26.1} See note 11, *supra* and accompanying text.

²⁷ McLure, Jr., "Replacing Separate Entity Accounting and the Arm's-length Principle With Formulary Apportionment," 56:12 *Bulletin for Int'l Tax'n* 586 (IBFD, 2002), page 587.

²⁸ Miller, "A Reply to 'From the Frying Pan to the Fire'," 61 *Tax Notes* 241 (1993), page 256.

²⁹ Bird and Brean, "The Interjurisdictional Allocation of Income and the Unitary Taxation Debate," 34:6 *Canadian Tax J.* 1337 (1986), page 1382.

³⁰ Bird, "The Interjurisdictional Allocation of Income," 3:3 *Australian Tax Forum* 333 (1986), page 348. Although Bird's comments referred to multinational entities in general, the case may be even stronger for multinational banks.

³¹ Note 29, *supra*, page 1383.

³² Note 22, *supra*.

³³ Sandler, "Slicing the Shadow—The Continuing Debate Over Unitary Taxation and Worldwide Combined Reporting," 6 *British Tax Rev.* 572 (1994), page 574.

³⁴ Weiner, "The European Union and Formula Apportionment: Caveat Emptor," 41:10 *European Tax'n* 380 (IBFD, 2001), page 380.

³⁵ McLure, Jr., and Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income," in Clossen (ed.), *supra* note 1, page 255.

³⁶ McLure, Jr., "Defining a Unitary Business: An Economist's View," in McLure, Jr. (ed.), *The State Corporation Income Tax* (Hoover Institution Press, 1984), page 95.

³⁷ Hammer, "Will the Arm's-length Standard Stand the Test of Time? The Specter of Apportionment," in Alpert and van Raad (eds.), *Essays on International Taxation*, (Kluwer Law and Tax'n Publishers, 1993), page 204.

³⁸ Mayer, "Reform of United States Tax Rules Governing Electronic Commerce Transfer Pricing," 21:2 *Thomas Jefferson L. Rev.* 283 (1999), pages 300-301.

³⁹ Hudson and Turner, "International and Interstate Approaches to Taxing Business Income," 6:2 *Northwestern J. Int'l Law and Business* 562 (1984), page 577.

⁴⁰ McLure, Jr., *supra* note 36, page 89.

⁴¹ Langbein, "A Modified Fractional Apportionment Proposal for Tax Transfer Pricing," 54 *Tax Notes* 719 (1992).

⁴² *Id.* page 723.

⁴³ *Id.* page 724.

⁴⁴ *Id.*

⁴⁵ Musgrave, "Auditing Multinational Firms: The Unitary Versus Separate Entity Approach," 29:2 *American U. L. Rev.* 361 (1980), page 363.

⁴⁶ OECD Guidelines, para. 1.25.

⁴⁷ *Id.*

⁴⁸ Notice 94-40, 1994-1 CB 351.

⁴⁹ OECD Guidelines, para. 1.29.

⁵⁰ Commission of the European Communities, *Company Taxation in the Internal Market: Commission Staff Working Paper* (Brussels, 2001), Part IV.C: Approaches for a Comprehensive Solution, ch. 17: Revenue Allocation: The Different Methods, page 410.

⁵¹ Kauder, "Intercompany Pricing and **Section 482**: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now," 58 Tax Notes 485 (1993), page 488.

⁵² Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions," 10:2 Law and Policy in Int'l Business 409 (1978), page 415.

⁵³ Miller, "None Are So Blind as Those Who Will Not See," 66 Tax Notes 1023 (1995), page 1035.

⁵⁴ *Id.*

⁵⁵ Langbein, *supra* note 11, page 1413.

⁵⁶ Sandler, *supra* note 33, page 592.

⁵⁷ Lester, "International Transfer Pricing Rules: Unconventional Wisdom," 2:1 ILSA J. Int'l and Comparative Law 283 (1995), page 300.

⁵⁸ Newlon, "Transfer Pricing and Income Shifting in Integrated Economies," in Cnossen (ed.), *supra* note 1, page 235; Miller, "Worldwide Unitary Combination: The California Practice," in McLure, Jr. (ed.), *supra* note 36, page 160; Cnossen, "Tax Policy in the European Union: A Review of Issues and Options" (Erasmus U., 2001), page 73.

⁵⁹ The OECD acknowledges this claim: "Apart from these arguments, advocates contend that global formulary apportionment reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes." See OECD Guidelines, para. 1.20.

⁶⁰ McIntyre, "Using NAFTA to Introduce Formulary Apportionment," 6 Tax Notes Int'l 851 (1993), page 854.

⁶¹ Hay, Horner, and Owens, "Past and Present Work in the OECD on Transfer Pricing and Selected Issues," 9 Tax Notes Int'l 249 (1994), page 255.

⁶² OECD Guidelines, para. 1.27.

⁶³ Hay, *supra* note 61, page 255.

⁶⁴ Miller, *supra* note 58, page 160.

⁶⁵ Tanzi, "The Nature and Effects of Globalization on International Tax Policy," paper presented at the symposium "International Tax Policy in the New Millennium," Brooklyn Law School, November 9-10, 2000, 26:4 Brooklyn J. Int'l Law 1261 (2001), page 1266.

⁶⁶ Bolkestein, “Towards an Internal Market without Tax Obstacles,” speech at European Commission Conference on Company Taxation in the European Union, Brussels, April 29, 2002.

Taxation of Multinational Banks

Using Formulary Apportionment to Reflect Economic Reality (Part 2)

[pg. 55]

As stated in Part 1 of this article, formulary apportionment does not attempt to undertake a transactional division of a highly integrated multinational entity; rather, it allocates income to the jurisdictions based on an economically justifiable formula. This article argues that the unitary taxation model is superior to the current arm's-length model for the taxation of multinational banks despite significant implementation, compliance, and enforcement issues. Part 1 of the article gave some background on the taxation of multinational banks, followed by a discussion of their uniqueness, and the theoretical benefits of the unitary tax model for multinational banking.¹ Part 2 below covers the practical implications of accepting formulary apportionment as an “optimal” regime for taxing multinational banks.

4. Formulary Apportionment as an “Optimal” Regime for Taxing Multinational Banks

Acceptance and agreement of unitary taxation based on global formulary apportionment as a theoretically superior model for taxing multinational banks is essential if it is to be embraced internationally. Gaining international acceptance is one of the greatest hurdles to formulary apportionment. This article, however, is not proposing that [pg. 56]unitary taxation based on global formulary apportionment replace the current tax regime for all multinational entities even though it has been argued that there are advantages to adoption of the regime in general. Rather, it proposes that it be implemented only for multinational banks. There is already evidence that the current jurisdiction and allocation rules, while adequate for traditional multinational entities, do not work for multinational banks. Thus, international acceptance of this model as theoretically superior for the specific industry of banking may not be as onerous as for multinational entities generally.

However, acceptance of formulary apportionment as a superior regime does not guarantee its implementation and it is this implementation process that in the end may lead to its demise as an alternative regime. The initial hurdle to reaching international agreement on formulary apportionment is exacerbated by complex methodological questions. Implementation also

requires a high degree of cooperation among nations on the various key economic components of the formulary apportionment regime; in particular the tax base, composition of the formula, definition of the factors, and scope of the unitary business are essential. Such agreement would not likely be reached without conflict.

The practical implications related to the theoretical examination of formulary apportionment are a consequence of its acceptance as a superior model. Thus, while they do not add to the discussion of the theoretical merits, they may help in determining whether formulary apportionment is a fundamentally fair and practical model. The discussion below considers the degree of international acceptance required before the implementation stage and the three key components to the regime. The issues relating to these components lead to the practical questions that must be addressed before implementation would be possible.

4.1 Requisite degree of international consensus.

The strongest argument against formulary apportionment is its lack of general acceptance internationally. The OECD relies on this argument to dismiss formulary apportionment, stating that reaching such an agreement would be time-consuming and extremely difficult: “[T]ransition to a global formulary apportionment system ... would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation.”² Many jurisdictions adopt a similar stance. For example, the Australian Taxation Office acknowledges global formulary apportionment as an alternative to the arm's-length principle in determining the proper allocation of profits across competing national tax jurisdiction. However, while it recognizes the theoretical merits of the model, it does not consider global formulary apportionment an acceptable alternative to the arm's-length principle in practice. One stated reason for this stance is the high degree of international cooperation and coordination needed.³ Yet international bodies and domestic jurisdictions have generally viewed unitary taxation as an all-or-nothing approach rather than an industry-specific solution. The OECD has already singled out the multinational banking industry as a potentially difficult area for taxation, so there is no reason why it could not be selected for possible use of formulary apportionment.⁴

Problems arise where there is no international consensus. The consequence of jurisdictions not agreeing to exclusive use of formulary apportionment would be the need to calculate profits attributable to the relevant jurisdictions using two different standards.⁵ However, difficulty in reaching international consensus is an inadequate reason for dismissing formulary apportionment outright and should not be an obstacle to its inception. Formulary apportionment is addressing the same fundamental issue as the current tax regime in attempting to find an equitable distribution of income to the relevant jurisdictions. Reaching international agreement on this equitable distribution is ultimately difficult, whether through

the traditional regime or agreement on a new model. It is also argued that the implementation of formulary apportionment is not feasible without international acceptance. Yet the obstacle of reaching international agreement on an equitable distribution can be overcome, the current regime being an example of where this has occurred. Reuven Avi-Yonah believes that the present "international tax regime, based on voluntary consensus, can be regarded as one of the major achievements of twentieth-century international law."⁶

The current regime with its arm's-length pricing requirement is an example of a model that requires substantial international cooperation to find an equitable distribution. This distribution is attempted through the arm's-length requirement even though, for a highly integrated entity, it does not achieve a result that reflects economic reality. Further, where the traditional arm's-length standard does not result in an accurate allocation, jurisdictions explicitly adopting the official stance of opposing formulary apportionment implicitly accept its use. Consequently, there is already a level of international cooperation on how to achieve this equitable allocation of profits to the relevant jurisdictions. It can be argued that multinational banking is an ideal example of where this has happened through the use of advance pricing agreements (APAs).

The current regime also provides an example where many of the rules are subject to disagreement. For instance, current application of the arm's-length principle itself causes difficulties in practice where different methodologies are used. This means that neither are the arm's-length rules applied uniformly, nor is there uniform consensus as to the assignment of income and expenses. Currently, disputes between nations are voluntarily resolved via treaties. Where jurisdictions continue to [pg. 57]disagree, there is no solution to the possibility of double taxation.

It has been stated that for unitary taxation to be successful, it would need to be accepted internationally. At the very least, it would need to be implemented multilaterally to achieve any sort of equitable distribution. Implementation of a unitary model by only one jurisdiction would not be a satisfactory approach to allocation as there would be a dual requirement to satisfy the arm's-length model and formulary apportionment model. There may also be complications for a unitary taxation model where it is adopted by a group of countries, as there may still be the dual requirement to satisfy both regimes.

International agreement would likely need to be in the form of a multilateral treaty to operate efficiently. The current international tax regime is dominated by a series of bilateral treaties based on model tax conventions, with multilateral treaties much rarer. However, it could be argued that use of such treaties may be possible as the role of the tax treaty is increasing.⁷ Further, many other regulatory issues are being dealt with at a global level. A multinational treaty not only enables consistent application but also aids administration through cooperation of information-gathering and consistent enforcement. At present, treaties allow formulary

apportionment in a limited number of cases. Expanding on this limited acceptance and adopting a multilateral approach would ensure that jurisdictions collaborate to develop a uniform application of the formulary apportionment model. Again, this would not be easy, and opposition from developing countries cannot be discounted as it may be argued that they have little to gain from a formulary apportionment regime. However, this would be achieved more easily under an industry-specific proposal than a broad adoption of the regime for all multinationals. It would also be a more likely possibility within existing trading blocks such as NAFTA, the EU, and ASEAN, given their similar levels of economic development.

A multilateral approach may also require individual jurisdictions to relinquish a certain degree of control over the taxation of multinational banks, which is likely to be met with reluctance by all jurisdictions concerned. A suggested, albeit extreme, approach to unitary taxation is the assessment of profits by a central administering body, which would allocate the income to the relevant jurisdictions according to the relevant formula. This would require the central body to administer all multinational banks, and the jurisdictions to agree on both the tax base and tax rate. [pg. 58] Such an approach would obviously require jurisdictions to hand over many of the rights currently assessed domestically. Consequently, it may be argued that sovereignty over taxation would be compromised. Agreement of this type, therefore, is unlikely in the near future. A more flexible version would allow the individual jurisdictions to apply their own tax rate and make base adjustments. The current regime also deals with these issues without an international body overseeing implementation and administration, so this should not be a bar to unitary taxation based on global formulary apportionment.

Opposition to formulary apportionment based on the difficulty in reaching international consensus also encompasses a compliance aspect. Opponents argue that agreement will not be reached because of the extra burden on entities to provide information globally, as well as translation requirements and the ongoing burden of complying with the accounting standards of individual jurisdictions.⁸ Yet in recent years there has been a movement towards the adoption of International Financial Reporting Standards (IFRS) by many countries. Previously, this article has argued that compliance may be less burdensome for multinational banks under the unitary tax regime than it is currently. At the very least, any additional compliance would not be excessive given the move towards an international approach to such matters.

A move towards a unitary tax model based on global formulary apportionment for taxing multinational banks would require vast changes in attitude by tax authorities internationally. There is no doubt that, politically and administratively, the substitution of the arm's-length pricing model with a unitary tax model for the taxation of multinational banks would introduce a range of complex issues. Further, the most successful way to achieve harmonization is through full international acceptance, without which compliance would be required for two systems. However, this should not be dismissed as impossible to achieve, since the current regime

effectively requires a similar degree of international acceptance and compliance to operate efficiently.

Consequently, this first step of achieving international acceptance is difficult but not insurmountable. However, this acceptance that formulary apportionment is a more theoretically sound model for taxing multinational banks only sets the foundation for implementation of such a regime. Agreement to a formulary apportionment approach does not connote agreement on the operation and administration of the regime.

Before formulary apportionment could be implemented for multinational banks, agreement would need to be reached on jurisdiction to tax, tax base to be divided, formula, unitary business, and enforcement principles. Difficulties are generally associated with these key components of formulary apportionment for taxing multinational banks, as discussed below.

4.2 Key components of formula apportionment system.

As with the current transfer pricing regime, implementation of a unitary tax model based on global formulary apportionment requires agreement on the unitary business, tax base, and formula. Agreement on the corporate tax rate is neither exclusive nor integral to unitary taxation and formulary apportionment. The current regime has differing corporate tax rates between taxing jurisdictions and this is unlikely to diminish in the future. Further, just as it is not necessary to have a uniform corporate tax rate under the current regime, it is not necessary to have one for an effective formulary apportionment regime.

The current regime also provides guidance on how to reach consensus on key issues. Consensus has generally already been reached on the key issues of the current regime, and many of these are similar to those under a unitary tax model. For example, determining what constitutes the unitary banking business can be equated to determining whether there are related parties for arm's-length pricing purposes. Determining the formula can be equated to the arm's-length standard itself, as it is simply a means of allocating profits according to a predetermined method. Thus, many of these issues are not new, with the possible exception of the tax base.⁹

As stated earlier, the OECD broadly opposes formulary apportionment based on the high degree of international consensus required. More specifically, the OECD's most significant concern lies with the requirement of "substantial international coordination and [pg. 59]consensus on the predetermined formulae to be used and on the composition of the group in question."¹⁰ Without this agreement, there may be double or less than single taxation. However, this agreement is not impossible to achieve. The key components are examined below.

4.2.1 Unitary business. The first key economic component of the unitary tax system is the unitary business, i.e., which parts of the banking business are considered part of the

multinational bank for taxation purposes? Defining the unitary banking business is essentially a case-by-case factual question. It will usually be obvious that a branch is part of the unitary banking business, so the main issue is whether separately incorporated affiliates should be included in the combined banking business.¹¹

The U.S. state model is an example of where this issue has had to be decided in a broad spectrum of cases. While unitary taxation is used in the United States in only a limited sense, the courts have had to decide the definition of a unitary business. In this setting, the definition is, and continues to be, a source of controversy. Two tests have been formulated, however, and may provide a foundation on which to base international tests. These tests are not statute-based but rather a product of the court system. Further, the U.S. Supreme Court, rather than defining “unitary business,” has left it to be decided case by case: “... the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing State.”¹²

The Californian courts have formulated the two tests for determining the unitary business. The first is the “three unities” test in *Butler Bothers v. McColgan*.¹³ Under this test, there is a unitary business if there is unity of ownership, operation, and use. The second test was developed in *Edison California Stores*.¹⁴ Under this test, “if the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered separate.”¹⁵

The debate as to which test applies has been ongoing. The tests, however, do provide guidance on the types of issues that can be considered to determine the unitary banking business at a global level. Further, as suggested earlier, this may be no more than the debate over associated enterprises and permanent establishments, as the question is which of the branches and subsidiaries should be included in the unitary banking business. The question in a unitary taxation setting does, however, have the advantage of being a determination of fact based on the individual circumstances, rather than one that considers the legal structure of the business. Consequently, subsidiary/branch recognition and distinction would not be part of the allocation process.

Determining the unitary business for purposes of multinational banking generally would not be difficult. It will usually be obvious whether a branch or a subsidiary is contributing to the overall business and, therefore, should be included as part of the unitary business for tax purposes. There may be some difficulty in deciding whether an [pg. 60]agency is part of the unitary business, but this assessment would be no more difficult than determining whether the agent is dependent or independent for purposes of the current permanent establishment threshold test.

4.2.2 Tax base. Once the unitary banking business is identified, the formulary apportionment system requires a definition of the tax base to determine the amount to be apportioned. This tax base has been referred to as “business taxable income,” which is the amount to which the formula should be applied. Before the formula can be applied, however, there needs to be a commonly agreed method for determining the profits to be apportioned. To maintain international equity and ensure that there is no under- or over-taxation, there must be a common definition of business income. To this extent, there also needs to be consensus on timing for purposes of income and deduction recognition.

Consensus on the multinational banking tax base may be more difficult than on the unitary banking business as there is no counterpart in the current regime. The current regime, by operating on a transactional basis, ensures that the rules in the country of allocation apply. There are, however, recognized methods for determining the tax base for multinational entities in general. The best example is in the work already undertaken by the European Commission in its proposals to move towards formulary apportionment. The Commission is currently focusing on two alternatives:¹⁶ home state taxation (HST) and a Common Consolidated Corporate Tax Base (CCCBT).¹⁷ Under the HST method, the home jurisdiction would determine the tax base according to its domestic rules. Under CCCBT, common rules would determine a standardized taxable income of all multinational entities.¹⁸

CCCBT is seen as the ultimate goal of a formulary apportionment regime but it would require immense cooperation between nation states. Currently, therefore, HST appears to be the more pragmatic approach to defining the tax base. If this method were adopted for multinational banks, there would be no change from the current system because the rules of the country of allocation would apply.

4.2.3 Composition of the formula, definition of the factors. Once the multinational banking tax base has been determined, it is necessary to allocate that base according to a predetermined formula. The composition of the formula is the main challenge in implementing a formulary apportionment model. The goal is to “develop a list of objective and easily measurable criteria that could be used to allocate, in an equitable manner, taxable income across tax jurisdictions.”¹⁹ It is essential that this objective is met, as formulary apportionment will represent an optimal regime for taxing multinational banks, superior to arm's-length pricing, only when the formulary factors reflect the location of the economic activity.

As with the previous key components, it is agreement that is essential, and it is the agreement on a formula that is important, rather than choosing a particular formula. While the definition of the formula and factors are important to the apportionment system, choice of the actual formula to be applied is less important than is often recognized. If agreement is not reached,

there is the potential for over- or under-taxation. Once agreement is reached, only 100% of the tax base may be allocated.

The choice of factors to be agreed, however, is influenced by competing forces. The factors should reflect how the income is produced and identify contributions by the relevant jurisdictions. Where the contributions are recognized, the interest of accuracy is met. Accuracy must be weighed, however, against simplicity. An increase in accuracy may lead to a decrease in simplicity. For accuracy, the formula should reflect the contributions in the income-producing process, whereas, for simplicity, the formula should be easy to administer. There is also the inherent incentive for individual jurisdictions to achieve a formula that emphasizes factors that have a significant presence within the jurisdiction. Further, there is the problem that developing countries may be disadvantaged where emphasis is placed on such factors as labor and capital that have lower costs in those countries.²⁰ Thus, they are unlikely to agree to a formula that weighs these factors heavily.

Because of the complex array of competing interests, both conceptually and at a practical level internationally, agreement to the factors is a difficult task. The OECD explains the competing jurisdictional interests:

Even if some countries were willing to accept global formulary apportionment, there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximize that country's own revenue. In addition, tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g. sales, capital) to low tax countries.²¹

The choice of formula should reflect an optimal regime, or one that allocates income to the relevant jurisdictions, based on economic activity, with the aim of achieving inter-jurisdictional equity. Economic theory does not provide a single formula for accurately allocating income, so international agreement is necessary on what is considered *fair*. As to what is fair, various factors may be considered to contribute to the economic activity undertaken in a jurisdiction.

Examples of factors that may make up the formula include the share of (1) physical assets or intangible assets, (2) employment, and (3) sales. Other examples that have been used at some time in the U.S. state formula include manufacturing costs, purchases, expenditures for labor, accounts receivable, net cost of sales, capital assets, and stock of other companies. While all of these factors have been used at some time for U.S. state tax, property, payroll, and sales are now the acceptable factors.²² It is believed that “the property, payroll and sales formula strikes

a balance between ... competing influences.” The rationale for use of the three-factor formula is that these factors “provide a reasonable measurement of the income generated by the business [pg. 61]activities located in the state. It does not place a disproportionate weight on any of the factors, and it apportions some income to the states where production occurs and some where sales occur.”²³

These factors, however, may not be suitable for multinational banking. It is generally understood that inequities may be created where the same formula is applied across differing industries. In the context of global trading, Charles Plambeck suggests that “most in accordance with economic theory would be to select factors of production (inputs) as the basis for this formula, on the theory that if unrelated parties in each jurisdiction were to enter into a joint venture to conduct global trading, they might be expected to divide the profits in accordance with each one's relative contribution of inputs.”²⁴ He states further that the predominant factor would be one that measures trader (human resource) input.

4.4.4 APAs. The only example of formulary apportionment being used for global trading is in U.S. APAs but even these formulas are not true instances of global formulary apportionment as they consider the particular facts of each case. They do, however, provide an example of suitable factors. The IRS, in arriving at an appropriate formula, considered that the factors of value, risk, and activity were most significant in determining source of income.²⁵ The APAs were entered into where the IRS considered that the businesses were functionally integrated, operating under a central management and risk model. The agreements allocated income on a profit split basis using these three factors. Consistent with an equitable inter-jurisdictional allocation, the use of these factors “was intended to measure the economic activity of each trading location and its contribution to the overall profitability of the worldwide business.”²⁶

The value factor in the APAs represents a measure of the contribution of a trading location to the worldwide profits of the entity; the best measure of this factor is the compensation of the traders at a trading location. Both the taxpayers and tax authorities considered that trader compensation, including bonuses, was the best measure of this factor, so it had the greatest weight.

The risk factor was a measure of the potential risk to which a trading location exposes the entity's worldwide capital. This factor is measured in several alternative ways, “such as the maturity weighted volume of swap transactions...or open commodity positions at the end of the year entered into in that trading location.”²⁷

The activity factor was a measure of the contribution of a trading location to the entity's worldwide profits, which takes into account key support staff. It can also be calculated by reference to the net present value of transactions executed at a trading location.

While the APAs were firm specific, formulas can be based on industry or other broad economic data.²⁸ Using these factors, a possible formula for multinational banking is shown in Exhibit 1.

It is not possible to predict the international reaction to agreement on the key components of a formulary apportionment regime for multinational banks. Thus, this article does not attempt to [pg. 62]determine the best way of defining these components, but rather offers suggestions and a foundation for discussion that may ultimately lead to consensus. What is evident, however, is that agreeing to the use and implementation of unitary taxation based on global formulary apportionment at an industry-specific level, such as multinational banking, will be easier than at a broad level for all multinational entities.

5. Conclusion

A move to unitary taxation based on global formulary apportionment is a “big bang”²⁹ approach to the problems associated with application of the traditional international taxing model to multinational banks. Consequently, there would need to be radical change in international tax procedures for such a model to be implemented. While some commentators believe that formulary apportionment introduces its own problems,³⁰ it has greater parity with the economic reality of multinational banks, thereby reflecting an optimal way to tax them. Global trading is one such activity of multinational banks where economic functions cannot be divided according to geographical boundaries. Accordingly, the traditional arm's-length model does not achieve a result that accurately reflects the economic activity in a jurisdiction. Formulary apportionment would achieve this result, and at the same time ensure that the intermediary activities undertaken by multinational banks are captured for tax purposes.

Global formulary apportionment is also a pragmatic answer to the problems associated with the current regime, as it accepts that it is not possible to determine an accurate allocation of income on a transactional basis. Rather, it focuses on an approximate answer that most closely reflects the economic reality and business strategy of the multinational banks.

The obvious downfall of formulary apportionment is related not to its theoretical soundness but to the problem of international acceptance and agreement, not only to implement the model but also on the key components of the regime. Without international compliance, global formulary apportionment may not exhibit many of the purported advantages or be a viable alternative to the current model. It is arguable, however, that international acceptance may be achievable on an industry-specific basis, particularly if the industry is multinational banking. This is because multinational banking has unique characteristics that make it difficult, if not impossible, to apply the traditional jurisdiction and allocation rules to the taxation of these banks, whereas unitary taxation based on global formulary apportionment represents an

optimal way to tax multinational banks because it recognizes these characteristics and the economic reality of the industry.

There are currently no examples of formulary apportionment being used in its pure form at an international level³¹ and there has been no comprehensive effort to do so. Further, formulary apportionment traditionally has not been applied at industry level. A unitary tax model based on global formulary apportionment is usually proposed based on geographical boundaries (such as country, economic groups, or globally) rather than industry boundaries (such as multinational banking). Yet there is no reason why a unitary tax model could not be implemented to apply specifically to an industry that warranted it where the current jurisdiction and allocation principles fail to accurately reflect the economic reality of that industry.

Formulary apportionment does not solve all of the issues associated with the current international tax rules governing jurisdiction and allocation of income but it is a potential solution to many of the problems associated with the separate-entity approach, and recognizes the consequences of globalization by multinationals. Principally, it removes the requirement to identify and price internal transactions. It also provides a complete solution to profit allocation between relevant jurisdictions where there is international acceptance of this model. Thus, many issues in the context of multinational banking, may be resolved through a unitary tax model. The model will be truly successful, however, only where application of global formulary apportionment is based on the whole enterprise, which is not an easy task.³²

Exhibit 1. Possible Formula for Multinational Banking*

$$T_i = t_i \text{ ll } \left[\alpha_i^V \frac{V_i}{V} + \alpha_i^R \frac{R_i}{R} + \alpha_i^A \frac{A_i}{A} \right]$$

where:

i = jurisdiction

T_i = tax liability in jurisdiction

t_i = statutory tax rate in jurisdiction

ll = tax base

V_i = value in jurisdiction

V = total value

R_i = risk in jurisdiction

R = total risk

A_i = activity in jurisdiction

A = total activity

α_i^V = weight on value in jurisdiction

α_i^R = weight on risk in jurisdiction

} $\alpha_i^V + \alpha_i^R + \alpha_i^A = 1$

α_i^A = weight on activity in jurisdiction

* Adapted from Commission of the European Communities, *Company Taxation in the Internal Market: Commission Staff Working Paper (Brussels, 2001)*, Part IV: Remedies to the Company Tax Obstacles in the Internal Market, Subpart IV.C: Approaches for a Comprehensive Solution, Section 17: Revenue Allocation: The Different Methods, page 413.

¹ 22 JOIT 46 (May 2011).

² OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris, 2010) ("OECD Guidelines"), paras. 1.22, 1.24.

³ Australian Taxation Office, *Taxation Ruling TR 97/20: Income Tax: Arm's Length Transfer Pricing Methodologies for International Dealings* (Canberra, 1997), ch. 3: Arm's Length Methodologies, paras. 3.100-3.101, 3.104.

⁴ See, e.g., "OECD Discussion Draft on Attribution of Profits to Permanent Establishment—Part II (Banks)," BNA Daily Tax Report, March 5, 2003, TaxCore.

⁵ OECD Guidelines para. 1.24.

⁶ Avi-Yonah, "The Structure of International Taxation: A Proposal of Simplification," 74:6 *Texas Law Review* (1996), page 1301.

⁷ See Treaty Special Report, 22 *Journal of International Taxation* (Thomson Reuters/WG&L) (April 2011).

⁸ Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises," 79:1 *Cornell Law Review* 18 (1993), page 69.

⁹ Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)," 45 Bull. for Int'l Tax'n 99 (IBFD, 1991), page 105.

¹⁰ OECD Guidelines para. 1.22.

¹¹ Weiner, "Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level" (Office of Tax Analysis Paper 83, Dept. of the Treasury, Washington, D.C., 1999), page 17.

¹² *ASARCO Inc. v. Idaho State Tax Comm.*, 458 U.S. 307 .

¹³ 111 P2d 334.

¹⁴ 183 P2d 16.

¹⁵ *Id.* page 481.

¹⁶ On the advantages and disadvantages of these approaches, see Weiner and Mintz, "An Exploration of Formula Apportionment in the European Union," 42:8 European Taxation (IBFD, 2002), page 346.

¹⁷ Commission of the European Communities, *Company Taxation in the Internal Market: Commission Staff Working Paper* (Brussels, 2001); Commission of the European Communities, *Towards an Internal Market Without Tax Obstacles: A Strategy for Providing Companies With a Consolidated Corporate Tax Base for their EU-Wide Activities—Communication From the Commission to the Council, the European Parliament and the Economic and Social Committee* (Brussels, 2001). Two other methods are outside the scope of this discussion. See "EC Publishes Final Common Consolidated Corporate Tax Base Proposal," *EY EU Watch*, 22 JOIT 24 (June 2011).

¹⁸ Bravenec, "Corporate Income Tax Coordination in the 21st Century," 40:10 European Taxation 450 (IBFD, 2000), page 455; McLure, Jr., "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment," 56:12 Bull. for Int'l Tax'n 586 (IBFD, 2002), pages 588-589.

¹⁹ See Tanzi, "Globalization, Technological Developments, and the Work of Fiscal Termites," 26:4 Brooklyn J. Int'l Law (2001), page 1261.

²⁰ Bolkestein, "Towards an Internal Market Without Tax Obstacles" (speech at European Commission Conference on Company Taxation in the European Union, Brussels, April 29, 2002).

²¹ OECD Guidelines para. 1.23.

²² The OECD sees problems with the use of these factors: "Difficulties also would arise in determining the sales of each member and in the valuation of assets (e.g., historic cost versus market value), especially in the valuation of intangible property. These difficulties would be compounded by the existence across taxing jurisdictions of different accounting standards and of multiple currencies. Accounting standards among all countries would have to be conformed in order to arrive at a meaningful measure of profit for the entire MNE group. Of course, some of these difficulties, for example the valuation of assets and intangibles, also exist under the arm's length principle, although significant progress in respect of the latter has been made, whereas no credible solutions have been put forward under global formulary apportionment." OECD Guidelines para. 1.28.

²³ Weiner, "Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level," 13 Tax Notes Int'l 2113 (1996), page 2123.

²⁴ Plambeck, "The Taxation Implications of Global Trading," 48 Tax Notes 1143 (1990).

²⁵ Notice 94-40, 1994-1 CB 351 ("IRS Describes Methods Used in Global Trading APAs").

²⁶ *Id.*

²⁷ *Id.*

²⁸ Weiner, "The European Union and Formula Apportionment: Caveat Emptor," 41:10 European Taxation 380 (IBFD, 2001), page 381.

²⁹ Both Ian Spence and Alex Easson refer to the two alternatives, an alternative model or alterations to the current model, as the "big bang" approach or the incremental step-by-step approach. See Spence, "Globalization of Transnational Business: The Challenge for International Tax Policy," 25:4 Intertax 143 (1997), page 146; Easson, *Taxation of Foreign Direct Investment* (Kluwer Law Int'l, 1999), page 178.

³⁰ See, e.g., Finch, "The Apportionment of Multistate and Multinational Corporate Income for Tax Purposes," 38 Bull. for Int'l Tax'n (IBFD, 1984), page 51.

³¹ As noted above, there are APAs currently in operation that contain elements of formulary apportionment.

³² See OECD Guidelines para. 1.31