



Georgetown University Law Center  
Scholarship @ GEORGETOWN LAW

---

2020


## Formulating the International Tax Debate: Where Does Formulary Apportionment Fit?

Itai Grinberg

This paper can be downloaded free of charge from:  
<https://scholarship.law.georgetown.edu/facpub/2238>

---

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.  
Follow this and additional works at: <https://scholarship.law.georgetown.edu/facpub>

 Part of the [International Law Commons](#), and the [Tax Law Commons](#)

The Allocation of Multinational  
Business Income: Reassessing the  
Formulary Apportionment Option

Edited by

Richard Krever  
François Vaillancourt



*Published by:*

Kluwer Law International B.V.  
PO Box 316  
2400 AH Alphen aan den Rijn  
The Netherlands  
E-mail: [international-sales@wolterskluwer.com](mailto:international-sales@wolterskluwer.com)  
Website: [lrus.wolterskluwer.com](http://lrus.wolterskluwer.com)

*Sold and distributed in North, Central and South America by:*

Wolters Kluwer Legal & Regulatory U.S.  
7201 McKinney Circle  
Frederick, MD 21704  
United States of America  
Email: [customer.service@wolterskluwer.com](mailto:customer.service@wolterskluwer.com)

*Sold and distributed in all other countries by:*

Air Business Subscriptions  
Rockwood House  
Haywards Heath  
West Sussex  
RH16 3DH  
United Kingdom  
Email: [international-customerservice@wolterskluwer.com](mailto:international-customerservice@wolterskluwer.com)

*Printed on acid-free paper.*

ISBN 978-94-035-0614-2

e-Book: ISBN 978-94-035-0615-9  
web-PDF: ISBN 978-94-035-0620-3

© 2020 Richard Krever

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without written permission from the publisher.

Permission to use this content must be obtained from the copyright owner. More information can be found at: [lrus.wolterskluwer.com/policies/permissions-reprints-and-licensing](http://lrus.wolterskluwer.com/policies/permissions-reprints-and-licensing)

Printed in the United Kingdom.

## CHAPTER 11

# Formulating the International Tax Debate: Where Does Formulary Apportionment Fit?

*Itai Grinberg*

---

### §11.01 INTRODUCTION

As the contributions in this volume are being written, the Inclusive Framework nations, a group drawn together by the Organisation for Economic Co-operation and Development (OECD) as part of its Base Erosion and Profit Shifting (BEPS) project, are in the midst of a consultation process intended to revise the international corporate tax profit allocation and nexus rules. At the end of May 2019, the OECD released its *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*.<sup>1</sup> At the beginning of June 2019, this Programme was endorsed by the G20 Finance Ministers during their ministerial meeting in Fukuoka, Japan.<sup>2</sup>

To use the OECD's terminology, the proposals under consideration to revise the current nexus and profit allocation rules would create a 'new taxing right' to be allocated to the 'market jurisdiction'.<sup>3</sup> The Programme of Work describes certain technical issues that must be considered when making such fundamental changes to the international tax architecture.<sup>4</sup>

The OECD's work on these major revisions to international tax norms is being undertaken under the auspices of the Inclusive Framework. The Inclusive Framework arose out of a G20 request that the OECD create a body in which all interested countries

---

1. OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, OECD/G20 Inclusive Framework on BEPS (OECD 2019).

2. Communiqué, G20 Finance Ministers and Central Bank Governors Meeting, Fukuoka, Japan, 9 June 2019, [11] (Fukuoka Communiqué).

3. OECD, *Programme of Work*, *supra* n. 1, at 11.

4. *Ibid.*, [24].

– regardless of G20 or OECD membership – could participate in the BEPS project on an equal footing.<sup>5</sup> The subsequently developed Inclusive Framework allows interested countries to work with the OECD/G20 on developing standards on BEPS-related issues.<sup>6</sup> As of this writing, over 125 countries have joined the Inclusive Framework<sup>7</sup> and committed to implementing the comprehensive BEPS package.<sup>8</sup> It was clear from the outset that the Inclusive Framework could be used as a stand-in for a world tax organization. In the current OECD project on profit allocation, it is in effect being used in that manner for the first time.

The Inclusive Framework is not currently considering a full move to formulary apportionment, as that term is understood in this volume. Yet evaluation of the proposals under consideration by the Inclusive Framework suggests that each and every one can be improved by reappraising formulary apportionment. Accordingly, the purpose of this chapter is to highlight the relationships between the options under consideration in the current OECD-led process and ‘formulary apportionment’, as that term is used elsewhere in this volume.

Section 11.02 of the chapter briefly offers some background on the major developments – arguably, tectonic shifts – of the last few years in the international tax arena. Section 11.03 describes the proposals for revising the profit allocation rules that are currently under consideration by the Inclusive Framework. Section 11.04 fleshes out ‘straw men’ that develop these ideas in greater detail, with the purpose of highlighting that the proposals that are under consideration by the Inclusive Framework at the time of this writing are partially formulary approaches and that lessons from formulary apportionment likely carry over to any partially formulary system that may be developed multilaterally in the future.

## §11.02 BACKGROUND: THE ROAD TO FUKUOKA

In the summer of 2019, the G20 endorsed the OECD’s *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy* intended to develop a new taxing right to change the international tax architecture. The Programme of Work is a continuation of the OECD’s Base Erosion and Profit Shifting (BEPS) project, another G20-endorsed international tax effort which ran principally from 2013 to 2015. One of the Final Reports associated with that project noted that the digitalization of the economy exacerbated BEPS issues, while also raising broader tax challenges.<sup>9</sup> At the same time, the top-line conclusion of the OECD’s 2015

---

5. G20 Leaders’ Communiqué, Antalya Summit, 15-16 November 2015, [15] (Antalya Communiqué); see also OECD, *Background Brief: Inclusive Framework on BEPS* (OECD 2017).

6. *Ibid.*, section 2.1.

7. OECD, *About the Inclusive Framework on BEPS*, <https://www.oecd.org/tax/beps/beps-about.htm> (accessed 12 Jun. 2019).

8. See OECD, *Background Brief: Inclusive Framework on BEPS*, *supra* n. 5, section 2.1, requiring that countries commit to the BEPS package and its consistent implementation in order to join the Inclusive Framework.

9. OECD, *Action 1 – 2015 Final Report: Addressing the Tax Challenges of the Digital Economy*, OECD/G20 Base Erosion and Profit Shifting Project 135 (OECD 2015).

project on the digital economy was that there was no such thing as a ‘digital economy’ that could be ring-fenced from the broader economy. Rather, the OECD came to the view that the entire economy was in the process of ‘digitalizing’.<sup>10</sup>

Nevertheless, in 2015 the OECD committed to continue working on issues related to the so-called digital economy, and to deliver an interim report to the G20 in 2018, and a final report in 2020.<sup>11</sup>

In the work undertaken in the three years following the 2015 Final Reports of the BEPS project, the Inclusive Framework again underscored that certain characteristics of highly digitalized business models allow multinational enterprises (MNEs) to create value through activities closely linked with a domestic economy, without needing to establish a taxable physical presence in that economy.<sup>12</sup> This conclusion was not initially intended to disturb the earlier conclusion that the digital economy could not be ‘ring-fenced’, because the entire economy was digitalizing, albeit with different parts of the economy digitalizing at different speeds.

Despite this conclusion, many jurisdictions that had hoped to collect more revenues from specific companies in the digital sector decided quite quickly that they were not satisfied with the relevant BEPS transfer pricing outcomes. Illustrative examples of the companies of interest were often mentioned in documents issued by governments either by name or by transparent references to specific business models, and almost always included Google, Apple, Facebook, and Amazon, as well as some other US-headquartered companies.<sup>13</sup>

- 
10. See Erik Cederwall, *Making Sense of Profit Shifting: Pascal Saint-Amans*, Tax Foundation (22 May 2015), <https://taxfoundation.org/making-sense-profit-shifting-pascal-saint-amans/> (accessed 28 Jun. 2019); OECD, *Addressing the Tax Challenges of the Digital Economy*, *supra* n. 9.
  11. OECD, *Addressing the Tax Challenges of the Digital Economy*, *supra* n. 9; see also PricewaterhouseCoopers, *OECD Consultation to Reshape the International Tax System for the Digitalised Age Commences*, Tax Policy Bulletin (15 February 2019), <https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-oecd-consultation-reshape-international-tax-for-digital.pdf> (accessed 29 Jun. 2019).
  12. OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018*, Inclusive Framework on BEPS (OECD 2018); see also OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document, 13 February – 6 March 2019*, OECD/G20 Base Erosion and Profit Shifting Project 11-13 (OECD 2019).
  13. Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate*, 97 *Taxes: The Tax Mag.* 73, 79 (2019); European Commission, *Digital Taxation: Commission Proposes New Measures to Ensure That All Companies Pay Fair Tax in the EU*, press release (21 March 2018), [http://europa.eu/rapid/press-release\\_IP-18-2041\\_en.htm](http://europa.eu/rapid/press-release_IP-18-2041_en.htm); European Commission, *Questions and Answers on a Fair and Efficient Tax System in the EU for the Digital Single Market*, fact sheet (21 March 2018), [http://europa.eu/rapid/press-release\\_MEMO-18-2141\\_en.htm](http://europa.eu/rapid/press-release_MEMO-18-2141_en.htm); HM Treasury & HM Revenue and Customs (UK), *Digital Services Tax: Consultation* (November 2018), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/754975/Digital\\_Services\\_Tax\\_-\\_Consultation\\_Document\\_FINAL\\_PDF.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/754975/Digital_Services_Tax_-_Consultation_Document_FINAL_PDF.pdf); Government of France, *GAFA Tax: A Major Step Towards a Fairer and More Efficient Tax System*, press release (9 April 2019), <https://www.gouvernement.fr/en/gafa-tax-a-major-step-towards-a-fairer-and-more-efficient-tax-system> (accessed 29 Jun. 2019); Federal Ministry of Finance, Austria, *Digitalsteuergesetz 2020*, draft Bill to amend Turnover Tax Law 1994 (5 April 2019), [https://www.parlament.gv.at/PAKT/VHG/XXVI/ME/ME\\_00132/index.shtml](https://www.parlament.gv.at/PAKT/VHG/XXVI/ME/ME_00132/index.shtml), discussed in Ernst & Young, *Austria Publishes Draft Digital Advertising Tax Bill*, Indirect Tax Alert (8 April 2019), <https://www.ey.com/gl/en/services/tax/international-tax/alert--austria-publishes-draft-digital-advertising-tax-bill>.

In March 2018, the European Commission called for new international rules that would alter the application of permanent establishment (PE) and transfer pricing rules to the digital economy alone.<sup>14</sup> The Commission released two digital tax proposals: an interim digital services tax (DST) which would be based on turnover or a withholding mechanism, and would be imposed on digital platform companies,<sup>15</sup> and a long-term proposal that would create a new digital PE based on ‘significant digital presence’.<sup>16</sup>

A number of individual EU Member States, as well as countries in other parts of the world, went ahead and proposed their own digital services taxes, separate and apart from the European proposal put forward by the Commission. European countries moving forward included France, Italy, Spain, and the United Kingdom, while major non-EU countries taking steps to enact DSTs included Australia, India, Mexico, New Zealand, and South Korea.<sup>17</sup>

Even before the DSTs were proposed, countries had begun taking unilateral steps inconsistent with the BEPS outcomes that targeted digital business. The first such action, which arguably opened the floodgates because it was proposed by a jurisdiction (the United Kingdom) which helped lead the BEPS project, was the United Kingdom’s diverted profits tax (DPT). The DPT enacted on 26 March 2015 with effect from 1 April 2015 a 25% tax on profits deemed to be artificially diverted away from the United Kingdom. The DPT targets instances where, under the existing PE rules, an MNE legitimately avoids establishing a taxable presence in the United Kingdom, despite the fact that the MNE supplies goods or services to UK customers. The United Kingdom’s decision to enact the DPT while simultaneously helping lead the BEPS project treated sovereignty as a licence for organized hypocrisy. But for the DPT, one could imagine that a more cooperative international tax environment might have evolved out of the BEPS project.

Shortly after the United Kingdom moved forward with its DPT, India went ahead and targeted the so-called digital economy by imposing a 6% ‘equalization levy’ on outbound payments to non-resident companies for all digital services, and by expanding its taxing rights over non-residents to cover profits arising from a ‘significant economic presence’.<sup>18</sup> Other countries that undertook unilateral actions other than DSTs, but not limited by or consistent with the BEPS agreements, include Australia,

---

14. European Commission, *Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM(2017)547 final 9 (21 September 2017).

15. *Ibid.*, 10; Ernst & Young, *European Commission Issues Proposals for Taxation of Digitalized Activity*, Global Tax Alert (21 March 2018), <https://www.ey.com/gl/en/services/tax/international-tax/alert-european-commission-issues-proposals-for-taxation-of-digitalized-activity> (accessed 29 Jun. 2019).

16. See Ernst & Young, *New Digital Tax Policies: What, When, Where, How and By Whom?*, Global Tax Policy and Controversy Briefing (August 2018), [https://www.ey.com/Publication/vwLUAssets/EY-new-digital-tax-policies-what-when-where-how-and-by-whom/\\$FILE/EY-new-digital-tax-policies-what-when-where-how-and-by-whom.pdf](https://www.ey.com/Publication/vwLUAssets/EY-new-digital-tax-policies-what-when-where-how-and-by-whom/$FILE/EY-new-digital-tax-policies-what-when-where-how-and-by-whom.pdf) (accessed 29 Jun. 2019).

17. See Grinberg, *International Taxation in an Era of Digital Disruption*, *supra* n. 13, at 79.

18. Deloitte, *Taxation of Non-Residents Through a Significant Economic Presence: Widened Scope Under the Indian Income Tax Law* (2018), <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/technology-media-telecommunications/in-tmt-significant-economic-presence-1-noexp.pdf> (accessed 29 Jun. 2019).

Argentina, Chile, France, Israel, Italy, Japan, Mexico, New Zealand, Poland, Spain, and Uruguay.<sup>19</sup>

The proliferation of unilateral measures targeting digital business had the unintended effect of bringing together an unusual coalition of traditional ‘source’ countries and the United States and China (major ‘digital business’ headquarter countries). Beginning in 2017 some countries (such as Brazil and India) that had long advocated major change to the international tax system, and others (such as the United States) that were historically seen as the vanguard of OECD traditionalism, came to believe that any discussion of changing profit allocation rules could not be limited to a narrowly defined digital sector.<sup>20</sup> They therefore pushed for multilateral work on profit allocation generally, rather than a specific focus on digital economy companies. Given the earlier conclusion that it was not possible to ring-fence the digital economy, this request was hard to deny on the basis of any logic of appropriateness. Thus, a multilateral project that was initially spearheaded by countries that wanted to tax the digital economy more heavily was in effect converted into a project sponsored by a wider range of states in which all states found themselves forced to confront basic conflicts regarding profit allocation that they had managed to set aside in the original BEPS project.

The Inclusive Framework then went through a difficult period, mostly as a consequence of disagreements between countries that believed that the serious problems in the international tax regime were limited to the taxation of social media companies, search engines, and online marketplaces and those countries that believed that the profit allocation issues raised by those business models were just particularly noteworthy examples of much more widespread issues.

In February 2019, cognizant of the looming 2020 deadline and the OECD’s newfound commitment to consult broad groups of stakeholders, the OECD distilled these intra-governmental tensions into a public consultation document that outlined three substantially irreconcilable proposals grouped under two ‘pillars’. The first pillar addressed proposals to revise the nexus and profit allocation rules; the second addressed the so-called remaining BEPS issues.<sup>21</sup> The Inclusive Framework acknowledged that all three of the proposals it was considering in the consultation document under the first pillar would ‘go beyond the arm’s length principle’<sup>22</sup> and came to call

---

19. For a more robust discussion on the rise of international tax unilateralism, see Grinberg, *International Taxation in an Era of Digital Disruption*, *supra* n. 13.

20. Remarks of Brian Jenn, Deputy International Tax Counsel, US Treasury, at the US Council for International Business (USCIB) 2018 OECD International Tax Conference, Washington, DC, 4-5 June 2018 (all major economies believe either the first or the second of the options).

21. OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note, As Approved by the Inclusive Framework on BEPS on 23 January 2019*, OECD/G20 Base Erosion and Profit Shifting Project 1 (OECD 2019).

22. *Ibid.*, 2. Both the ‘marketing intangibles’ and ‘user participation’ proposals that were described in the consultation document were different ‘flavours’ of a modified residual profit split method, while the significant economic presence proposal took a worldwide formulary apportionment approach: OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document*, *supra* n. 12, at 11-13. Under the first two proposals, routine returns are calculated at arm’s length. The marketing intangibles approach then carves out the portion of residual profits that can be deemed attributable to ‘marketing intangibles’. Under the marketing



these ideas the ‘new taxing right’. Two of the ‘new taxing right’ proposals continued to utilize the arm’s length principle in allocating routine returns. One of the proposals – the so-called significant economic presence proposal – contemplated an approach which allocated profit to a significant economic presence in a jurisdiction, based on a ‘fractional apportionment’ method. Fractional apportionment was the term used to describe formulary apportionment regimes in the multilateral context in earlier generations.<sup>23</sup> There is no substantive difference between the two ideas.

After inviting public input on the consultation document proposals, the OECD received over 200 submissions. In March 2019, the OECD hosted a one and a half-day public consultation at which key members of the Task Force on the Digital Economy discussed the possible directions for future work.<sup>24</sup> In the months after the publication of the consultation document, it became clear that the majority of governments would not support a full move to fractional apportionment based on a significant economic presence concept.<sup>25</sup> Nevertheless, three alternative proposals for revising the international tax profit allocation and nexus rules were advanced by the Inclusive Framework. Each required that a significant portion of an MNE’s returns be allocated using a formulary method. The Inclusive Framework produced a Programme of Work to further study these ideas and move towards a new international tax consensus for profit allocation. In the summer of 2019, the G20 Finance Ministers approved the Programme, with the (unrealistic) hope that the work would be completed by the end of 2020.<sup>26</sup>

---

intangibles concept, affiliates of an MNC were to be compensated for their functions on a cost-plus or return on assets basis using the arm’s length principle. The ‘residual return’ would then be divided between marketing or customer-based intangibles and other intangibles. Residual returns deemed attributable to ‘marketing intangibles’ would be allocated in part or in whole to the market – the jurisdictions where the customers reside. Residual returns deemed attributable to other intangibles would be allocated based on current transfer pricing rules: Public Consultation Document, *supra* n. 12, at 14 [43]. In contrast, whereas the marketing intangibles approach did not ring-fence the ‘digital economy’, a user participation approach would be limited to social media platforms, search engines, and online marketplaces. The user participation proposal also required that profits deemed attributable to user participation would somehow be separated from other non-routine profits.

23. See, e.g., Mitchell B. Carroll, *Taxation of Foreign and National Enterprises: A Study of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country, Vol. IV: Methods of Allocating Taxable Income*, League of Nations Document No. C.425(b). M.217(b).1933.II.A. (League of Nations 1933); Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*, 54 *Tax Notes* 719 (1992); Vinay Kumar Singh, *Interaction of Transfer Pricing and Profit Attribution: Conceptual and Policy Issues for Developing Countries*, South Centre Tax Cooperation Policy Brief No. 3 (August 2018), [https://www.southcentre.int/wp-content/uploads/2018/08/TCPB3\\_Interaction-of-Transfer-Pricing-Profit-Attribution\\_EN.pdf](https://www.southcentre.int/wp-content/uploads/2018/08/TCPB3_Interaction-of-Transfer-Pricing-Profit-Attribution_EN.pdf) (accessed 29 Jun. 2019); Joann M. Weiner, *Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level* 3 n. 7 (US Treasury Office of Tax Analysis Paper 83, April 1999).
24. Ernst & Young, *OECD Hosts Public Consultation on Document Proposing Significant Changes to the International Tax System*, Tax News Update (19 March 2019), <https://taxnews.ey.com/news/2019-0563-oecd-hosts-public-consultation-on-document-proposing-significant-changes-to-the-international-tax-system> (accessed 29 Jun. 2019).
25. Remarks of L. G. ‘Chip’ Harter, Deputy Assistant Secretary (International Tax Affairs), US Treasury, at the USCIB 2019 OECD International Tax Conference, Washington, DC, 3-4 June 2019.
26. See Fukuoka Communiqué, *supra* n. 2, at [11].

**§11.03 INCLUSIVE FRAMEWORK PROPOSALS**

The Programme of Work endorsed by the G20 Finance Ministers advanced two key methods for quantifying the amount of an MNE's profits to be reallocated to market jurisdictions under the new taxing right, and determining how those profits are to be allocated among the market jurisdictions.<sup>27</sup> These methods are labelled in the Programme of Work as a modified residual profit split (MRPS) and a distribution-based (DB) approach.<sup>28</sup>

The Work Programme identified three technical issues to be resolved when designing the new taxing right, regardless of whether an MRPS or DB approach was taken:

- (1) how to determine the amount of an MNE's profits that are subject to this 'new taxing right' and how those profits are allocated among the relevant jurisdictions;
- (2) how to design a new nexus rule that establishes a business presence in a market jurisdiction without the need for a physical presence; and
- (3) creating instruments that ensure full implementation and efficient administration of the 'new taxing right'.<sup>29</sup>

Reappraisals of lessons learned in the debate over formulary apportionment can assist with all three of these questions. However, describing the relationship of these issues in the new taxing right to lessons learned in studying formulary apportionment first requires describing the OECD's modified residual profit split and distribution-based approaches to creating a new taxing right in greater depth. Accordingly, the next subsection turns to that task. The task remains useful even if the OECD process moves beyond these particular proposals in the immediate term, because this debate is likely to continue for a number of years.

**[A] Modified Residual Profit Split Method**

According to the Programme of Work, a modified residual profit split method would allocate a portion of an MNE's non-routine profits that 'reflects the value created in markets' to market jurisdictions.<sup>30</sup> This allocation of taxing rights would take place in four steps: (i) determine the parameters of the total profits to be split; (ii) remove routine profits from total profits; (iii) determine the portion of non-routine profit that is within the new taxing right, and (iv) use an allocation key to allocate that portion to the relevant market jurisdictions.<sup>31</sup> In the modified residual profit split method, three allocations and/or apportionments are therefore required. First, a distinction between

---

27. OECD, *Programme of Work*, *supra* n. 1, at 12.

28. *See ibid.*, 12-16.

29. *Ibid.*, 11.

30. *Ibid.*, 12.

31. *Ibid.*

routine and non-routine profits must be made; then the non-routine profit must be divided between an amount that is subject to the new taxing right and an amount that is not subject to the new taxing right; and finally the amount subject to the new taxing right must be allocated among jurisdictions. This final allocation between jurisdictions where the customers reside would be based on an ‘agreed allocation metric (e.g. revenues)’.<sup>32</sup> Importantly, the Programme of Work specifies that any modified residual profit split method must be calibrated to run alongside the current arm’s length transfer pricing rules. Therefore, it is clear that at least part of the arm’s length standard is intended to be preserved.<sup>33</sup>

### **[B] A Distribution-Based Approach**

In contrast to a modified residual profit split method, a distribution-based approach likely would not be limited in application to non-routine profits. It might, for example, also address profits arising from routine activities associated with marketing and distribution, or all routine profits.<sup>34</sup> One way to design a distribution-based system would be to specify a baseline profit in the market jurisdiction for marketing, distribution, and user-related activities. For example, the Programme suggests that a baseline profit allocation to market jurisdictions could be increased based on the MNE group’s overall profitability or modified to accommodate additional variables that may also indicate value such as the relevant industry sector. The result would be a reallocation of some of the MNE group’s profit – both routine and non-routine – to market jurisdictions.<sup>35</sup>

One professed appeal of the distribution-based approach is its potential for simplicity and ease of administration, including for developing countries. The distribution-based approach is thus intended to allocate more profit to market jurisdictions while also reducing the ongoing controversies associated with the current transfer pricing system.<sup>36</sup>

However, despite its superficial simplicity, the Programme acknowledges that such a distribution-based system raises complex issues. Some concerns include considering whether the system’s allocation to market jurisdictions is a final allocation or one that would allow for post-allocation re-evaluation; how reallocations could be applied where the MNE has no established tax presence in the market jurisdiction; and how this approach would run alongside the current transfer pricing system without resulting in double taxation or double non-taxation.<sup>37</sup>

---

32. OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy: Public Consultation Document*, *supra* n. 12, at 10, [24.3]; see also OECD, *Programme of Work*, *supra* n. 1, at 14.

33. OECD, *Programme of Work*, *supra* n. 1, at 13.

34. *Ibid.*, 15 [32].

35. *Ibid.*, 15 [33].

36. *Ibid.*, 15 [32].

37. *Ibid.*, 16, section 1.4.

**§11.04 'STRAW MEN' FOR PARTIALLY FORMULARY APPROACHES TO PROFIT ALLOCATION**

The parameters of the two approaches that were laid out by the Inclusive Framework in the 2019 Programme of Work are ill-defined. As a result, both to consider what reappraising formulary apportionment might teach us about the Programme, and to make the lessons of this chapter relevant to periods after that Programme is complete, it is helpful to specify 'straw man' proposals that add content to the proposals.

The straw man discussed in §11.04[A] below builds out a modified residual profit split-type profit allocation approach and is termed in this chapter the capitalized expenditure method (CE Method), while the straw man discussed subsequently in §11.04[B] builds out the distribution-based type of profit allocation approach and is termed the operating margins method (OM Method). While the CE Method and the OM Method serve as more detailed illustrations of a modified residual profit split and a distribution-based approach respectively, they are not intended to be descriptive of what the OECD is actually developing as this chapter goes to publication. Indeed, by the time this volume is published, the specifics of the straw men will almost certainly be shown to differ from what the OECD in fact is working towards. Nevertheless, the straw men are fully consistent with the language in the OECD's public consultation document; the general direction of the Inclusive Framework's public consultation in March 2019;<sup>38</sup> the Inclusive Framework's Programme of Work published on 29 May 2019;<sup>39</sup> and public remarks made in various venues by the leading international tax officials of the OECD and of the largest economies participating in the Inclusive Framework through the summer of 2019.

**[A] The Capitalized Expenditure Method**

The CE Method would begin by separating 'excess' or 'residual' returns from 'routine returns'.<sup>40</sup> The CE Method provides a normal rate of return to productive economic functions. It uses arm's length methods to determine this return, on the theory that the arm's length method works reasonably well in the context of determining appropriate 'non-entrepreneurial' returns for specific economic activities. Then, to allocate the remaining 'entrepreneurial', 'non-routine', or 'residual' returns, the CE Method in effect deems the country in which customer sales take place to be an 'entrepreneurial'

---

38. See Ernst & Young, *OECD Hosts Public Consultation*, *supra* n. 24.

39. OECD, *Programme of Work*, *supra* n. 1.

40. The CE Method raises various technical challenges. My prior article (Grinberg, *supra* n. 13) focused on pragmatic administrative issues associated with implementing the proposal. In contrast, this chapter focuses only on *stabilizing* a marketing intangibles proposal internationally. Thus, my description of the method in this section does not restate the pragmatic administrative issues I believe are raised by the CE Method, except to the extent these are relevant to stabilizing the proposal within the international tax system.

affiliate with respect to local market sales. The CE Method treats part of the ‘non-routine’ or ‘residual’ profits to be due to ‘market intangibles’ and allocates that part of the non-routine profits to the affiliate in the market country.<sup>41</sup>

Thus, splitting the residual profit between profits being allocated to market intangibles and profits being allocated to other intangibles is necessary in the CE Method. The CE Method for arriving at that split would involve specifying which expenditures contribute to developing market intangibles and which expenditures contribute to developing other intangibles. Governments would then establish (presumably on a presumptive basis) ‘useful lives’ for various ‘buckets’ of expenditure. The resulting relative ‘capitalized values’ associated with functional costs incurred for market intangibles as compared to other intangibles would produce a ratio. The ratio would change each year as a result of both new expenditures by the MNE and the operation of whatever ‘amortization schedule’ was adopted for the various buckets of expenditure. The ‘amortization schedule’ would not produce actual deductions; it would simply establish the annual ratio of ‘market intangibles’ to ‘other intangibles’ (the CE Method Ratio). The CE Method Ratio would determine the ratio of excess return to be allocated through the current arm’s length system as opposed to being assigned to market jurisdictions in the CE Method.<sup>42</sup> Other mechanisms could be utilized to calculate the CE Method Ratio. For purposes of the analysis in this chapter, all that matters is that a CE Method Ratio is somehow established.

CE Method analyses could be undertaken on a consolidated MNE basis or (with substantially increased complexity) on a business unit or product line basis. The amount of residual return deemed attributable to market intangibles would then be allocated among market jurisdictions based on the percentage of gross sales revenue by country.

This method requires global consolidation because there must be a measure of taxable income at the consolidated level in order to identify the amount of residual return. Most discussion of market intangibles and residual profit allocation more

---

41. See Michael Devereux, *Residual Profit Allocation Proposal* (presentation to the Urban Institute and Brookings Institution Tax Policy Center Conference, ‘A Corporate Tax for the 21st Century’, Washington, DC, 14 July 2016), [https://www.taxpolicycenter.org/sites/default/files/residual-profit-allocation-proposal\\_2.pdf](https://www.taxpolicycenter.org/sites/default/files/residual-profit-allocation-proposal_2.pdf).

42. In theory, the CE Method Ratio – especially an approach to calculating the CE Method Ratio involving preset presumptive useful lives for marketing intangibles, on the one hand, and trade intangibles, on the other, and calculations at the consolidated entity level – could function as a safe harbour. Some have suggested MNCs might be allowed to elect either the safe harbour method or a pure facts and circumstances transfer pricing valuation method for marketing intangibles and trade intangibles respectively as an alternative means to compute their CE Method Ratio. Skadden, Arps, Slate, Meagher & Flom LLP, *Comments on Public Consultation Document: Addressing the Tax Challenges of the Digitalization of the Economy* (6 March 2019), [https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0&file\\_subpath=%2FSkadden.pdf](https://www.dropbox.com/s/hou6dvuckmahoft/OECD-Comments-Received-Digital-March-2019.zip?dl=0&file_subpath=%2FSkadden.pdf) (accessed 21 Sep. 2019). However, it is unclear what would motivate governments to provide this election. The already high risk of controversy would increase without obvious systemic revenue or compliance gains. As a result, governments would need a truly deep conviction around the clarity of the distinction between marketing intangibles and trade intangibles, combined with a high tolerance for controversy with other tax administrations, in order to believe that such an election is justified.

generally in the OECD process assumes ‘top down’ calculations, and therefore implicitly requires this form of global consolidation.<sup>43</sup>

The CE Method is a compromise between a destination-based residual profit allocation (DBRPA) and the current transfer pricing system. Thus, analysing the relationship between the CE Method and formulary apportionment is easier if one first understands the relationship between formulary apportionment and the destination-based residual profit allocation. In turn, explaining the relationship between formulary apportionment and the destination-based residual profit allocation first requires defining what we mean by formulary apportionment and what we mean by destination-based residual profit allocation. This section addresses those questions in order.

### [1] *What is Formulary Apportionment?*

Most analysts tend to agree on the two first-order features of formulary apportionment. Formulary apportionment involves: 1) a unitary system of taxation and 2) agreed upon apportionment factors that allocate taxing rights over the unitary tax base across jurisdictions.

Beyond those two features, consensus as to what ‘formulary apportionment’ entails breaks down. One key reason that there is no perfectly shared definition of what ‘formulary apportionment’ means in the context of cross-border transactions between related entities is that, while there is no existing global formulary apportionment system, there are two existing subnational formulary systems to apportion corporate income tax rights, namely those in Canada and the United States. Moreover, there is a proposed intra-EU system – the common consolidated corporate tax base (CCCTB)<sup>44</sup> – that is based on a formulary approach as well. Finally, academics have proposed

---

43. In theory, an alternative mechanism for determining the amount of residual income allocable to each jurisdiction could be developed from the ‘bottom up’: see description of such an approach as an alternative in Michael P. Devereux, Alan J. Auerbach, Michael Keen, Paul Oosterhuis, Wolfgang Schön & John Vella, *Residual Profit Allocation by Income* (Oxford International Tax Group Working Paper No. 19/01, March 2019), [https://www.sbs.ox.ac.uk/sites/default/files/2019-03/WP1901\\_0.pdf](https://www.sbs.ox.ac.uk/sites/default/files/2019-03/WP1901_0.pdf) (accessed 29 Jun. 2019). The details of the Oxford Working Paper ‘bottom up’ system are not essential to the analysis in this chapter. Nevertheless, it is worth observing, first, that the Oxford Working Paper ‘bottom up’ system remains unitary in the sense that it requires a unitary definition of indirect expenses (notably including interest expense, global non-allocable sales and marketing expenses, research and development expenses, and other general and administrative expenses) that must then be allocated out according to a consistent and agreed multilateral system. Second, the ‘bottom up’ system would only be workable if the concept of ‘residual gross income’ developed in the Oxford Working Paper were adopted by all jurisdictions consistently and used by each of them as the allocation key for indirect expenses. Third, and most importantly, the ‘bottom up’ method results in an allocation of all residual profits to the destination jurisdiction. In contrast, in a marketing intangibles concept, some mechanism is needed to split residual profits being allocated to marketing intangibles from residual profits being allocated to the destination jurisdiction. Methodologically, a bottom-up approach (unlike a top-down approach) for the CE Method would have to ‘take away’ profits initially allocated to the destination country from that market country. Given the politics of the marketing intangibles debate, that last result seems untenable.

44. European Commission, *Common Consolidated Corporate Tax Base (CCCTB)*, [https://ec.europa.eu/taxation\\_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en) (accessed 20 Jun. 2019).

allocating only ‘residual profits’ using a residual formulary apportionment (RFA) regime. In residual formulary apportionment, apportionment factors are complemented by a rule that assigns a return related to a fixed percentage of costs to the jurisdiction where the costs are incurred. None of these systems is entirely alike. Nor do they all use the same apportionment factors. Indeed, some US states use only one factor – the destination of sales.

Nevertheless, using even the thinnest consensus definition of formulary apportionment brings certain quintessential features into focus.<sup>45</sup> In particular, taxation under a formulary apportionment regime takes place in three steps.<sup>46</sup> First, the integrated business whose income is subject to apportionment is defined. Second, the global income of the defined integrated business is aggregated. Third, the aggregated income is divided among the members of the integrated business, using a formula based (at least in the main) on certain apportionment factors.<sup>47</sup> Dividing aggregated income using apportionment factors is an alternative to arm’s length pricing because it generally dispenses with the need to recognize transactions among related entities within the integrated business.

Defining an integrated business whose income is aggregated entails unitary taxation which generally disregards the independence of related entities.<sup>48</sup> Such a system necessarily involves consolidation for tax purposes<sup>49</sup> across the integrated business using a shared single definition of the taxable base. That is, the measurement of the MNE’s total income is undertaken ‘using a consistent set of accounting and income recognition principles’.<sup>50</sup> That income is then divided using apportionment factors and weights given to each factor that are meant to be common across all participating jurisdictions.

45. Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61(3) Tax L. Rev. 169, 172-173 (2008); Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU 1* (Springer 2006).

46. Joseph L. Andrus, Mary C. Bennett & Caroline Silberztein, *The Arm’s-Length Principle and Developing Economies*, 20(12) Tax Mgmt. Transfer Pricing Rept. 495, 496-501 (2011).

47. *Ibid.*; Roin, *supra* n. 45, at 172-173.

48. In fact, Canadian apportionment does not allow a multi-provincial corporation, operating through subsidiaries in different provinces, to consolidate its income for tax purposes. However, it does require such consolidation across permanent establishments in different provinces. Weiner, *supra* n. 45, at 69. Nevertheless, there is a general consensus that this feature of Canadian formulary apportionment would not make sense in the global context (or in any situation where there was not a supranational authority recognized by all participating jurisdictions).

49. Consolidation itself can mean various things. For instance, it could mean ‘worldwide consolidation’, under which commonly owned corporations which meet an appropriate control threshold would be treated as a single taxpayer. Weiner, *supra* n. 45, at 70; *See also* James W. Wetzler, *Is It Time to Consider Worldwide Consolidation?*, 163 Tax Notes 253 (2019). It could also mean ‘unitary combined reporting’, which is applied by many US states, and defines the consolidated base at the unitary business level, with less pressure on the definition of common control. In addition, the US implements, and the European Commission has proposed, ‘water’s edge consolidation’, which limits the consolidated tax base to entities and income within their respective territorial boundaries. But such a system does not, by definition, make sense at the international level. Weiner, *supra* n. 45, at 70-71.

50. Andrus, Bennett & Silberztein, *supra* n. 46, at 499.



[2] *What is Destination-Based Residual Profit Allocation?*

The destination-based residual profit allocation proposal was developed by a group consisting of Alan Auerbach, Michael Devereux, Michael Keen, Paul Oosterhuis, Wolfgang Schön, and John Vella. The idea is most extensively explained in their working paper *Residual Profit Allocation by Income*.<sup>51</sup> The destination-based residual profit allocation proposal represents an attempt to move to a destination-basis corporate income tax system by means that can be described as remaining consistent with some of the principles of the current arm's length transfer pricing architecture.

Like single factor sales-based formulary apportionment, the destination-based residual profit allocation proposal is animated by the understanding that the location of consumers is less mobile than the location of booked profits, intellectual property, corporate assets, corporate employees, or any other element that purportedly creates value. However, the destination-based residual profit allocation attempts to separate 'excess' or 'residual' returns from 'routine returns' and provide a normal rate of return to productive functions.

Although destination-based residual profit allocation is not a sales-based formulary apportionment proposal, in many circumstances destination-based residual profit allocation could produce results that are similar to a sales-based residual formulary apportionment proposal put forth by Avi-Yonah, Clausing, and Durst in 2011.<sup>52</sup> Avi-Yonah, Clausing, and Durst would allocate a fixed markup on costs to entities that undertake activity within an MNE. All other profits would then be allocated to the destination/market country. In contrast, the destination-based residual profit allocation tries to salvage the existing arm's length system with respect to routine returns while using a sales-based system to allocate residual returns.

To allocate excess/residual returns, the destination-based residual profit allocation in effect deems the country in which customer sales take place to be an 'entrepreneurial' affiliate with respect to local market sales and ascribes the part of the 'non-routine' profits allocated to marketing intangibles to the entrepreneurial affiliate in the market country.<sup>53</sup> Destination-based residual profit allocation requires global consolidation because there must be a measure of taxable income at the consolidated level in order to measure the excess return to be allocated as among market jurisdictions. The tax base harmonization conundrum associated with unitary taxation is, of course, most well known in the context of formulary apportionment.

Achieving a destination-based residual profit allocation of non-routine profits to the market jurisdiction would also require MNEs to measure gross revenues on a country-by-country basis and on a product-by-product basis using some concept of

---

51. Devereux, Auerbach, Oosterhuis, Keen, Schön & Vella, *supra* n. 43.

52. Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9(5) Fla. Tax Rev. 497, 540-541 (2009).

53. See Devereux, *supra* n. 41.



‘destination’ or ‘place of supply’. Of course, the sales factor of a traditional formulary apportionment system confronts this same issue.<sup>54</sup>

**[3]     *The Relationship Between the CE Method and Formulary Apportionment***

Importantly, each of the formulary apportionment-like issues that arises in the destination-based residual profit allocation method also arises in the CE Method, because the CE Method has the same starting point as a destination-based residual profit allocation. Affiliates in an MNE are compensated for their functions on a cost-plus or return on assets basis using arm’s length principles. Unlike in the destination-based residual profit allocation, however, the ‘residual return’ must then be divided between returns allocated to the ‘new taxing right’ and returns allocated to the arm’s length standard system. The portion of the residual return deemed to arise from market intangibles is then allocated to the market of destination for the good or service; the remaining residual return is allocated under existing transfer pricing principles.

The CE Method therefore raises three basic administrative concerns. First, it retains all of the problems of current transfer pricing law because, with respect to residual returns that are not attributed to market intangibles, current law applies. Second, the proposal imposes a hard-to-administer distinction between residual returns associated with marketing intangibles and other residual returns. Third, since the CE Method allocates residual returns subject to the new taxing right to the market jurisdiction, all the challenges associated with any sales-based formulary proposal are present in the CE Method.

The problems of current transfer pricing law and historical evidence suggesting that attempting to split a residual return between some allocation to ‘market-based’ intangibles and some allocation to ‘other intangibles’ continue to exist. However, those two issues are beyond the scope of this chapter. They have been discussed by this author elsewhere.<sup>55</sup>

The most important overlaps between the CE Method and formulary apportionment relate to determining destination and using a unitary approach. A further discussion of those issues follows below.

---

54. Other technical questions that arise in thinking about the DBRPA also have analogues in the formulary context. Such issues include the treatment of losses, the treatment of flow-through entities, the treatment of certain financial transactions, and the treatment of mergers and acquisitions. Unlike traditional formulary apportionment, global costs in the DBRPA would need to be measured at a product line level, and then either traced or apportioned out to revenues from specific countries. Cf. Mitchell Kane, *Transfer Pricing, Integration and Synergy Intangibles: A Consensus Approach to the Arm’s Length Standard*, 6(3) *World Tax J.* 282 (2014).

55. See Grinberg, *International Taxation in an Era of Digital Disruption*, *supra* n. 13.

**[4] *Determining Destination under the CE Method***

In any system that allocates part of the return to the market (in other words, any ‘destination-basis’ system), the tax burden is meant to rest in the jurisdiction of the final consumer, rather than the jurisdiction of residence of any intermediaries in the supply chain. The economic rationale for this result is that the final consumer is thought to be the least mobile factor. Thus, from a theoretical economic perspective, a destination-basis system is less economically distortive than other more mobile bases for assessing corporate tax.<sup>56</sup>

However, if the administrative mechanism for measuring the location of sales does not conform to the location of the final consumer, this justification for attempting to tax at destination is undermined. Importantly, MNEs can easily structure their transfer pricing arrangements to book sales income in a jurisdiction other than the residence of the final consumer and are incentivized to do so if they can lower their tax burden as a result.

The most common destination-basis tax (and likely the most important tax on Earth (measured by revenue raised) is the value added tax (VAT). The VAT generally resolves the issue of determining destination using the credit-invoice mechanism. Two of the most important features of the credit-invoice mechanism are taxation on gross amounts and imposition of tax on every transfer, both intra-firm and inter-firm. An income tax cannot adopt the credit-invoice mechanism for one key reason: income taxes tax net income, rather than gross revenues. In an income tax, cross-border business input purchases are generally deductible. By contrast, the VAT establishes destination, in large measure, by affording cross-border business input purchases, a treatment that is the equivalent of non-deductibility.<sup>57</sup>

*Destination of Goods*

For tangible goods, VAT laws generally assess VAT using frontier or border controls<sup>58</sup> – imported goods are in effect treated as having the destination of the jurisdiction where they clear customs. VAT is assessed on the full value of the good as it enters the jurisdiction. VAT laws then free exports of VAT through a combination of non-inclusion of proceeds and a refund mechanism for VAT previously paid. As a result, the VAT avoids the difficulties a destination-basis income tax would have with cross-border sales through third-party intermediaries.

---

56. See, e.g., Alan J. Auerbach, Michael Devereux, Michael Keen & John Vella, *Destination-Based Cash Flow Taxation* (University of Oxford Saïd Business School Research Paper 2017-09, February 2017).

57. The VAT mechanism works cross-border and is not equivalent to a tariff because the VAT credit mechanism then provides a credit to registered businesses (and not to consumers). The whole tax is passed on to consumers; businesses bear none of it. In contrast, in an income tax, businesses are intended to pay tax. As a result, the full credit mechanism is not an option in an income tax.

58. VAT on imports is generally collected at the same time as customs duties, although in some countries collection is postponed until declared on the importer’s next VAT return.

The reason third-party cross-border intermediation does not obscure destination in the VAT is that the intermediary pays a full tax on its purchases and has the full amount refunded on re-export. Exports are not included in the tax base, and then a tax based on the sales price of the good is collected at the jurisdiction of (further) destination. A similar result applies with respect to the importation of intermediate inputs (whether raw materials, components, or intermediate goods) that are subsequently exported as part of a different tangible good. Due to expensing, the result even applies to capital goods that are purchased to allow for the manufacture of other products for export.<sup>59</sup> In all cases, the credit-input system thereby moves the tax burden to the final buyer.

The VAT system for ensuring that tax is collected only at the destination of the good works because the system taxes on a gross basis and provides refunds on every intra-firm and inter-firm transfer. An income tax cannot adopt this basic element of the credit-invoice mechanism as it operates in cross-border situations and remain a tax on net income. As a result, the VAT does not provide useful guidance for determining the destination of goods in an income tax system. Formulary apportionment and the CE Method thus share the problem of being unable to use the VAT credit-invoice mechanism to determine destination.

#### *Location of Services*

Determining the destination of cross-border services is a highly significant issue in the international formulary apportionment and CE Method contexts. One important and challenging sub-issue is the destination of cross-border services provided to MNEs. Determining the destination of these services raises especially difficult issues.<sup>60</sup> In many cases, MNE service recipients utilize the services of a service provider in multiple jurisdictions.

In the VAT context, charge-out mechanisms of the kind used in today's income tax system can, and do, conceptually resolve the problem of determining the destination of services an MNE recipient receives and uses in multiple locations.<sup>61</sup> However, tax administrations attempting to employ this solution in the formulary apportionment and CE Method contexts would encounter distinct problems. Tax administrations would need to audit service recipients to determine whether charge-outs had been made appropriately in order to inform their audit of the service provider. While charge-outs can be a subject of audit in today's income tax system, tax administrators never need to ask whether charge-outs by an unrelated party change the tax result for

---

59. Of course, income taxes cannot provide expensing treatment in all cases while maintaining their status as income taxes.

60. See Roin, *supra* n. 45, at 208 and Walter Hellerstein, *A US Subnational Perspective on the 'Logic' of Taxing Income on a 'Market' Basis*, 72(4/5) Bull. Int'l Tax'n 9 (2018) for a discussion of these issues.

61. Note also that to solve the problem of determining where globally provided MNC to MNC services are 'consumed', most VATs today generally follow the result achieved for the purpose of corporate income tax charge-outs. It is obviously no answer to rely on the VAT to solve an income tax problem if the present law VAT solution is to rely on the income tax answer to solve that same problem.

a separate, unrelated taxpayer. The level of internal coordination such a system would require of government auditors simply does not exist today.

Since the administrative features of the VAT do not help, other anti-abuse rules would be needed in a CE Method, just as they would be needed in a formulary apportionment system. Indeed, US states – which manage to operate a formulary apportionment regime in a country without a VAT – have had to live with this problem and its consequences for many years. Understanding their approach to the problem and the potential distortions it can cause is therefore a potentially useful means to considering the issue in the CE Method context.

### *[5] Unitary Approach under the CE Method*

The CE Method calculates most revenues at a country level. However, just like the ‘unitary’ aspect of formulary apportionment, the CE Method calculates costs on a global consolidated basis. In other words, one needs a single measurement of apportionable income. The CE Method may not require a common measure of gross income, but it would require common rules regarding costs. The most obvious category of costs that need common allocation rules is so-called indirect costs, such as research and development, interest expense, and stewardship expenses.<sup>62</sup>

Moreover, for the CE Method to work well, schedules for depreciation or amortization of tangible and intangible property and treatment of original issue discount – and perhaps even issues like the method used to inventory costs or the treatment of fines and penalties – would ideally be standardized across jurisdictions. As one commentator explained a decade ago with respect to formulary apportionment, unitary systems become inadministrable if global costs must be measured for purposes of determining income in each jurisdiction, but each jurisdiction has its own rules with respect to when those global costs are taken into account.<sup>63</sup>

#### *Pressure to Move Towards 100% Allocation to Sales*

Issues raised by determining destination and addressing unitary taxation are technical in nature. In addition to these technical issues, the history of US subnational formulary apportionment highlights an obvious policy concern with the CE Method – in the era of globalization, business activity is mobile. By contrast, sales are much less mobile. As a result, any formula that allocates less than 100% of the residual profit to sales would find itself under policy pressure.

Over the years, the US states have shifted – in inconsistent ways – away from traditional three-factor apportionment towards sales-only apportionment factors to

---

62. Cf. OECD, *Revised Guidance on the Application of the Transactional Profit Split Method*, OECD/G20 Base Erosion and Profit Shifting Project [2.154]-[2.157] (June 2018) (describing the importance of aligning accounting rules in transactional profit splits). The problems of indirect cost allocation are familiar to US practitioners from the foreign tax credit system and current debates about the Global Intangible Low-Taxed Income (GILTI) rules.

63. Roin, *supra* n. 45, at 200.

gain a competitive advantage in attracting tangible investment and jobs.<sup>64</sup> In the international setting, with higher tax rates than state income taxes and fewer coordination mechanisms to limit competition, most commentators agree that this competitive dynamic would be more intense. Moreover, customers are much less mobile than employment in the cross-border setting, so economic theory would suggest that a sales-based apportionment should produce fewer economic distortions than an apportionment formula that takes the location of employment into account.<sup>65</sup>

In the context of fixed ratio formulas, the inclusion of an apportionment factor that is immobile and an apportionment factor that is highly mobile creates an implicit excise tax on the mobile factor. That reality would likely push countries in the direction of unilaterally choosing a 100% allocation to the immobile factor (the location of the consumer), in order to eliminate the implicit excise tax on high-skilled jobs that the 50:50 split would create, just as US states have overweighted sales and abandoned the payroll factor to encourage job creation in their jurisdictions.

## **[B] The Operating Margins Method**

### **[1] General Remarks**

Even though the OM Method may be characterized as a part of the market intangibles genre, it departs from the conceptual motivation for ‘market intangibles’ proposals in the interest of administrative ease.<sup>66</sup> Importantly, advocates of simplified approaches might suggest that an appropriately calibrated OM Method could, in practice, produce results are no more or less likely than the capitalized expenditure method to allocate only profits attributable to ‘market intangibles’ to market jurisdictions.<sup>67</sup>

The OM Method also has a conceptual relationship with the deemed profit methods that were common in Latin America a generation ago.<sup>68</sup> The OM Method would specify a minimum taxable income due from an MNE in a given jurisdiction. The main variable that would determine this minimum market jurisdiction taxable amount is a measure of the global operating margin, either overall or by business line. A fixed return on sales would then be allocated to market jurisdictions in general. The fixed return percentage would vary based on operating margins. The global minimum

64. See Hellerstein, *supra* n. 60.

65. For similar reasons, most academic observers agree that formulary apportionment employed internationally would probably be implemented (sooner or later) under a single factor sales-based formulary apportionment system.

66. However, the OECD Transfer Pricing Guidelines already hint that sometimes it is worth considering the ‘trade-off between strict compliance with the arm’s length principle and administrability’: OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* [4.112] (2017).

67. In other words, advocates would say the OM Method usually would in practice allocate only residual returns and returns that are the result of functions in market jurisdictions to market jurisdictions.

68. See, e.g., Lewin & Wills, *Managing Corporate Taxation in Latin American Countries: An Overview of Main Corporate Taxes in Selected Jurisdictions 2013* (Lataxnet 2013), [http://lewinwills.com/wp-content/uploads/2017/03/2013\\_Managing\\_Corporate\\_Taxation\\_in\\_Latin\\_American\\_Countries.pdf](http://lewinwills.com/wp-content/uploads/2017/03/2013_Managing_Corporate_Taxation_in_Latin_American_Countries.pdf) (accessed 27 Jun. 2019).

market profit amount deemed allocable to market jurisdictions would be calculated by multiplying the fixed return percentage by revenues. The global minimum market profit amount would then be apportioned among market jurisdictions on the basis of local revenues (sales).

The return on sales percentage that determines the global minimum market profit amount would increase (or decrease) for businesses or business lines with operating margins above (or below) an empirically determined average operating margin (the Margin Adjustment Factor). When a business has very low, zero per cent, or negative operating margins, the deemed minimum allocation to market jurisdictions would be zero. Since the OM Method is not limited to residual returns, without a properly calibrated Margin Adjustment Factor, the market profit amount would disproportionately allocate profit to market jurisdictions for low margin businesses. To avoid double taxation in the OM Method, it would be necessary to specify the 'surrender jurisdiction' that would give up the right to tax the market profit amount.

**[2]     *The Relationship Between the OM Method and Formulary Apportionment***

The OM Method is clearly dominated by formulas. Yet the OM Method's relationship to formulary apportionment as that term is commonly understood is more tenuous than that of the CE Method. What that tension reveals is that the key distinguishing features of formulary apportionment from an analytical perspective are actually unitary taxation and an apportionment factor that requires defining destination.

Notwithstanding the fact that it does not use an apportionment factor, the OM Method faces exactly the same issues regarding defining destination as the CE Method (described in §11.04[A][4] above). The reason is that the fixed return percentage is allocated among jurisdictions by comparative sales revenues, and this calculation requires determining where sales occur. Thus all the concerns described above with regard to the CE Method apply to the OM Method.

In contrast, the unitary taxation questions raised in §11.04[A][5] above with respect to the CE Method are less of a concern in the OM Method. The basic reason is not that the OM Method does not require global consolidation. To the contrary, calculating global operating margins either by business line or overall requires global consolidation. The reason the OM Method differs from the CE Method on this dimension is only because it explicitly relies on financial accounting conventions to provide the consolidated results. In doing so, the method accepts book-tax conformity as the price of administrability. The question then becomes what is sacrificed by giving up or attempting to give up the segregation between tax accounting and financial accounting as developed by the two major self-regulating accounting bodies (US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS)). While this is an important issue to consider, historically, the literature has suggested that the problems of book-tax conformity would be less severe in a formulary apportionment regime than in regimes based on recognition of the legal

independence of related entities and use of the arm's length standard.<sup>69</sup> As this volume goes to press, an OM Method-type approach seems to be the focus of discussions at the OECD. Thus, further work on the consequences of book-tax conformity in formulary taxation regimes may well be required in the international tax policy debate going forward.

#### §11.05 CONCLUSION

The contributions in this volume attempt to reappraise formulary apportionment at a time when international tax policymakers are considering proposals to develop a hybrid system for allocating taxing rights internationally that combines some features of the arm's length standard with some formulary features. This chapter highlights the relationship between the current debate being undertaken within the Inclusive Framework of the OECD and the various issues involved in formulary apportionment considered in this volume. Evaluation of the proposals under consideration by the Inclusive Framework suggests that each and everyone can be improved by reappraising formulary apportionment.

---

69. Michelle Hanlon & Edward Maydew, *Book-Tax Conformity: Implications for Multinational Firms*, 62(1) Nat'l Tax J. 127, 139-140 (2009).