IFA 2022
BERLIN · GERMANY

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IFA 2022
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Group approach and separate entity approach

Chair: Janine Juggins
Date: 5th of September 2022

1. Agenda

Agenda

1. Introductions
2. Scope and historic perspective – Dr Johanna Hey and Dr Arne Schnitger
3. EU perspectives – Jasna Voje
4. Tax Neutrality - Marlies de Ruiter

   Panel discussion

   Coffee break 10.30 -11.00

5. US perspectives – Dr Brigitte Muehlmann
6. Lower income countries' perspectives – Belema Obuoforibo
7. Formulary apportionment - Matt Andrew

   Panel discussion & closing remarks

Introductions

Johanna Hey

Dr Arne Schnitger

Dr Brigitte Muehlmann

Janine Juggins

Jasna Voje

Marlies de Ruiter

Belema Obuoforibo

Matt Andrew

Objectives of our session

- Corporate income tax systems rooted in separate entity principle => therefore a transactional approach
- We will examine how far this separate entity principle has eroded and why through the lens of the EU, the US and less developed countries
- In what circumstances is the erosion of this principle justified?
- What does this mean for tax neutrality?
- Given the way large Groups operate, is a more formulaic approach the answer?
- What does this mean then for transactional approaches tax treaties, withholding taxes, exit taxes, or even the arm’s length principle?

2. Setting the scene

Starting point and aims of the General Report

Separate entity principle as the globally recognized standard of corporate taxation. Starting point of profit allocation in international tax law, based on the dealing at arm's length principle.

Questioned by

- Most businesses are organized as corporate groups, commercial law requiring group accounts besides stand-alone financial statements for each group company
- BEPS potential of separate entity taxation

→ Leads to a trend of special provisions directed against the (abusive?) use of the separate entity principle in group situations and in regard to controlled entities

General Report

Overall view on the increasing number of special rules that take into account the specific relationship of a company to its subsidiaries, parent company or other group members

→ Results in double taxation and high compliance burdens, inconsistencies and complexity

→ No real group taxation

Definition: separate entity approach vs. Group approach

Separate entity approach	Group approach
Legal entity as the independent tax subject	„Piercing the legal veil“ = consolidated tax treatment of different legal entities

Special provisions related to qualified shareholding /control

Allocation of key elements to the approaches

Separate entity approach ⟷ Group approach

Dividend exemptions

PE: Authorized OECD Approach (AOA) | Indirect profit allocation method

TP: CUPM, RPM, Cost+ | DEMPE | PSM

CFC: Deemed dividend rule | Income allocation rule

Group taxation: Group contribution | Allocation of income | Full consolidation

Hybrid mismatch rule

Country-by-country-Report (CbCR)

Change of control provision

Interest barrier rules (mostly)

Example 1: Tax groups – different approaches

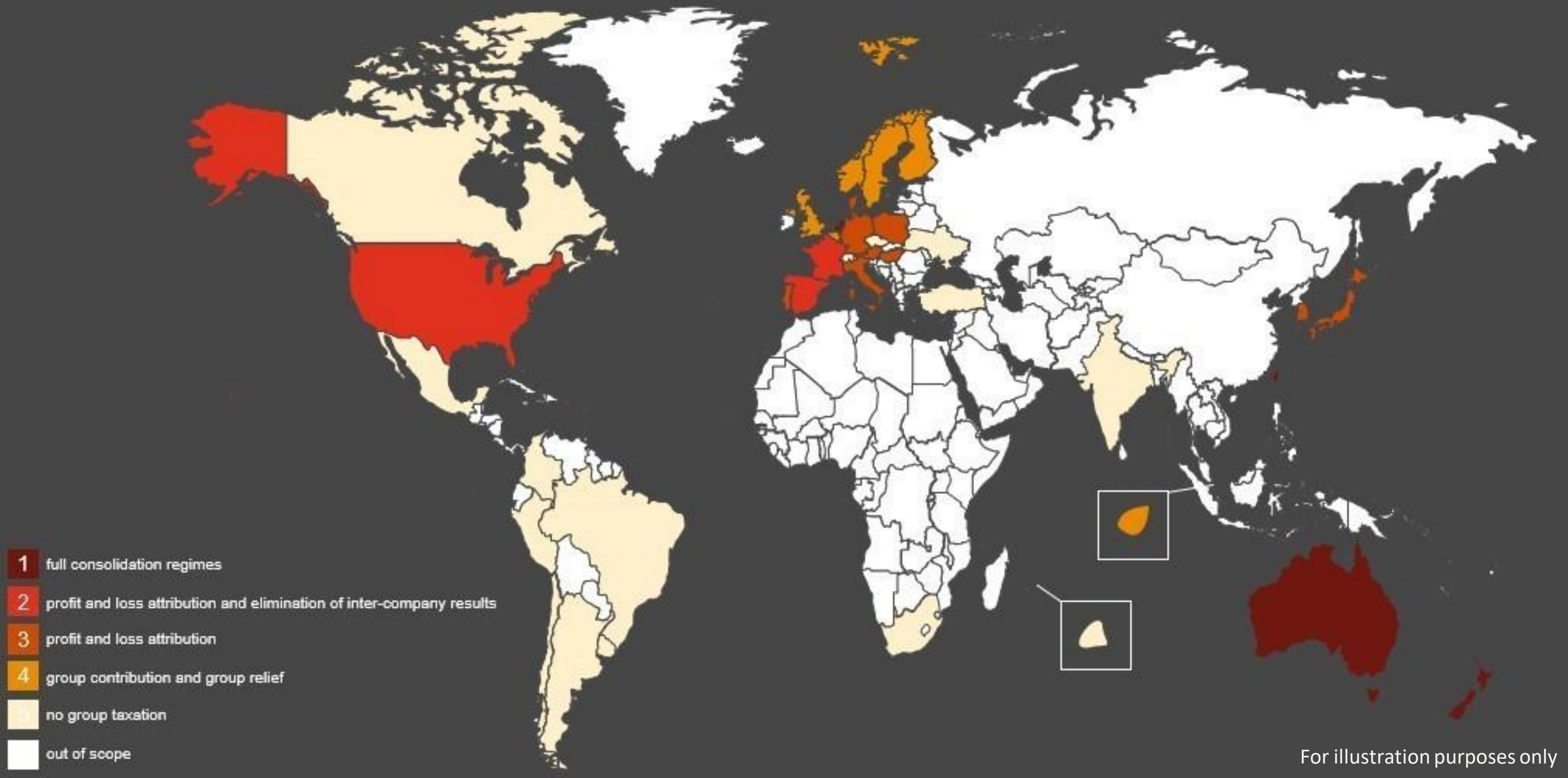
Separate entity approach → Group approach

Group contribution and group relief	Profit and loss attribution	Profit and loss attribution and elimination of inter-company results	Full consolidation regimes
no aggregation	aggregate income of a group	aggregate income of a group	consolidated income of a group

Key elements:

- Requirements to form a tax group
- Determination of the group profit, treatment of intra-group transactions
- Anti-avoidance rules
- Group tax liability
- Cross-border tax groups

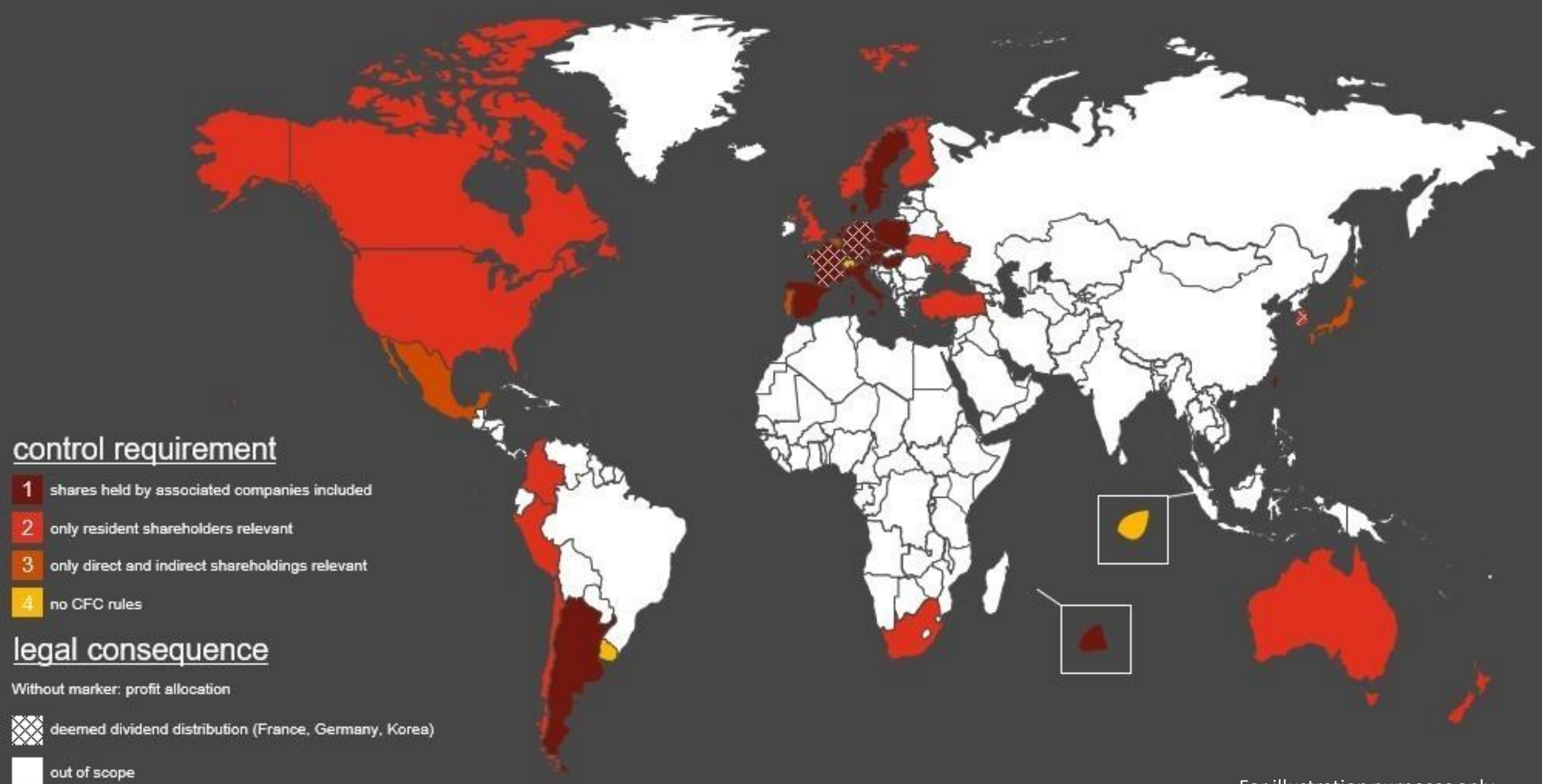
Tax group regimes



Example 2: CFC Rules

Separate entity approach	Group approach
Legal consequences: Deemed dividend rule	Legal consequences: income allocation rule
Determination of CFC income on stand-alone basis	Determination of CFC income: income allocation under foreign group taxation principles is recognized
Offsetting of losses only allowed within the same CFC	Offsetting of foreign low-taxed losses against foreign low-taxed income possible
	Control requirement: shares held by associated companies considered

CFC regimes



For illustration purposes only

Example 3: Transfer pricing rules

Separate entity approach	Group approach

- Examples:
  - Comparable Uncontrolled Price Method
  - Resale Price Method
  - Cost Plus Method
  - Transactional Profit Split Method
- Determination of income on stand-alone basis
- First choice in almost all countries to determine transfer prices

- Examples:
  - Comparable Profit Method
  - Global Formulary Apportionment
  - Profit Split Method
- Dividing the profit of the overall group between the group companies

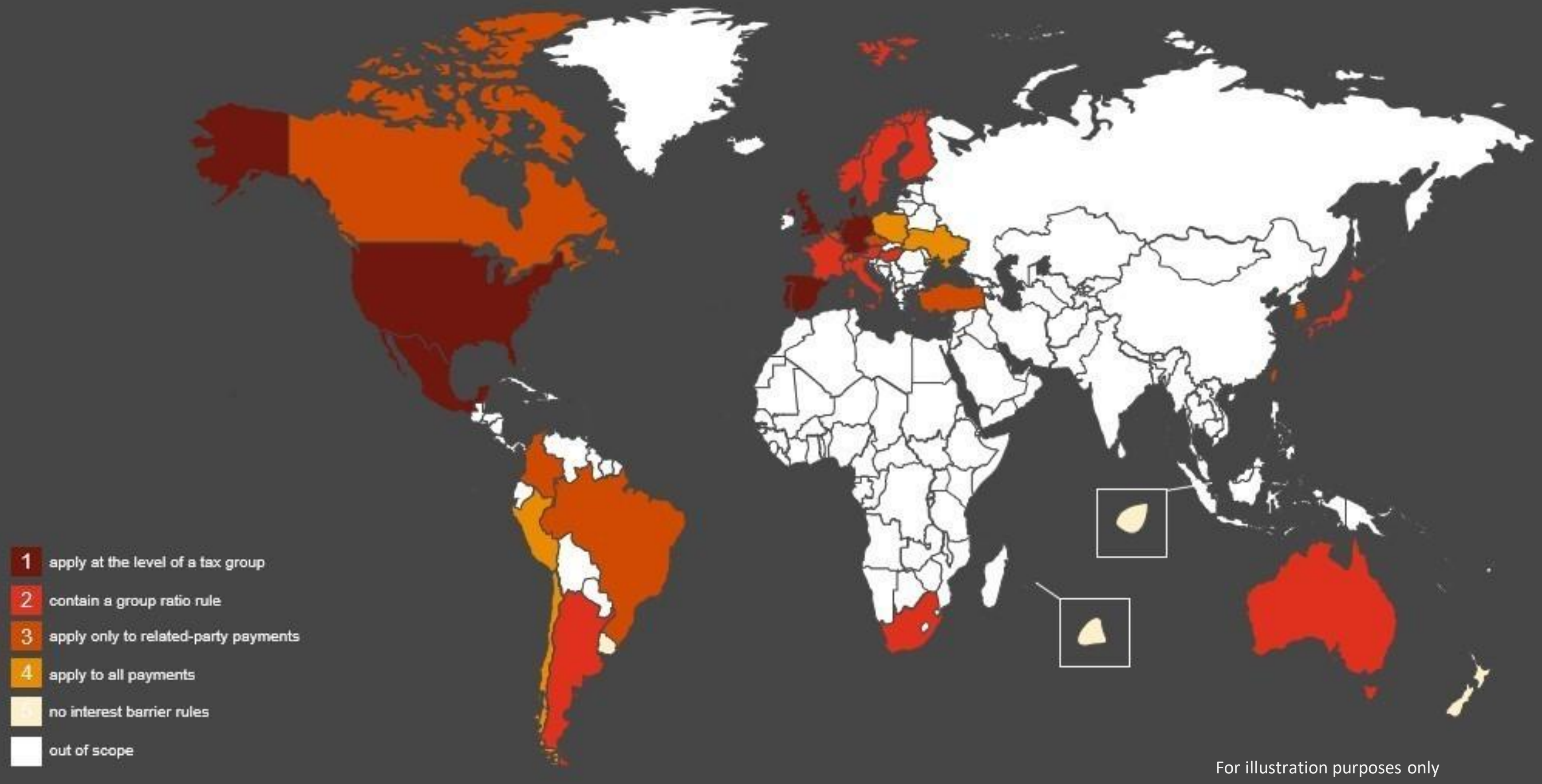
- DEMPE (Action items 8-10 BEPS): elements of group taxation approach were transferred into the classical transfer pricing methods

Note:
Application of TP rules in some countries only in cross-border situations, in other countries also in domestic situations

Example 4: Interest barrier rules

- Different types: Debt-to-equity rules and EBITDA threshold rules
- Usually: Rules follow a strict separate entity approach
- Exceptions:
  - Application of the rules at the level of a tax group
  - Rules contain group-relevant elements
    - Art. 4 para. 5 let B) ATAD: deduction depends on groups‘s net interest/EBITDA ratio
    - Art. 4 para. 5 let A) ATAD: deduction depends on comparison of the taxpayer‘s equity over its total assets to the equivalent ratio of the group

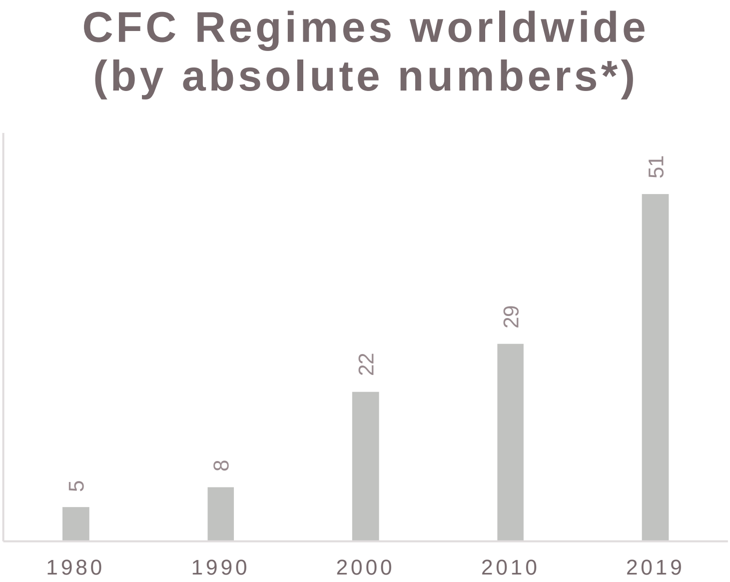
Interest barrier rules

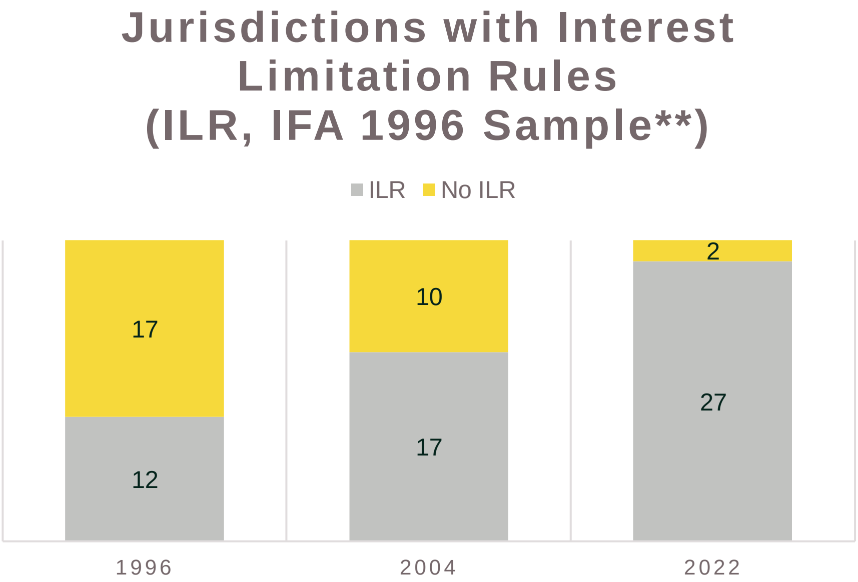


Historic Perspective

- Until 1945: First Group Tax Regimes; Agreement on ALS
- 1962: First CFC-Rules (U.S.)
- 1968: Beginning of “serious“ ALS enforcement (U.S.)
- 1972: First interest limitation rule (Canada)
- 1977: First OECD TP Guidelines
- 1998: OECD Report on Harmful Tax Competition
- 2011: First CCCTB Proposal (EU)
- 2013: BEPS 1.0 Action Plan
- 2015: BEPS 1.0 Final Reports
- 2016: ATAD I
- 2017: GILTI/BEAT
- 2019 - present: Work on BEPS 2.0

Historic spread of CFC and interest limitation rules



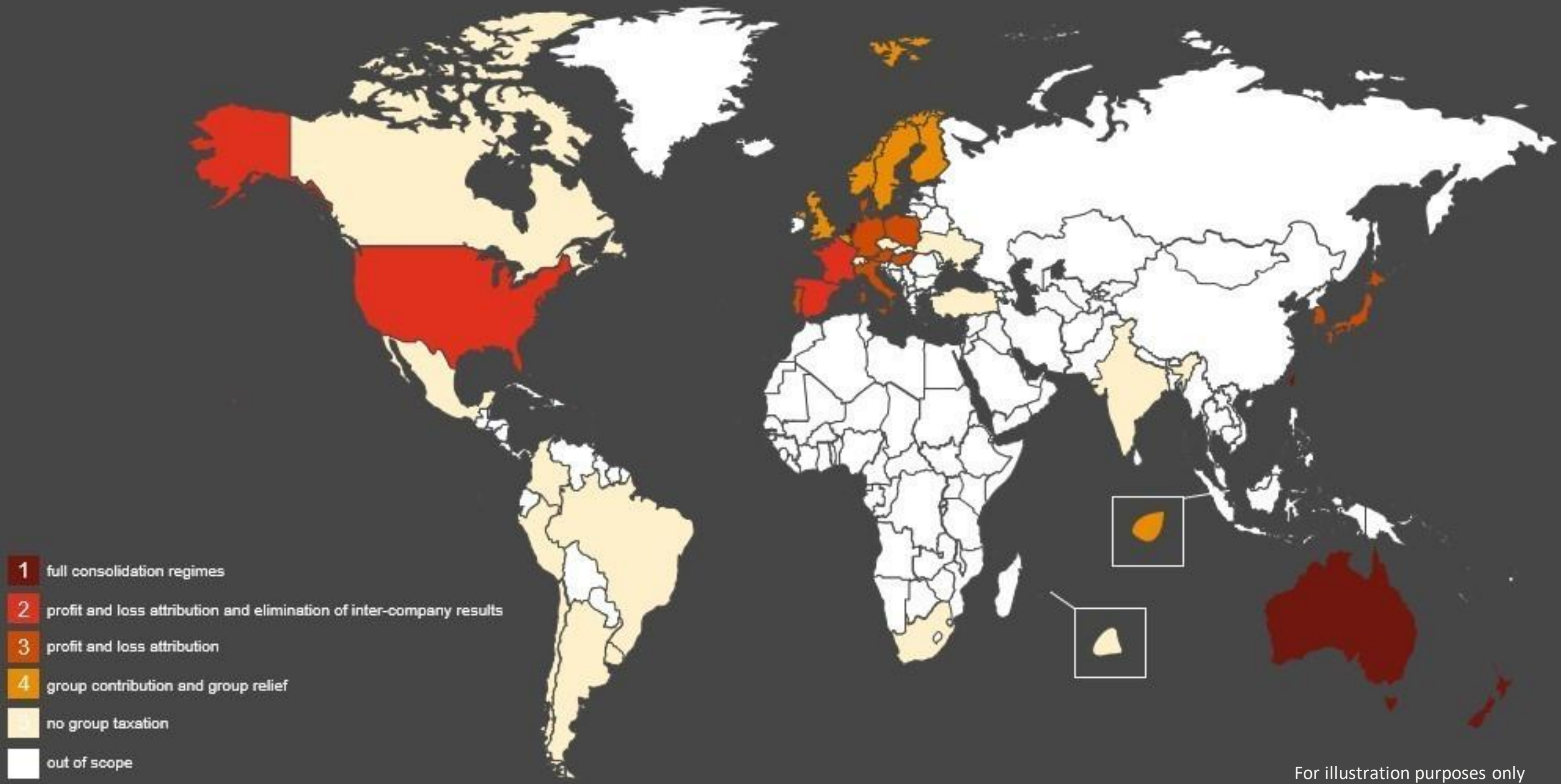


With data from:

* OECD (2019), Tax Database.

** OECD (2019), Tax Database; PWC Worldwide Tax Summaries; Piltz, General Report, IFA Cahiers 81b (1996); Blouin et al., IMF WP 14/12 (2014).

Tax group regimes



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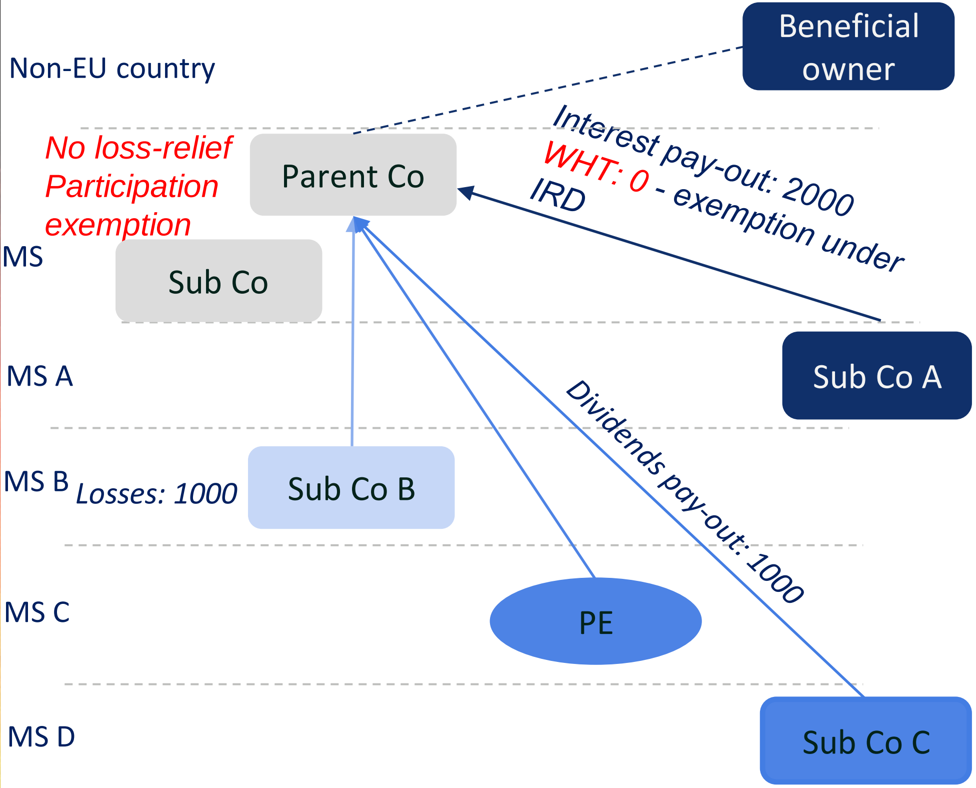
3. EU perspectives

Allocation of key initiatives to the approaches

Separate entity approach	Group approach
Parent Subsidiary Directive + Interest and Royalties Directive	CCCTB 2011 & 2016
Code of Conduct	
State aid	CbCR
DEBRA	
ATAD 1 & 2	
UNSHELL	
CJEU case law	

DST & SDP → Pillar 2 → Pillar 1 → BEFIT

CJEU case law implications



Loss-relief (*Marks & Spencer*)

- Restriction if benefit is not granted to the Sub Co B
- But **justified on the grounds of** ensuring 'balanced allocation of taxing rights, prevention of tax avoidance and the risk for using losses twice'
- Exception: final losses

Group inclusion

- No inclusion, **justified** to safeguard allocation of taxing rights (*X Holding*)
- No inclusion, but no justification for denying benefits where they are not inextricably linked to consolidation, i.e. full exemption for dividends if consolidation excludes (additional) partial taxation of consolidated profits (*Groupe Steria*)

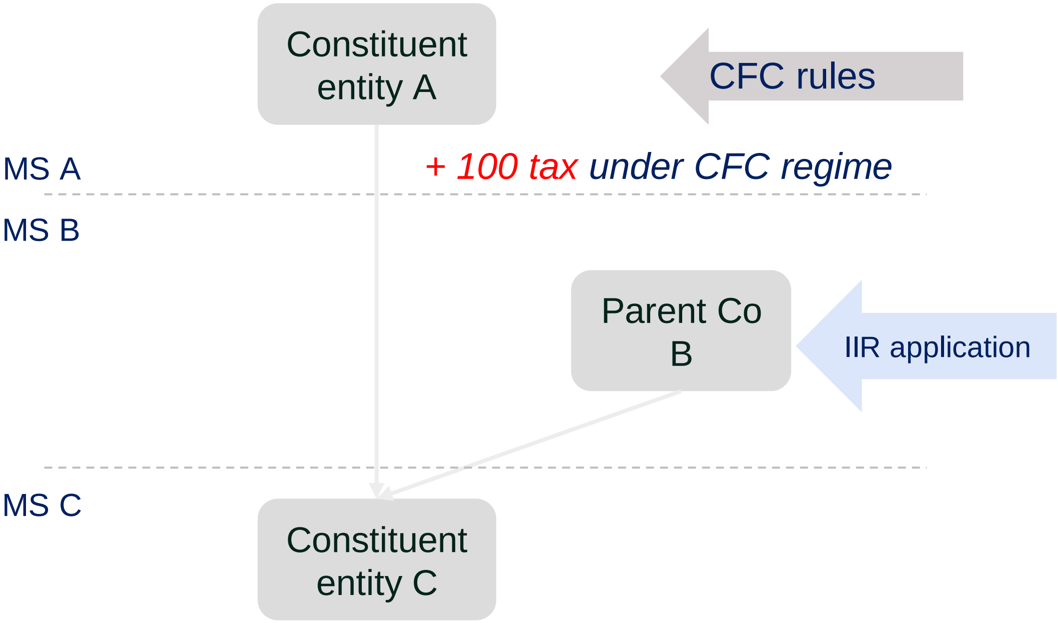
IRD benefits (*Danish cases*):

- Benefits of PSD and IRD denied in cases of abuse, i.e. recipients are conduit companies (e.g. flow-through, no substance, …)

Pillar 2

- **Group elements**
  - Starting point : financial consolidated accounts adjusted for tax purposes
  - Top-up tax calculated for the entire group
- **Separate entity elements**
  - ETR calculation at entity level, blending per jurisdiction

Example of CFC rules and Pillar 2



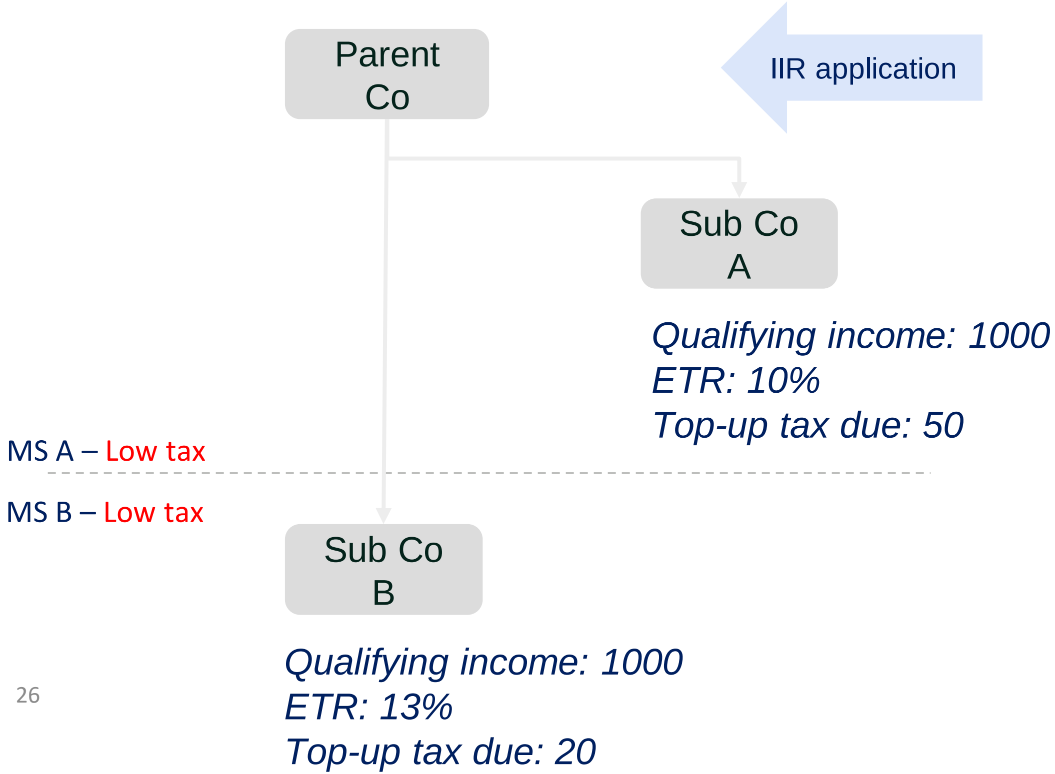
Qualifying income: 1000
Covered taxes: 100 + 100 (push-down of CFC tax)
ETR: 20%

- CFC rules
- Constituent entity A pays an additional 100 tax on C's income under the CFC rules

- Pillar 2
- Parent Co B applies the IIR to C
- The additional 100 tax paid by A is added to C's covered taxes for the calculation of the ETR

25

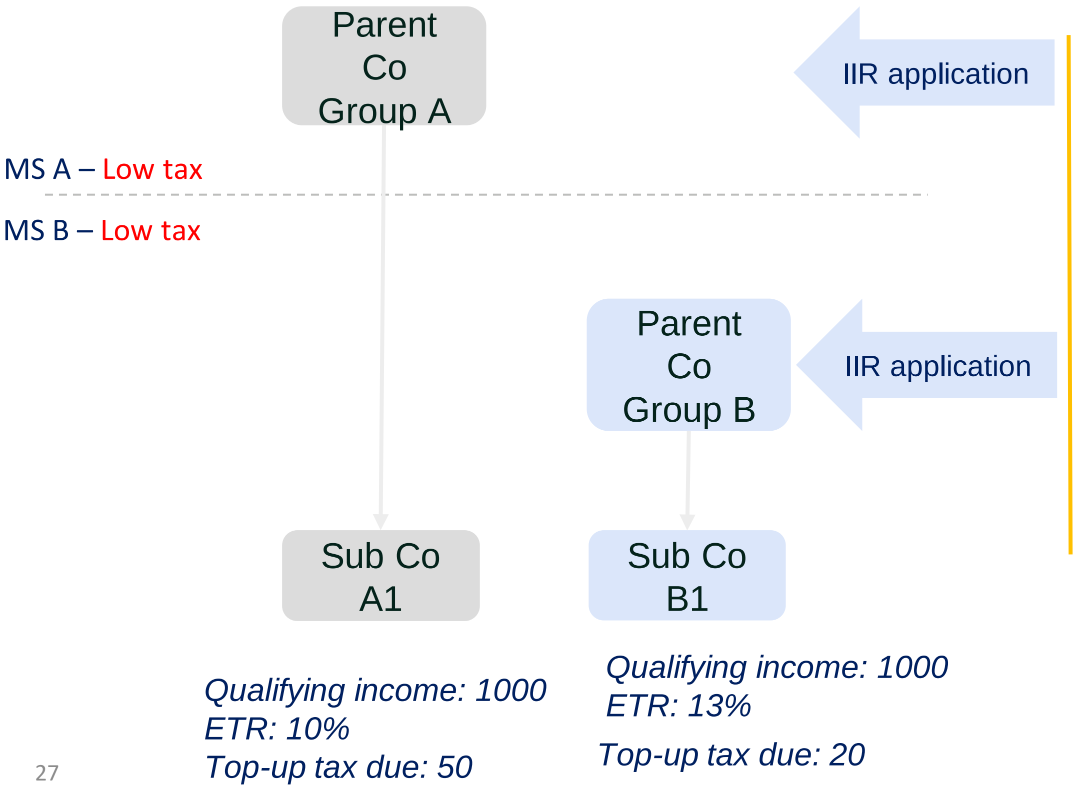
Pillar 2 – Application to domestic constituent entities



- OECD MR
- Parent Co applies the IIR with respect to Sub Co B
- Parent Co does not apply the IIR to Sub Co A even if its ETR < 15%

- Directive Proposal
- Parent Co applies the IIR with respect to Sub Co A and Sub Co B

Pillar 2 – Application to large scale domestic groups



- <u>OECD MR</u>
- Parent Co of Group A applies the IIR with respect to Sub Co A1
- Parent Co B of purely domestic Group B does not apply the IIR to Sub Co B1

- <u>Directive proposal</u>
- Parent Cos A and B apply the IIR to their respective Sub Cos

Pillar 1 and Own resources dimension

- Pillar 1
  - Global re-allocation of taxing rights
  - Multilateral Convention and Model Rules

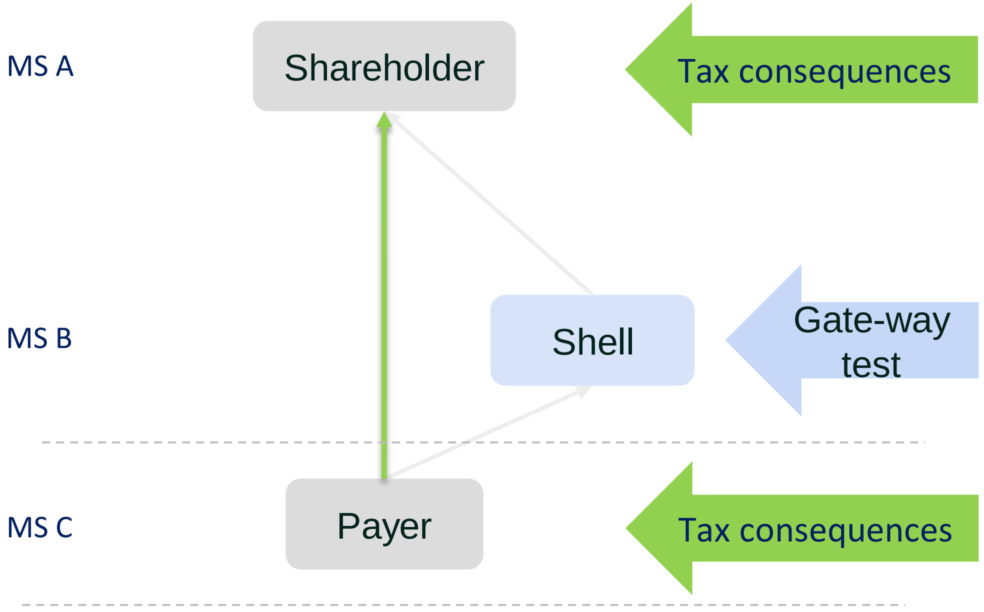
- Own resources
  - Proposal to amend Decision on Own resources – 22 December 2021:

“(g) the application of a ***uniform call rate of 15%*** *to the share of residual profit of multinational enterprises reallocated to Member States pursuant to [the Directive on implementation of the global agreement on re-allocation of taxing rights.]”*

UNSHELL

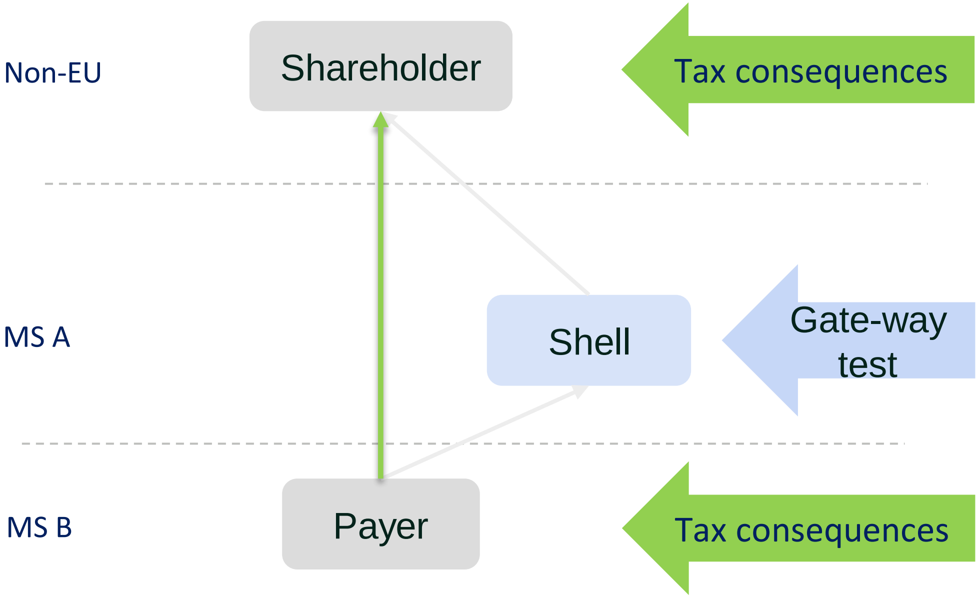
- State of play:
  - Commission proposal adopted on 22 December 2021
  - Technical discussions in Council ongoing
- Basic elements:
  - Gate-way test applied on entity level
  - Tax consequences have an effect on taxation of the group

Tax consequences for shells – intra EU



- UNSHELL
- MS A of the shareholder taxes the income and deducts any tax paid at the MS of the shell or at source
- MS C of the payer disregard tax treaties concluded with MS B of the shell as well as relevant directives

Tax consequences for shells – with non-EU country



- <u>UNSHELL</u>
- MS B of the payer disregard tax treaties concluded with MS A of the shell
- MS B shall take into account tax treaties with non-EU country
- If the shareholder is outside the EU, the MS B of the payer can apply withholding tax in accordance with its national law / DTC (if applicable)

BEFIT

- Objective: simplification for business active in the EU
- Key design features under examination:
  - Scope
  - Tax base
  - Formulary apportionment
  - Simplification of transfer pricing with non-EU jurisdictions

4. Tax neutrality

The Pillar One policy objectives according to EU-politicians

“GAFA are very much welcome. I want them to be part of my ecosystem, but they don’t play on the same level-playing field as the other players in the digital or traditional economy.”
Emmanuel Macron, the President of France

“We need to make our tax system fairer."
Olaf Scholz, Chancellor of Germany

“Big Tech has to pay a fair amount of taxes in Europe, especially as they are the real winners of the coronavirus crisis. If we will not have decent results at the global level, the European Commission will come out with our own proposal.”
Paolo Gentiloni, European Commissioner

- In particular in the EU, focus has been on levelling the playing field between businesses with different organizational models
- This means that a in order to meet the policy aims communicated a distinction is required between MNE groups already allocating residual profits to the market and those who do not

Example testing the effects of the Marketing and Distribution Profits Safe Harbour
Step 1: Setting the scene

Full-fledged distributor	ACo	BCo	Consolidated
Revenue	2,000 (to Bco)	5,000 (to consumers)	5,000
Profit	**500**	**500**	**1,000**
Payroll and Depreciation **Scenario 1** **Scenario 2**	 250 500	 1,000 2,000	 1,250 2,500
Profit margin (ros)	**25%**	**10%**	**20%**

Routine distributor	ACo	BCo	Consolidated
Revenue	3,200 (to Bco)	5,000 (to consumers)	5,000
Profit	**800**	**200**	**1,000**
Payroll and Depreciation **Scenario 1** **Scenario 2**	 1000 2000	 250 500	 1,250 2,500
Profit margin (ros)	**25%**	**4%**	**20%**

Step 2: Amount A calculations (assumption 100% residual returns feed into the MDSH)

A and B associated	Amount A (based on consolidated profit)
Full-fledged distributor	25
Routine distributor	25

Conclusion

Amount A does not recognize residual profits already allocated to the market

	MDSH threshold routine activities 4% of sales	Amount A
Full-fledged distributor	200 routine profits 300 residual profits	From 25 to 0
Routine distributor	200 routine profits 0 residual profits	Remains 25

Conclusion

An appropriately designed MDSH can prevent double allocation of residual profits to the market

Testing the MDSH in the Progress Report

The Progress Report:

- uses a Return on Sale of 10% as a starting point of calculating the routine returns and
- introduces payroll and depreciation as a relevant factor in the allocation the total pool of routine profits between the different jurisdictions

<u>Formula for allocating routine profits to a jurisdiction</u>

The highest of:

- ((Group revenues x 10%) /Group Depreciation and Payroll)

Or

- 40%

x jurisdiction's Payroll and Depreciation

Step 3: Application of the Progress Report MDSH

(assumption 100% residual profits feed into the MDSH calculation – amount Y = 100%))

Scenario 1:
RoDP = ((5000 x 10%) / 1250 = 40%.

Low capital intensity	MDSH threshold based on Progress Report	Amount A
Full-fledged distributor	400 (=1,000*40%) routine profits **100 residual profits**	**From 25 to 0**
Routine distributor	100 (= 250*40%) routine profits **100 residual profits**	**From 25 to 0**

Scenario 2:
RoDP = ((5000 x 10%) / 2500 = 20% = <40%.

High capital intensity	MDSH threshold based on Progress Report	Amount A
Full-fledged distributor	800 (=2,000*40%) routine profits **0 residual profits**	**Remains 25**
Routine distributor	200 (=500*40%) routine profits **0 residual profits**	**Remains 25**

Conclusion

- *The MDSH as included in the Progress Report leads to arbitrary MDSH calculations depending on business model and thus does not prevent double allocation of residual profits*
- *The design discriminates based on capital intensity*

Dilemma: What if Aco and Bco are not associated?

	Amount A in Country B A and B not-associated	Amount A in Country B 4% RoS A and B associated	Amount A in Country B Progress report – scenario 1 A and B associated	Amount A in Country B Progress report – scenario 2 A and B associated
Full-fledged distributor	**18.75**	**0**	0	25
Routine distributor	30	25	0	25

Conclusion

- *Residual profits already in the market will not be recognized for split supply chain cases*
- *When tax rates between the surrendering and market jurisdiction vary, differences in taxation of similar supply chains will result if a MDSH is available for group situations only*
- *Economic theory indicates that in a competitive market, companies will need to move to the least costly model to remain competitive*
- *Hence: Amount A causes economic distortions which can lead to restructurings, e.g. of franchise and other split supply chain models, unless the MDSH is also available in split supply chain situations*

MDSH is subtracted from the Elimination Profits: Example

Scenarios: The EU R&D is located in different size market jurisdictions respectively

Country/activity	Sales	Profit	D&P	Amount A
Country A **Big market outside EU**	450,000 (to consumers)	36,000 (8% ROS)	150,000	29,000
Country A R&D	250,000 (internal)	125,000	50,000	
EU				
Country F&G	150,000 p/ctry (to consumers)	12,000 (8% ROS)	50,000	9,667
Country H	0 (to consumers)	0	0	
Country I,J,K,L	37,500 p/ctry (to consumers)	3,000 (8% ROS)	12,500	2,417
EU R&D	250,000 (internal)	125,000	50,000	
Group	**900,000** **consolidated**	**322,000**	**400,000**	**58,000**

Resulting Returns on Depreciation and Payroll (F)

EU R&D in Country F	RoDP before MDSH	MDSH Progress Report	RoDP when EP lowered with 1 x MDSH	RoDP when EP lowered with 4 x MDSH
Country A	**81%**	29,000	**66%**	**23%**
Country F	**137%**	9,667	**127%**	**98%**
Country G	24%	0	24%	24%
Country I, J, K, L	24%	0	24%	24%

Conclusion
Even though exactly the same R&D activities are taking place in Country A and country F, Country F will have a (much) higher return on depreciation and payroll, solely due to its smaller market. This has impact on its profile as a surrendering jurisdiction in the context of Elimination of Double Taxation (EoDT)

Resulting Returns on Depreciation and Payroll (I)

EU R&D in Country I	RoDP before MDSH	MDSH	RoDP when EP lowered with 1 x MDSH	RoDP when EP lowered with 4 x MDSH
Country A	**81%**	29,000	**66%**	**23%**
Country I	**205%**	2,418	**201%**	**189%**
Country F&G	24%	0	24%	24%
Country J, K, L	24%	0	24%	24%

Resulting Returns on Depreciation and Payroll (H)

EU R&D in Country H	RoDP before MDSH	MDSH	RoDP when EP lowered with 1 x MDSH	RoDP when EP lowered with 4 x MDSH
Country A	**81%**	29,000	**66%**	**23%**
Country H	**250%**	0	**250%**	**250%**
Country F&G	24%	0	24%	24%
Country I, J, K, L	24%	0	24%	24%

Conclusion

As bigger market jurisdictions tend to have more Depreciation and Payroll due to the local sales and distribution activities, the RoDP for big market jurisdictions tends to be lower than for small jurisdictions in the case where similar residual return generating activities such as R&D are being performed

Indication of relative market size

Country	Household Final Consumption Expenditures (billions of US-$, current)	Reference Year
United States	14,048	2020
European Union	8,710	2021
Japan	2,711	2020
Germany	2,085	2021
Sweden	275	2021
Ireland	121	2021

Source: https://data.worldbank.org/indicator/NE.CON.PRVT.CD

Elimination of double taxation

The mechanism for EoDT aims to ensure that the obligation is borne by the jurisdictions in which the group earns its residual profits

The design of the mechanism determines that jurisdictions with the highest RoDP are the ones relatively having the highest level of residual profits to surrender

Elimination of double taxation seems to be a compromise between two potential methods:

- Waterfall method
- Pro rata Method

We have established that the level of RoDP is heavily influenced by the size of the market, making it more likely for small open economies to be subject to the Waterfall method/being a surrendering jurisdiction

Conclusions

- General observations:
  - Does not meet policy objectives
  - Does not stabilize the international tax environment

- Key tax neutrality distortions arise due to:
  - Discriminates based on capital intensity, business operating models and size of markets

Audience poll

- Do you think we will see a form of global formulary apportionment for the largest companies?

A. Within 5 years
B. Within 10 years
C. Unlikely

- Do you think we will see an EU federal corporate income tax?

A. Within 5 years
B. Within 10 years
C. Unlikely

5. Coffee break !

- Enjoy the chance to chat
- Please be back by 11am CET

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A. Within 5 years
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5. US perspectives

US Alternative Minimum Tax/es

Separate entity approach

Group approach

aggregation

Corporate Alternative Minimum Tax - 2022

Base Erosion and Anti-Abuse Tax - 2017

Experience with BEAT includes:

- Intended to be focused on inbound but hit outbounds more.
- Under-inclusive, because it does not apply to costs that are capitalized into COGS.

- Itai Grinberg
  Deputy Assistant Secretary, U.S. Treasury
  2022 IFA USA Annual Conference

BEAT - Group Approach

Multi-national group	**BEAT** **Base erosion and anti-abuse tax**
US–parented	
Threshold	$500 million, average annual gross receipts, and “base erosion” add-back of deductions
Aggregate Group	25 percent owner by value or voting rights, or related party under the transfer pricing rules in general
Foreign-parented *Threshold*	$500 million, same as above gross receipts
Aggregate Group	Excludes foreign corporations, but includes income that is, or is treated as, effectively connected with the conduct of a trade or business within the U.S.

BEAT – Intercompany Transactions

Intercompany Transactions	**BEAT** **Base erosion and anti-abuse tax**
General rule	Ignore - should not change the consolidated taxable income or consolidated tax liability
Exception Example	Intercompany sale of depreciable property at a $10M gain. Gain is deferred. Remaining useful life: 4 years Additional depreciation: $2.5M/year Offset by recognizing gain: $2.5M/year Net effect on the group result: zero Exclude additional depreciation, because “base erosion” add-back of deductions computed solely on deductions

US: New Corporate Alternative Minimum Tax

Statement from Former Treasury Secretaries on Inflation Reduction Act

August 3, 2022

“... **the extra taxes levied on corporations do not reflect increases in the corporate tax rate, but rather the reclaiming of revenue lost to tax avoidance** …” (emphasis added)

Timothy Geithner, Jacob Lew, Henry Paulson Jr., Robert Rubin and Lawrence Summers

2009-13

2013-17

2006-09

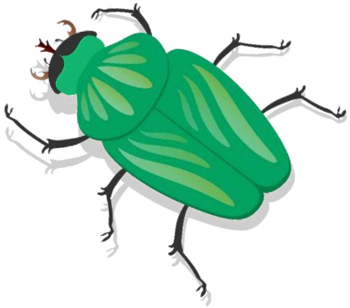
1995-99

1999-2001

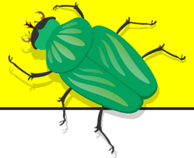
BEAT & the New Corporate Alternative Minimum Tax

- BEAT (Base erosion and anti-abuse tax), Later Edition
  → BEATLE
- Beatles' refrain in *Across the Universe:* "Nothing's gonna change my world"
- Former Treasury Secretaries suggesting the end of abuse,
  a base erosion and end-of-abuse tax

  → Let's call it BEETLE.



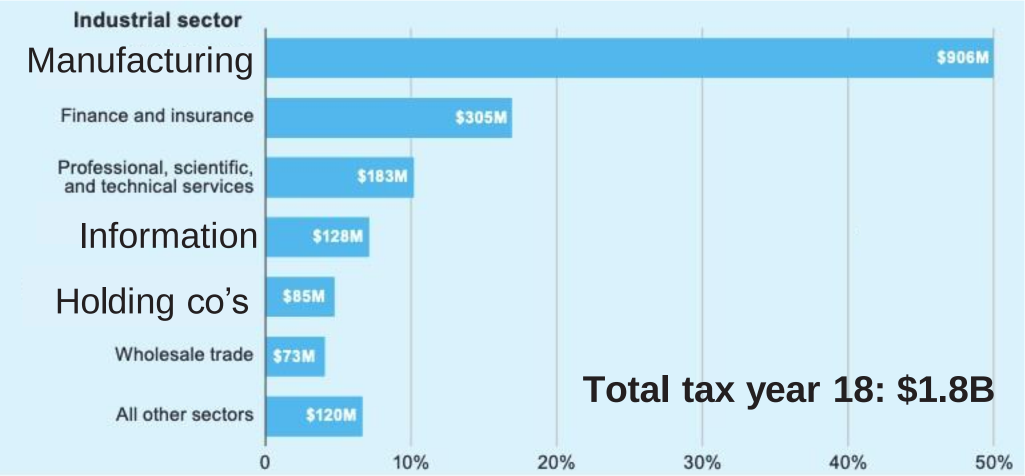
Group Approaches

Multi-national group	**BEETLE** **Base erosion and end-of-abuse tax** 
US–parented *Threshold*	$1 billion, average annual adjusted financial statement income, US-GAAP
Examples of adjustments	• Include foreign corporation ECI and pro rata share in CFC income • Include disregarded entity income and distributive partnership share • Add back income tax deduction, use tax depreciation, adjust fiscal years • Don’t adjust for interest deductions or bad debt.
Aggregate Group	All corporations which are members of the same controlled group of corporations.
Foreign-parented *Threshold*	$100 million U.S. of $1 billion globally
Aggregate Group	Same as above, financial reporting standards not defined

Tax Revenue

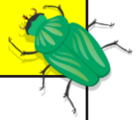
BEAT
Tax Year 2018, actual

Number of firms: 479



Source: https://www.irs.gov/pub/irs-pdf/p5586.pdf

BEETLE
Projected Estimates



Number of firms: 150-200

Industrial sector

Manufacturing: ~50%

Information: ~11%

Holding companies: ~11%

Total Revenue:

$222B, 10 years

$35B in 2023

Source: https://crsreports.congress.gov/product/pdf/IF/IF12179 & https://www.jct.gov/publications/2022/jcx-18-22/

Pillar Two vs. BEETLE

Issue	Observations & Possible Consequences
Group size	€750M revenue for Pillar Two (2/4 yrs) vs $1B profit for BEETLE (3 yrs) BEETLE applies to a far smaller set of companies than Pillar Two
Tax credits	Pillar Two: "Direct pay" credits in CHIPS Act and Inflation Reduction Act of 2022 BEETLE: all tax credits
Deferred taxes	Pillar Two: adjustment; BEETLE: not an adjustment Final guidance could trigger Pillar Two top-up tax
Pre-enactment losses	Pillar Two: Use of pre-2020 losses triggers Pillar Two Unclear: CFC losses for pre-2023 years
Taxation of foreign income	Potentially inconsistent allocation to different countries. Special allocation rules needed
Eligible foreign taxes	BEETLE could apply to foreign income that appears high-taxed under Pillar Two because of US pre-FTC calculation

6. Lower income countries' perspectives

Lower income countries and the Two-Pillar Solution

- **General comments:**
  - General concerns of developing countries
  - Group approach generally vs. particular elements
  - ‘Acceptable’ elements of a Group approach
  - Concerns re. particular elements
  - Progress Report vs. Inclusive Framework Statements
  - The underlying policy concern for developing countries

Pillar 1

- Scope
- Percentage of residual profits
- Size of expected tax revenues
- Current & planned unilateral measures
- Withholding taxes and Amount A
- Marketing and distribution profits safe harbour
- Treatment of losses
- Dispute resolution
- Amount B
- Broader issues regarding general concepts
- **Group approach generally vs. particular elements**

Pillar 2

- **Potential benefits**
- **Some key concerns**
- **GloBE**
  - The minimum rate
  - Rule order
  - UTPR implementation timeframe
  - UTPR carve-out
  - Tax incentives (next slide)
- **Subject-to-tax rule**
  - Scope and rate
- **Group approach generally vs. particular elements**

What does the Group approach mean for FDI competition?

Non Tax Factors	• Market size access to raw materials e.g. natural resources, energy supplies • Availability and cost of skilled labour • Access to infrastructure • Transportation costs • Access to output markets e.g. high consumer demand in region, • Low export costs • Political stability • Macro-economic stability • Financing costs
Tax Factors	• Transparency • Stability and certainty in the application of the tax law and in tax administration • Tax rates • Tax incentives

MENA-OECD Investment Program, Tax Incentives for Investment – *A Global Perspective: experiences in MENA and non-MENA countries* (2007) page 4

Non tax incentive factors will become more important to attract FDI. With the imminent implementation of the pillar 2 minimum tax, jurisdictional promotional authorities are looking to their business friendly eco-systems to attract MNE FDI

Expansion of withholding taxes?

- WHTs: advantages for developing countries
- Overview of general trends
- Impact under tax treaties
- Insights from recent policy proposals:
  - STTR
  - Article 12B
- As an alternative to transfer pricing?
- What is an ideal combination?

6. Formulary apportionment

Formulary Apportionment

Common issues with separate legal entity income allocation system:

Open to profit shifting – intangibles; capital; risk shifting
Creates tax competition between nations
Difficult to apply to digital models
Scope to manipulate transfer prices

"The stakes are high. Although measuring the scope of BEPS proves challenging, the findings of the work performed since 2013 confirm the potential magnitude of the issue, with estimates indicating that the global corporate income tax (CIT) revenue losses could be between 4% to 10% of global CIT revenues, i.e. USD 100 to 240 billion annually."

https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf

Formulary Apportionment

Where has it been used?

Country	FA Factor(s)
US State Corporate Income Tax - Unitary	• **Three factor formula** – equal weighting *(payroll; sales; property)* • **Three factor formula** – different weighting *(sales given higher weighting)* • **Single factor formula** – sales
German Local Business Tax	• Payroll

- The U.S. Uniform Division of Income for Tax Purposes Act (UDITPA), is drafted in broad enough to leave considerable discretion to each state that adopts it.
- Many states, only apply formulary apportionment to corporations, while other states combine unitary taxation.

Formulary Apportionment

Can Formulary Apportionment be applied globally?

- Many commentators consider Global Formulary apportionment would stabilise the current international tax system:
  - Tax liabilities would reflect a globally-integrated business – not separate legal entities.
  - No incentive to shift income across countries because tax liabilities would be based on total world income as well apportioned on the same factor.
  - Since there would be no tax savings, the overall incentive to locate real activities in low-tax countries would also be reduced.

Key issue: Which apportionment factor should be used – sales determined on a destination basis?

Formulary Apportionment

Advantages and disadvantages of Global Formulary Apportionment

Advantages	Disadvantages
Accurately reflects economic reality where MNE's are highly integrated	Conflicts with internationally accepted method therefore difficulty in obtaining international agreement and risk of double taxation
Decreasing uncertainty of an audit increases tax compliance	Interaction between countries with different systems
Transfer pricing manipulation and Tax haven usage eliminated by consolidated accounts and apportionment	The choice of formula factors, their measurement, and the relative weight – are not precise indicators of MNE economic activity
Simplification of tax administration and reduction in compliance costs	Possible risk of continued tax planning based on formulas
Improved perceived fairness and transparency	Exclusion of intangibles
Taking account of Group functions as a whole	From a country perspective different groups with similar activities are treated differently / no tax neutrality

Key issue: Destination based apportionment factors may work best (i.e., sales) – as other factors can still be manipulated to undertake profit shifting

Formulary Apportionment

What does it mean for tax treaties?

- Likely require a **new institutional framework** of global taxation to support implementation of Global Formulary Apportionment and administration.

- Would not work without first *"revoking the current treaty-based international tax regime, entering a multinational tax convention, or establishing an international tax organization to administer it."**

- Would entail **greater multilateral discussion and co-ordination** in order to resolve disputes in the design and implementation of a UT/FA regime.

* Avi-Yonah, R and Benshalom, I (2011) "Formulary Apportionment - Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Mis-Understood and Under-theorized Formulary Alternative" *World Tax Journal* 3(3)


Group approach and separate entity approach
Fair
Certain
Efficient
SO what REALLY motivates your colleagues?
GETTING PAID
GETTING PAID
GETTING PAID
Country X
Country Y
Country Z
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