

INTRA-COMPANY PRICING WITHIN THE EUROPEAN UNION - EUROPE AT ARM'S LENGTH FROM GLOBAL DEVELOPMENTS

Contents

1. Introduction
2. Transfer pricing as an international tax problem
3. Transfer Pricing at European level - the EC Arbitration Convention
4. The arm's length fiction
5. Apportionment methods
6. Apportionment methods for the EU
7. Epilogue

1. INTRODUCTION

TRANSFER PRICING is the price that affiliated companies charge each other for goods or services moving across national borders. The process of transfer pricing, or the manipulation of transfer prices is at the same time a tool for tax planning within multinational groups and a particular source of attention for national tax authorities.

Within a multinational group of companies the price paid for goods or services by one affiliate to another is immaterial as far as group results are concerned: the real profit or loss to the group as a whole results only after these goods or services are sold to a party outside the group.

However, the price paid by one company of the group to another affects the overall tax position of the multinational because it may artificially shift transaction results from a high tax jurisdiction into a lower one.

The transfer pricing problem is the result of global mobility of capital without effective coordination of the tax authorities. It is very easy for multinationals to transfer profits "from one pocket to the other" but it is not as easy for tax authorities to coordinate in order to share tax income.

Statistical evidence on the growth of the intra-firm trade suggests that the proportion of trade likely to involve transfer prices has increased sharply over the last two decades. Hence, the opportunity for transfer price manipulation has increased, and with it, the danger of revenue erosion from high tax countries. A related trend in international trade has been the growth in services and intangibles as a component of total trade. With the increased importance in total trade flows of such intangible items such as royalties and license fees, the scope for tax avoidance through price manipulation has increased correspondingly.

In the United States rules governing transfer pricing have been developed since the beginning of the century in order for the states to share the tax paid by corporations which operate in more than one of them. Two schools of thought have been developed as to the direction that U.S. transfer pricing rules should take. The apparent minority view is that of the advocates of the so called formulary or unitary methods. The apparent majority view supports the arm's length standard. The latter is also adopted by the OECD in its model tax treaty and all its guidelines to tax authorities and MNEs. The arm's length method is also the official European Union approach along the lines of the OECD methods but also by the signing of the Arbitration Convention in 1990.

This study is focused on the issue of transfer pricing within the EU. However, because it would not be wise to ignore the global developments in the field some issues are not considered in isolation. After outlining the global transfer pricing concern (Chapter 1) the study goes on to analyse the problematic of the European approach (Chapter 2). Chapter 3 is a challenge to the arm's length principle as a way to tackle transfer pricing problems in a global economy. The alternative method is presented in Chapter 4 as well as the way it has been used in the U.S. Finally the study aims to conclude that the alternative methods have a better potential for a Single Market.

2. TRANSFER PRICING: AN INTERNATIONAL TAX PROBLEM

Following the explosive growth in international trade, transfer pricing has been an increasingly important issue. The modern communication systems allow trade and investment to flow across national borders within seconds. International business has been integrated with trans-national alliances among firms that combine technology, production and marketing. One of the main reasons for these developments has been the opening of borders to both inward and outward capital flows. In the 70s most OECD countries¹ operated exchange controls and restrictions that have to a large extent disappeared nowadays.

Multinational enterprises are not a new phenomenon. However, their impact on global economy has never been so strong and is getting stronger as consolidation is spreading at ever-quicker pace. Comprising approximately 39,000 parent corporations and 270,000 foreign affiliates, multinational corporations account for approximately 60% of international trade in goods, services and technology. They control approximately US\$2.7 trillion of foreign direct investment stock with global sales of foreign affiliates in excess of US\$6 trillion. The top 100 multinationals, excluding those of the banking and financial sectors employ about 12 million people worldwide, including 5 million by their foreign affiliates. Their global assets are worth over US\$4.2 trillion, of which foreign assets are worth approximately US\$1.4 trillion²

¹ The original member countries of the OECD were Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the UK and the USA. The following countries became members subsequently through accession at the dates indicated hereafter: Japan (1964), Finland (1969), Australia (1971), New Zealand (1973), Mexico (1994), the Czech Republic (1995), Hungary (1996), Poland (1996), and Korea (1996). The Commission of the European Communities also takes part in the work of the OECD (art. 13 of the OECD Convention)

² (1996) Vol. 3 *The Institutional Investor* 75, p. 76.

The removal of capital barriers has made it significantly easier for multinationals to design their operations in a sophisticated manner. Although non-tax factors play a primary role in the location of manufacturing facilities³, many aspects of a multinational's activities are not location-specific: for example, head offices and co-ordination centers, distribution centers, research and development centers and financial service centers including holding companies and offshore banking facilities.

In a 1996 survey conducted by Ernst & Young⁴, for the purposes of which 200 tax and finance executives of multinationals were interviewed, transfer pricing was identified as the most significant international tax issue facing these companies. Five out of six companies surveyed had been involved in a transfer pricing dispute and half of them were engaged in one at the time of the survey.

A common scenario under which a transfer pricing dispute can arise is the following. A multinational company has its head office in country A. It has a subsidiary in country B which manufactures dresses for 10 EUROS. Another subsidiary in country C sells the dress for €100. Assuming that country B is lower taxed, the parent company can shift some of its taxable profits there, by paying to subsidiary B €60 for the dress that only cost B €10.

National tax authorities are nowadays aware of the tactic of shifting transaction results. So, as a defensive action, they often adjust these intra-company prices in manner that national branch profits are higher than what the group anticipated. At a first glance this attitude by national tax authorities is justified. The problems arise in a situation where the transfer prices are adjusted by one national tax authority without a

³ Rudding Committee, table 5.5, at p. 114

corresponding adjustment by another. If, for example a high tax jurisdiction suspects an artificially higher pricing shifting results to a lower tax jurisdiction it may adjust it in a manner that more profits are made in the higher tax jurisdiction. This may result in double taxation if the lower tax jurisdiction does not make a corresponding adjustment lowering the results of the branch located in its territory. The problem is even more apparent where a transfer price challenged by a national tax authority is correct. Since national tax authorities in theory only care about collecting more taxes there is a conflict of interest between them. What country A will not collect will be collected by country B; if this results in double taxation will then be left to the detriment of the company concerned or to the discretion of the courts.

Most tax jurisdictions and international tax agreements adopt the arm's length principle: a taxation concept referring to dealings between unrelated parties which are completely independent of one another⁵. Tax authorities are often given the power of adjusting prices paid in respect of business transacted between affiliated parties to arm's length prices, or prices that independent parties would have agreed upon in the same circumstances.

The arm's length principle can find easier application in transactions involving real or tangible property for which precise or at least conventional valuations can be established. On the other hand, managerial services, royalties for intangible rights and transfers of finished goods for resale are activities typically subject to disputes.

THE OECD Model Tax Convention on income and capital provides in article 9 the following.

1. Where

⁵ Originally it was section 482 of the U.S. Internal Revenue Code which established the foundation for the arm's length principle as the touchstone for intercompany transfer pricing under the US tax rules. It was enacted in 1923 (as section 45 under the law then in effect).

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,

or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between those enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State- and taxes accordingly- profits on which an enterprise of the other Contracting State has been charged to tax in that other state and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such an adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Article 9 essentially provides two things. First that a contracting state is authorised to make an adjustment of the profits of an enterprise if these profits have been incorrectly determined following a dealing with an associated party that was not in accordance with the arm's length principle. Secondly, that the other contracting state should make a corresponding adjustment to avoid double taxation where a re-writing of profits has taken place in the first contracting state.

According to the commentary of the OECD on Article 9 the second state is only committed to make the appropriate adjustment if it agrees in principle and as regards the amount with the adjustment made in the first contracting state.

Moreover, article 9 does not provide for time limits with regard to the corrective adjustment i.e. for how long state B is committed to make the corrective adjustment.

The Convention is a general framework and still many matters are left to mutual agreement between the independent states. It cannot go into the details of every single judicial system and the effectiveness of its provisions might be prejudiced as early as when trying to establish the link between the two enterprises required by paragraph 1. Some state authorities adopt a secrecy policy with regard to company holdings in a way that investigations by another state as to the fact that two companies are connected with each-other may be blocked at their beginning.

Belgium, Finland and Portugal⁶ reserved the right not to insert paragraph 2 in their conventions. Also with respect to paragraph 2, France reserved the right to include in its conventions that it will only proceed with a corrective adjustment if it considers it justified.

Needless to say, the solutions provided by the OECD model tax convention in that respect are not sufficient. They have a restorative and not a preventive character.

3. TRANSFER PRICING AT EUROPEAN LEVEL

Of course, transfer pricing problems are reflected in intra-community trade. Since Community action was undertaken in order to eliminate the obstacles of cross border trade, this was done in order to increase the efficiency of the Single Market operating as a whole. After trade between Member States has been boosted by the customs union and other major

⁶ also Switzerland and Norway

EU policies there has been an increase not only in the association of enterprises of different MS but also an increase of the transactions between them. Both these factors i.e. the association and the transactions are constituents of the transfer pricing issue; and if its constituents are increased it is unavoidable that transfer pricing problems are generated in a Single Market more frequently and to a larger extent than in transactions between associated companies outside the EU.

Precise figures on the volume of transfer-pricing which relate to EU countries do not exist. However, total trade in goods between the different Member States amounted to as much as ECU614 billion in 1989⁷. Estimates put the figure of transfer prices within the EU to ECU 38 billion excluding trade between EC and third countries. This is an enormous proportion of trade which has to be scrutinised. It implies a considerable compliance effort by both tax authorities and businesses, so, the way to solve the problem efficiently needs to be balanced with questions of fairness. The way that disputes are resolved has an impact on the division of tax revenues between the Member States. So, it is not surprising that the developments with regard to solving the transfer pricing problem at European level are as disappointing as most attempts to harmonise corporate taxation.

In 1976 the Commission proposed a Directive on the issue of transfer pricing based on article 100 of the Treaty⁸. This was linked to the simultaneously proposed Directive on mutual assistance of tax authorities of different Member States⁹. The linkage was justified by the view that an increased exchange of information between

⁷ EC information No 5/1991, p. 7

⁸ Proposed Directive concerning the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure), submitted to the Council 29 November 1976, O.J. No C 304 of 21 Dec. 1976, at 4.

⁹ Council Directive 77/799/EEC of 19 December 1977, O.J. No L336 of 27 Dec. 1977, at 15

the tax authorities would result in an increase of profit adjustments.¹⁰ The first Directive was never adopted although the Directive on mutual assistance was one of the first European steps towards corporate tax coordination-ordination.

The proposed Directive was changed in a draft Arbitration Convention¹¹ in 1978 at the initiative of the Netherlands. The change of legal form did not speed up the adoption which came into effect some 12 years later.

Why it took so much time for this development to occur in the EU is disappointing, especially if one considers its very limited contribution. The starting point of the Convention is along the lines of article 9 of the OECD model tax convention. It recognizes profit adjustments where transactions are not at arm's length.

Article 5 of the Convention requires a Contracting State to inform in due time an enterprise whose profits it intends to adjust so that the latter can inform its affiliate which will be able in that way to inform the other Contracting State. Quite surprisingly, the Convention does not make reference to the corresponding adjustment obligation set out in paragraph 2 of article 9 of the OECD model, what Professor Hinnekens thought to be "sloppy drafting".¹²

Most conventions for the avoidance of double taxation concluded between Member States already contain a provision for mutual agreement procedure between the tax authorities. But these conventions go no further than merely laying down an obligation to enter upon such a

¹⁰Prof. Peter J. Wattel, *European Tax Law*, Second Edition 1997, FED at p. 279.

¹¹ Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises 90/436/EEC OJ No L 225/10, 20/8/90.

¹² Luc Hinnekens: "the Tax Arbitration Convention, its significance for the EC based enterprise, the EC itself and for Belgian and International tax law" *EC TAX REVIEW* 1992/2 at 94.

procedure, which clearly gives no guarantee that the double taxation will in fact be eliminated.¹³The real significance of the Convention lies in its system of mandatory arbitration. OECD model treaties do not, as a general rule provide for arbitration.

Article 7 provides for the setting up of an advisory commission charged with delivering its opinion on the elimination of double taxation. The Commission, comprised of "independent persons of standing" shall have an arbitrary role. It shall be set up within two years after an enterprise has complained of double taxation to the competent authorities of one of the Contracting states. The submission of a case to the advisory commission shall not prevent the parties from initiating judicial proceedings in relation to the same matter in the Member States concerned. The two years period in the latter case would be extended until judicial decision is obtained accordingly.

The advisory commission must deliver its opinion within 6 months after its composition. So even if the enterprises have not initiated national judicial proceedings, 2 and a half years are contemplated until the matter is resolved. This may have significant consequences in the financial position of the enterprises concerned since there is no provision regarding any obligation of the enterprises to pay tax in the meantime, whether any tax refunds or obligations are to be charged with interest and if so at what rate.

There are also some escape provisions for the Member States:

a) According to art. 6(2) the Contracting States are not required to initiate an arbitration procedure if the complaint of the enterprise involved does not appear to be well founded. Similar wording is found in article 25(2) of the OECD model. There is no guidance as to why a complaint should be considered as such which means that the matter is left to the discretion

¹³Dirk Schelpe - administrator, European Commission, "The Arbitration Convention: its origin, its opportunities and its weaknesses", *EC TAX REVIEW* 1995/2 at p. 70.

and the goodwill of the national tax authorities. In that respect, the Convention does not provide with any protection for companies such as an obligation for tax authorities to give written reasons as to why a complaint is not qualifying for the procedure.

b) Art. 8 leads to the same effect if one of the enterprises involved is subject to administrative or criminal sanctions in relation to the actions that gave rise to the price adjustment.

c) If according to national rules the competent authorities of a contracting state are not allowed to derogate from judicial decisions, and the dispute is already subject to proceedings in court then there is no obligation to initiate arbitration unless the enterprises involved have essentially waived their rights under the court proceedings (art. 7(3)). In their unilateral declarations to this article, France and the UK have expressly stated that they will apply this article. This effectively means that enterprises of those two states will have a choice between national procedure and the arbitration procedure.

The rest of the provisions are details regarding formalities. Article 20 limits the life of the Convention to five years. The countdown started on 1 January 1995 i.e. the period expires on 31 December 1999.

The Arbitration Convention's only contribution to the existing article 9 of the OECD model convention is the provision for arbitration. The "restorative character" of the solutions provided is still the case. Moreover the Arbitration Convention has been subjected to academic criticism due to other important drawbacks that it presented.

Objections as to the legal form

The main objection with regard to the Arbitration Convention is about its legal form; i.e. that instead of a Convention based on art.220, the original Directive should have been adopted on the basis of art. 100. The choice was a political decision made by Member States resulting from their

hesitation to surrender a significant part of their fiscal sovereignty.¹⁴ On the contrary, there have also been academic views in support of the adoption of a Convention instead of a Directive. Professor Lehner¹⁵ points out that amendments made to national law under a Directive risk disturbing the balanced system of international tax treaties. Because art. 220 is dominated by the general subsidiarity principle of article 3(b) and because it is mainly the Member States which can take better action to amend tax treaties, Prof. Lehner concludes that a Convention was more appropriate. This may be true but what are the priorities set? If action is necessary to eliminate double taxation at Community level is this not so even if it results in distortion of the "balanced system of international tax treaties". After all both instruments are aiming at one thing. Is there no priority for solving it within the EU before we protect the treaty network with third states? As it was highlighted earlier in this study, transfer pricing problems within a Single Market are actually and potentially more important and severe than in an international context where no comparable developments in the field of customs union and freedom of movement of capital have taken place. Moreover, why should we prefer protecting the existing bilateral treaty network to the prejudice of an effective step towards European integration in the field?

The choice for a Convention instead of a directive means that arbitration on transfer pricing disputes within the EU are governed by international law of the treaties. The Arbitration Convention constitutes a multilateral treaty with the same status in international law as any ordinary international treaty. It is not Community Law in the strict sense because it is not subject to ECJ interpretation, it had to be ratified by national parliaments and new members of the Union do not automatically accede to it. The expiry of the Convention is only 6 months ahead.

¹⁴ *ibid.* at p. 71

¹⁵ M. Lehner, 'EC law and the Competence to abolish Double taxation', *Tax Treaties and EC la, Kluwer Law International, 1997, Series on International Taxation, no. 16 p. 3*

At the May 1999 ECOFIN meeting, following agreement on the text, the Member States signed the Protocol amending the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits on associated enterprises. The Protocol provides an extension of 5 years of the Arbitration Convention from the existing expiry date of 31 December 1999. The Convention will then be renewable every five years by tacit procedure, that is, unless any Contracting State objects.

The 1999 ECOFIN meeting did not lead to any considerable developments. The news is that corporate tax matters progress very slowly at European level - if they progress at all. The ECOFIN confirmed that also for the following 5 years the Arbitration Convention will be the solution to transfer pricing disputes. Unfortunately there are many reasons to doubt that. The European approach should not focus only to the avoidance of double taxation but more importantly to common determination of taxable profits by the adoption of common rules.

The solution is not necessarily "harmonisation". We do not have to harmonize everything. This is what all MS governments try to avoid as far as taxation is concerned. Member States are not ready to give up this sovereignty and perhaps they will not be for another 30 years. What should be done instead is to realise how business patterns are being re-shaped by global integration and by the revolution of information technology. Thanks to the existence of the World Wide Web a firm can nowadays be everywhere at all times and move billions within seconds. The next chapter attempts to analyse why the arm's length method does not suffice anymore as a way to tackle transfer pricing disputes.

4. THE ARM'S LENGTH FICTION

People dealing on a strict business footing with each other, do not dance cheek to cheek but at an arm's length from each other¹⁶. The arm's length method is therefore a fiction since it states that the price at which transactions between related foreign entities should take place is the price that would have occurred had the related parties transacted as unrelated ones. Related parties will always be willing to dance cheek to cheek; because as the economist Coase¹⁷ has observed, 'the firm is an island of non-market control, within which exchange is predicated on the existence of a planned institution'. As such, exchange within firms is, in some sense, not comparable to the arm's length exchanges carried out in the market.

In 1979 the OECD published a comprehensive survey entitled 'Transfer pricing and Multinational Enterprises' where it is reflected that the arm's length standard is generally accepted by all member countries of the OECD, as well as most other industrialised countries in the world. It is an international norm.

It is useful for the purposes of this study to outline the basic methods of specifying the arm's length price:

1) *transactional approaches*; these require price observations for "comparable" transactions between unrelated parties (CUPs or Comparable Uncontrolled Prices). The 1979 OECD report affirms that "the comparable uncontrolled price method offers the most direct way of determining an arm's length price. The transfer price is set by reference to comparable transactions between a buyer and a seller who are not associated enterprises¹⁸. Neither the Arbitration Convention nor the

¹⁶ Prof. Peter J. Wattel, *European Tax Law*, 2nd edition 1997, FED at p. 275, footnote 2

¹⁷ Ronald H. Coase, "the Nature of the Firm" *The firm, the market and the law*, Chicago University Press, 1988 pp. 33-55

¹⁸ OECD report para. 48

national statutory provisions¹⁹ establish an express priority over that method. In practice, the tax authorities recognize (in principle) the primacy of the price comparison along the lines of the OECD report²⁰.

2) profit-based approaches; They are expressly dealt with in the 1979 OECD report according to which "tax authorities may find some help in a comparison of an enterprise's overall performance with that of other similar enterprises in the same or similar circumstances"²¹. A comparison of profit is usually just a method for selecting the companies to be audited: a profit lower than the industry average profit is an indication of non-arm's length pricing. The application of this method shows a high degree of arbitrariness. Notions like "similar enterprise" and "profits" are not sufficiently defined. This is why the profit comparison method can only be used as an auxiliary method and not as the main or the only one.

The literature surrounding the arm's length principle provides with two main conclusions. First, due to the nature of the firm as a substitute for the market, there is little reason to expect that observations of actual arm's length prices even exist for most goods traded inside the multinational corporation. Second, the arm's length principle provides no guidance as to the allocation of the costs saved by the organisational form. In other words, the arm's length theory ignores the impact to real pricing of the fact that transactions are taking place not in the market but within an integrated group. According to Coase it is inferred that goods being transferred between related parties would not, in fact have been

¹⁹ except in Italy where art. 9. of the Consolidated Tax Act defines the concept of "normal value" in a fashion which does not permit methods other than the price comparison.

²⁰ This approach is evidenced by the administrative guidelines issued by the tax authorities or by current audit practice as in Netherlands, Finland and Sweden where the tax authorities confirmed that they would start from a comparable price if available.(OECD).

²¹ para 71

transferred between unrelated parties because the transaction costs associated with the exchange would have been too high.

Suppose that a parent corporation purchases chairs from a manufacturing subsidiary and then sells them. The same operation can be undertaken by two non-integrated firms, one manufacturing and one distributing. If the profit of each of the separate firms is 10% of the capital invested, then the combined profit of the parent and the subsidiary in the same business should be also 10% of the total capital invested ?

No, because this simplification ignores the cost savings associated with vertical integration. The costs of selling to a third party are higher than internal transfers within a firm.

The problem is also referred as asset-specificity: a condition whereby transaction related investments are made which would not be viable if the economic relationship to which they are unique were to break down. That is to say, investments are specific to a given transaction or economic relationship. The difference between a specific asset's value within a transaction and its total value outside the transaction is called quasi-rent which would be lost if the economic relationship between the subsidiary and the purchasing distributor were to break down.

Many of the most obvious opportunities for transfer pricing abuse relate to the transfer of intangible property such as know-how, patent rights and trademarks, and because an MNE can be realistically characterised as a substitute for the market as a means of facilitating cross border transfers of intangibles, there should be no expectation that arm's length prices even exist for the most significant cross border transfers.

In the context of significant intangible assets, the arm's length standard requires an allocation of income to the intangible assets, which essentially involves a valuation of the intangible assets. The courts that have attempted to deal with cases involving highly valuable intangible assets have reached determinations that whether high or low seem less arbitrary

than the results of a formulary methodology. Even assuming that income from intangibles could be determined in some acceptable manner, the arm's length standard presents severe administrative problems because, as in other valuations it requires a factual determination of the circumstances of each taxpayer, perhaps even of each product line of the taxpayer.

Apart from the economic arguments set out above there are more situations where the arm's length method can prove insufficient. One way to circumvent transfer pricing legislation that uses the arm's length method is by overriding the "associated enterprise" element. The method is also known as interposition and it involves the use of an intermediary company in the transaction. Assume for example that Company I, instead of entering into an agreement concerning the transfer of goods directly to an associated foreign company C, enters into the said agreement with an "interposed" party X which, later on, transfers the effects of the transaction to C under the same terms and conditions. Since the link between I and C is broken by the interposition of X the transaction is likely to escape transfer pricing regulations that apply a relatively strict requirement of association.

The same circumvention can occur without an intermediary company if the tax authorities of a country investigating a transfer price do not manage to establish the association between the parties involved in the transaction. Some countries employ business secrecy practices that prohibit the disclosure of information relating to shareholdings. Although in the European Union the Directive on mutual assistance of tax authorities has been one of the first steps on tax harmonisation, there have been occasions where tax authorities of a Member State have denied disclosure of such matters. If the other Member State requiring information does not establish that an association exists, then the transactions will be deemed to be concluded between unrelated parties and this is the point where the investigation will end.

Next, the alternative to the arm's length method is considered.

5. APPORTIONMENT METHODS

As it was illustrated in the previous chapter the arm's length standard looks to fair market value in a third party marketplace. Apportionment methods, however, allocate profit within a controlled group according to a predetermined formula. Apportionment methods include formulary apportionment, global methods, profit splits, unitary methods and worldwide combined reporting. All of these are variations on a theme.²²

Formula-based taxation began in the United States in the late 1800s as a means to tax intangible property values of the transcontinental railroad system. States began to use apportionment for income tax purposes at the turn of the century. The U.S Supreme court soon²³ approved the unit rule for taxing manufacturing income. Its reasoning was that a series of transactions, beginning with manufacture in one state and ending with sale in other states generated income for a multi-state company. The integrated series of cross-border transactions made it impossible to allocate specifically profits earned by the processes located within national borders. This was the reason why the court considered the apportionment method necessary to determine state income.

The principle used is the unitary theory, which justifies the apportionment and allocation. This principle views an MNE as a unitary business that cannot be separated into independently operating divisions.

Apportionment is generally²⁴ based on a three factor formula that especially weights sales property and pay-roll, or on a modified three factor formula where the sales factor is assigned a double weight.

According to the principles of international tax a state has the right to tax a business incorporated in its territory. For a state to tax a business not

²² Richard M. Hammer "Will the arm's length standards stand the test of time? the specter of apportionment". Price Waterhouse & Co. New York, N.Y. U.S.A

²³ Underwood Typewriter Co. v Connecticut (1920)

incorporated in its territory depends on the business having a sufficient nexus established with that state. A nexus is the degree of activity needed before a state can impose a tax on an entity's income. Unless a company has business activities in more than one state and has established sufficient means with these states, it must allocate and apportion its income among these states. The difference between apportionment and allocation is that apportionment involves the division of income among states, while allocation is the direct assignment of an income to a state. The most extreme example of an apportionment method is a full global method.

The use of apportionment methodologies has been debated for decades but it has usually been rejected on tax policy grounds. The OECD report specifically rejects global apportionment or any other method that sets transfer prices by reference to predetermined formulas. In principle, the OECD Report opposes global methods on the basis of the practical difficulties of administering them on a worldwide basis.

Historically, apportionment methods have been implemented in only limited circumstances. The United States, however, has increasingly applied that method, also referred as profit split, at the federal level.

Their application in the United States

In the UNITED STATES corporations are subject to income taxes at the federal level; in addition, there exist also state and local taxes. For federal income tax purposes, income and expenditure are allocated between related companies by using the arm's length method.

Although apportionment methods are usually applied only to domestic income certain US States (Alaska, Arizona, California, Colorado, Connecticut, District of Columbia, Illinois, Indiana, Iowa, Kansas, Massachusetts, New Hampshire, New Jersey, New York, Ohio, Rhode

²⁴ in the United States this is the case

Island and West Virginia) assess State corporate income tax for foreign-owned corporations on the basis of an arbitrarily calculated proportion of their total world-wide profits - a system referred to as 'unitary worldwide combined assessment'²⁵. This proportion is calculated in such a way that a company may have to pay tax on income arising outside the State, by thereby expanding considerably the tax base and potentially giving rise to double taxation.

Whether a given state can include a corporation's -whether foreign or domestic- worldwide unitary income or it should be confined only to US operations of the corporation has been one of the most contentious issues surrounding formulary taxation in the U.S. The Supreme Court, in a landmark decision²⁶, affirmed the constitutionality²⁷ of a state's authority to require worldwide combined reporting of U.S. parent firms with the income of its foreign subsidiaries.²⁸ In addition the court stressed that because double taxation is as likely to occur under separate accounting as under formula apportionment, 'a state should not be required to give up one allocation method that sometimes results in double taxation in favor of another allocation method that sometimes has the same result'.

²⁵ also referred to as world-wide combined reporting (WWCR).

²⁶ Container Corporation of America vs. Franchise Tax Board, 103 S. Ct 2933 (1983)

²⁷ more specifically the compatibility with the Due Process and Commerce clauses of the U.S. constitution.

²⁸ In Germany also, in the *Schering* case (1963) the *Bundesfinanzhof* (federal fiscal court) rejected the taxpayer's argument that the taxation of the world-wide income of a company that is both incorporated and managed abroad was against the principles of international tax law and therefore unconstitutional. decision of 18 December 1963, BStBl II 253

EU approach to the U.S. practice

World-wide combined reporting was strongly opposed by all European Community member states as well as Japan, Australia, Canada and Switzerland.

The 1975 United Kingdom-US tax treaty prohibited the application of the unitary system: in determining the tax liability of the US subsidiary of a UK corporation, neither the US federal government nor a state of the US is permitted to allocate, apportion or include in the subsidiary's tax base any income earned by corporations related to the US subsidiary or to the UK parent, except to the extent that the US subsidiary has dealings (with such related corporations) which are not at arm's length²⁹. The US Senate had delayed the ratification of the above treaty mainly on account of California's reluctance to abandon this system of assessment.³⁰

The unitary system implies the application of extraterritoriality. This is a long-standing and growing feature of the US legal system manifesting itself in - amongst others - the fields of the environment, banking, tax and export control. The fact that unitary taxation looks at the worldwide income of a corporation raises questions of constitutionality in certain countries as well as questions of conformity with WTO and GATT rules.

A Commission's Report on United States Barriers to Trade and Investment published on July 1997³¹ makes reference to the unitary system as

²⁹ S.N. Frommel, *Taxation of branches and subsidiaries in Western Europe, Canada and the USA*, 2nd edition, Kluwer-Deventer 1978 at p. 53

³⁰ The US senate had ratified the Treaty but had rejected the unitary prohibition provision

³¹ The 1997 Report on United States Barriers to Trade and Investment is the thirteenth such annual report. It has been compiled by the Unit for Relations with the United States of America in cooperation with the Market Access Unit, both part of the Directorate General for External Relations: Commercial Policy and Relations with North America, the Far East, Australia and New Zealand, on the basis of material available to the services of the European Commission. Its aim is

applied by the U.S. and in particular to the onerous requirements imposed to EU corporations by U.S. tax authorities. The information reporting requirements of the US Tax Code as applied to certain foreign-owned corporations mean that domestic and foreign companies are treated differently. These rules apply to foreign branches and to any corporation that has at least one 25% foreign shareholder. They require the maintenance, or the creation, of books and records relating to transactions with related parties. The documents must be stored at a place specified by the US tax authorities, and an annual statement filed containing information about dealings with related parties. There are stiff penalties for non-compliance with the various provisions. Although their purpose, the prevention of tax avoidance and evasion, is reasonable, they are burdensome and add to the complexity for foreign-owned corporations of doing business in the US.

The report supports the view that "world-wide" unitary taxation is inconsistent with bilateral tax treaties concluded by the US at the Federal level. A company may also face heavy compliance costs in providing details of its world-wide operations. The 1994 US Supreme Court ruling that California's former world-wide unitary tax was not unconstitutional was not encouraging. The EU and its Member States remain concerned about unitary regimes and will keep a watch on possible developments.

While the EU may share some of the objectives underlying such laws, it is opposed, as a matter of law and principle, to the extraterritorial application of domestic legislation insofar as it purports to force persons present in - and companies incorporated in - the EU to follow US laws or policies outside the US and to the extent that it serves only to protect US trade or political interests. In particular, the EU opposes the extraterritorial provisions of certain US legislation which hampers

to provide an inventory of obstacles that EU exporters and investors encounter in the US

international trade and investment by seeking to regulate EU trade with third countries conducted by companies outside the US.

An example of unitary apportionment

To illustrate³² the above formulas we assume that "EUROCOMPANY LTD" has realised €3,000,000 of taxable income in the Netherlands, the UK and Germany and that the following data are provided:

| | NL | UK | D |
|----------|------------|------------|------------|
| SALES | €2,000,000 | €4,000,000 | €4,000,000 |
| PROPERTY | €6,000,000 | €4,000,000 | €2,000,000 |
| PAYROLL | €1,000,000 | €5,000,000 | €4,000,000 |

If all three states use an equally weighted three factor formula the tax payable on the €3,000,000 of income realised is divided between them as follows.

In the Netherlands

EUROCOMPANY has 20% of its sales
50% of its property
and 10% of its payroll

The sum of these percentages [20+50+10 = 80]
is then divided by 3 (the number of the factors) which equals 26,7%

In the UK

EUROCOMPANY has 40% of its sales
33,3% of its property

³² illustration adapted from example provided in "Significant Current Issues in International taxation" - Ahmed Riahi - Belkaoui, *Quorum Books* 1998.

and 50% of its payroll
this gives 41,1%

In Germany

EUROCOMPANY has 40% of its sales
16,7% of its property
and 40% of its payroll
this gives 32,2%

In that way of the € 3,000,000 of EUROCOMPANY's taxable income
26,7% is taxed by Netherlands
41,1% by the UK and
32,2% by Germany.

The three factor formula can be determined in other ways, for example by assigning double weighting to the sales factor as illustrated above.

Disadvantages of the unitary method

The problem with unitary taxation involves foreign multinational corporations. This method is not popular with most multinational corporations. The question concerns the legitimacy of a state levying taxes on business conducted in another country i.e. whether an individual state should be allowed to impose income taxes on foreign source income. Proponents of the unitary tax method answer the question positively.

If the state unitary taxation has no provision for credits for foreign tax paid this will lead to international double taxation.

Also, under a unitary tax system there are potentially a large number of different tax bases to be calculated. If each country charges tax on a proportion of Europe-wide taxable profits, defined according to each tax

system, then not only does that country need details of all the company's operations in Europe (which it currently does not need), but the company or group concerned will need to calculate its Europe-wide profits under as many different tax systems as the number of countries in which it operates. Given such a multiplication of administrative and compliance costs such a system could only work if the tax bases of the different countries were very similar. It should be noted that the systems operating in North America have very similar tax bases in the different jurisdictions.

This means that if countries maintain different tax codes, the benefits of a unitary tax system are much reduced. First, Capital Export Neutrality is not achieved, since the country of production affects the total tax burden. Capital Import Neutrality will be achieved. As explained above, the administrative costs and difficulties of a unitary tax system without harmonised tax bases are big.

There is always the problem of sovereignty. This will have to be solved once and for all when the Council would be asked to unanimously approve an apportionment formula. Assuming the formula apportioning profits is based on work force and buildings, the source country will have jurisdiction over a large proportion of profits; on the other hand, the residence country where the head office and administration are located would be worse off. In agreeing upon the formula national states hosting sales outlets of the unitary business will stress the importance of sales figures, whereas States hosting production plants will probably be in favor of heavy weighting of balance sheet totals or payroll totals. National fiscal sovereignty would virtually have to limit itself to selecting the rate to be applied to the assigned portion.

The use of a global apportionment formula to allocate profits of MNEs operating in both high and low wage countries will not produce a desirable tax allocation from the perspective of the low wage countries, if the payroll is an important component of the formula. This will mean that developing (low-wage) countries will not be benefited from such a change.

The opposite of that argument is that countries will be motivated to have higher wages,

The three factor formula has been found in the U.S. not to produce satisfactory results because of the particular characteristics of certain industries. These industries include transportation, communications, public utilities, natural resources and services. Many of the U.S. states have developed specialised rules for applying the formulary approach to these industries.

The universal application of this technique is unlikely; there are no signs of an international agreement about the computation of the consolidated tax base or upon the factors of a apportionment formula. For instance, this method was considered, but rejected, by the 1974 Report of the United Nations' Group of Eminent Persons. If the initiative for the replacement of the arm's length method is regionally based will lead to the adoption of different formulas by different jurisdictions.

6. APPORTIONMENT METHOD FOR THE EUROPEAN UNION

Under the unitary system there is no advantage to declaring a taxable profit in one country rather than another. If the tax base includes all profits made by the group in Europe then several administrative complications of international tax disappear. All activities would be lumped together.

In a single market formulary apportionment seems the most logical method to allocate revenues between Member States. This is so because, within the EU, the only problematic issue with regard to transfer pricing is the fair division of tax revenues among the Member States. If we accept the latter conclusion, effecting this allocation by means of hypothetical profit calculations based on the arm's length method makes no sense. This is so because the two pillars on which arm's length pricing is based -

geographic source of income and the national location of a given corporate entity- generally are irrelevant in a common market.

As is evidenced by the U.S. experience, the basic elements required to achieve a fair revenue allocation is adoption of a relatively uniform apportionment method and a mechanism for resolving claims of overreaching by a particular member state. It would be desirable for regulations to be adopted setting out the factors and weighting to be applied to each according to every industry's special characteristics. As to the mechanism for resolving disputes in the U.S. it is the Supreme Court the equivalent of which already exists in the EU system. This mechanism of control and appeal would be necessary. The apportionment method can work only if binding decisions can be made which will prevent M. States from adopting domestic rules that produce double taxation.

A Member State would be entitled to a portion of a unitary business' taxable income if a threshold level of economic contact with the MS is met. Whether that threshold should be the permanent establishment standard of existing treaties or some other would be resolved by multilateral negotiations.

Negotiations on the factors to be applied in the formula may be able to mitigate the effects of differences in the current economic positions of the 15 Member States. The representatives of each country will be required to analyse data on matters such as trade and investment flows, property values, salary levels, technology transfers etc. in order to develop an apportionment formula acceptable for every MS. This will involve thorough economic analysis and consultation between the national tax authorities. A formula can also have a positive impact to the system of collecting the so called Community's own resources if a percentage of tax income is designated for that purpose.

Because of application of the formula it may be that a corporation has income which is not taxed in any state, or can be isolated in a state with no income tax. In that case, factors attributable to the low tax jurisdiction

can be excluded from the numerator and the denominator of the formula so that all states in which the corporation is subject to taxation will obtain their proportionate shares of the MNE's total taxable income.

In that respect, the apportionment method facilitates the taxation of offshore activities that constitute a particularly important reason of loss of tax revenue. Tax havens seek to attract the 'paper profits' of MNE's that may locate their head offices there in order to facilitate tax avoidance although real control and the source of investment are located elsewhere. In addition, MNEs with headquarters in industrialised countries may require branches and affiliates in capital-importing countries to purchase their input through subsidiaries located in tax havens.

Although still at the academic level, there have been discussions about adaptation of the unitary approach by the NAFTA countries. The European Union, instead of protesting and publishing Commission Reports that tend to safeguard the arm's length method, it should consult other OECD members for the possibilities of adopting formulary methods at the OECD level or at least in order to restrict any foreseen and unforeseen objections. Since most of the bilateral treaties entered by Member States are based on the OECD model and therefore the arm's length method, it would be necessary to develop mechanisms to insure that international double taxation does not result from the interaction of the two methods.

tax rate convergence

It is not necessary that the EU countries impose identical corporate tax rates. The rates currently in effect are within a reasonable band from each other. Too great difference in rates could encourage manipulation of the factors employed in the formula by companies in a position to do so and for this reason the general convergence of rates is desirable.

The Ridding Report came up with a comparison of the allocation formula vs. arm's length method for the EU. Unfortunately, out of 463 pages of report only a page was dedicated for considering the prospects of a adopting a unitary system in the Union.

The Rudding Committee begins by a passive remark that if formulary methods are adopted in the EU that would be only internally, without suggesting the negotiation with other OECD countries of the future of the arm's length method. The Report recognizes that within a single country with separate and local taxing jurisdictions, allocation formulae might be the best solution for integrated businesses.

However, the Committee believes that allocation formulae are suitable only if states have reached a certain degree of integration, namely common currency, common company law, common accounting standards and common expertise in tax administrations. The Committee also feared that a shift to formula apportionment would involve re-negotiation of all bilateral tax treaties between Member States and possibly also with third countries. Finally it was believed that tax inspectors would have difficulty in applying two separate standards (arm's length & apportionment) to transactions involving third countries. The Committee concludes its consideration of the issue by stating that, in its view, "there is no case for introducing a system of formulary apportionment within the Community in the foreseeable future... it might be reconsidered when a much higher level of integration is achieved.

The reasons that justify the Rudding Committee's rejection of unitary formulas reflect the situation in 1992. Since then, a common currency has been introduced and if it was one of the main problems with regard to the adoption of formulary methods, it is now out of the way. As far as the harmonisation of company laws is concerned or "common company law" in the Report's own wording, it may be argued that a sufficient degree of harmonisation has already taken place. For example, the developments in Competition law can be of significant assistance in defining cross border corporate structures.

The need for common accounting standards is also satisfied to a certain extent.

Commercial accounts produced for financial reporting purposes should form the starting-point for the computation of taxable income in all Member States. The Seventh Accounting directive on consolidated accounts that has been implemented by all Member States requires undertakings to draw up consolidated accounts which include subsidiaries and sub-subsidiaries irrespective of their location. Subsidiaries are defined with respect to majority voting rights or appointment of board members, or dominant influence by contract. Member States were also allowed to require consolidation of companies managed on a unified basis and companies over which a dominant influence is exercised.³³

As to the need for "re-negotiation of all existing tax treaties" it can only be said that it is not a very sophisticated argument. Of course there will be a need to re-negotiate the tax treaties because otherwise the systems would conflict. When considering so fundamental changes in the system we are faced with obstacles such as administrative complications and lengthy negotiations. The advantages are potentially a lot bigger for a Single Market in the long run than the technical obstacles of a transitional period.

The negotiation of tax treaties with other countries is another issue. International tax rules have already reached a point of high complexity. If the arm's length method creates certain imbalances and distortions the interaction of the two methods is not going to improve anything. This is why it may be argued that any initiative for the adoption of unitary methods in the EU has to be negotiated at the OECD level. At least if we are opting for the "full global" method. If there is no consensus at the OECD level, the EU can always consider unitary apportionment internally.

³³ This is a wide approach to the concept of control and affiliation which, as illustrated earlier, is not defined by the Arbitration Convention.

7. EPILOGUE

What is happening today poses a challenge to the long term viability of the arm's length standard. The world has become increasingly more complex. The increasing presence of high tech products and services, the expanded degree of licensing and transferring of know-how are challenging the traditional trade patterns globally and make the application of the arm's length standard more difficult.

Differing corporate taxes create or maintain inefficiencies in an otherwise harmonised business environment. The only way to completely eliminate such inefficiencies is to have a single European tax system for all companies based in the Union. Unfortunately the economic aims are kept buried by the lack of political will of national governments that want to maintain their fiscal sovereignty.

Maintaining a state's fiscal sovereignty, however, is one thing; tax-competition between the participant states of a Single Market is another. The latter can in no way help in pursuing common aims.

The growth of the transfer pricing problem in the European Union has been different than in the United States. The U.S. has been a mature "single market" with a single currency that confronted the development of multi-state and multinational corporations for as long as they have been around. On the other hand, in Europe the Single Market has not been achieved yet. It will take years for it to mature while corporate giants already operate within it.

Formulary apportionment is the solution for transfer pricing issues within the Community. By adopting it other problems such as thin capitalization and cross border finance will also become obsolete. Furthermore, it will align EU practice with practices already applied by major trading partners of the Union. This alignment will not only prevent distortions. It will also respond to the consequences of globalisation and mobility of capital. A

method that treats the MNE as a unitary enterprise is more in tune with economic realities than those based on hypothetical market prices.

Unfortunately it has not been given much emphasis until now.

The ECOFIN meeting of May 1999 extended the life of the Arbitration Convention to eternity unless a MS objects (although there are no reports of cases submitted to arbitration so far). Across the Atlantic, there is a potential for employing formulary approaches for MNE's operating within the NAFTA countries. For the Union, It is hoped that in the near future this solution will be given wider support whether as a respond to the developments or as a defense to conflicting U.S. practice.