It's Time to Adopt Formulary Apportionment

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International tax reform cannot wait.

In 1996 the Treasury Department rejected the formulary apportionment (FA) method for taxing multinational corporations. That was the right decision at the time; economic integration and multinational activity was not sufficiently advanced to justify abandoning the arm's-length method. But developments since then reveal that it is time to reconsider that decision.

The arm's-length method reflects an era when companies delivered tangible goods, provided services in person, and conducted business through simple corporate structures. That era is long gone. Companies now deliver goods and services electronically, conduct cross-border operations via an intangible economic presence, and operate through complex, often hybrid corporate structures.

Unfortunately, the arm's-length method ignores those realities. It requires that multinational enterprises have a permanent establishment to be subject to tax in a country. It requires them to calculate their profits as if their integrated operations were separate and distinct from each other and to price every internal transfer of goods and services under the fiction that those transfers occurred with unrelated parties at market prices. It allows them to shift income to low-tax countries and expenses to high-tax countries with a keystroke. The United States can no longer afford to ignore those realities.

The arm's-length method may have been the best way to tax multinational corporations in the 20th century, but there is a better way to tax them in the 21st century.

The Formulary Apportionment Alternative

FA is the way. Under FA, a corporation's tax liability depends on its business activity in a country, not on the income it reports to that country. If a corporation has employees, sales, and factories in a country, it not only has income in that country, but it also has a tax liability, regardless of what its internal transfer prices indicate.

The vast majority of corporations do not abuse the arm's-length method. But with tens of thousands of cross-border transactions occurring daily, it is anachronistic to price each internal transaction — especially because equivalent results can occur by distributing profits across countries using a simple formula.

Simplicity, flexibility, stability, and competitiveness are the keywords that describe FA.

FA is simple. A multistate company finds out how much it earned in each state by multiplying its total profits by the share of its business activity in each state. FA has one measure of profits and one formula.

FA is flexible. It treats a complex multinational corporation as a single economic unit for tax purposes. Under FA, economic substance triumphs over legal form.

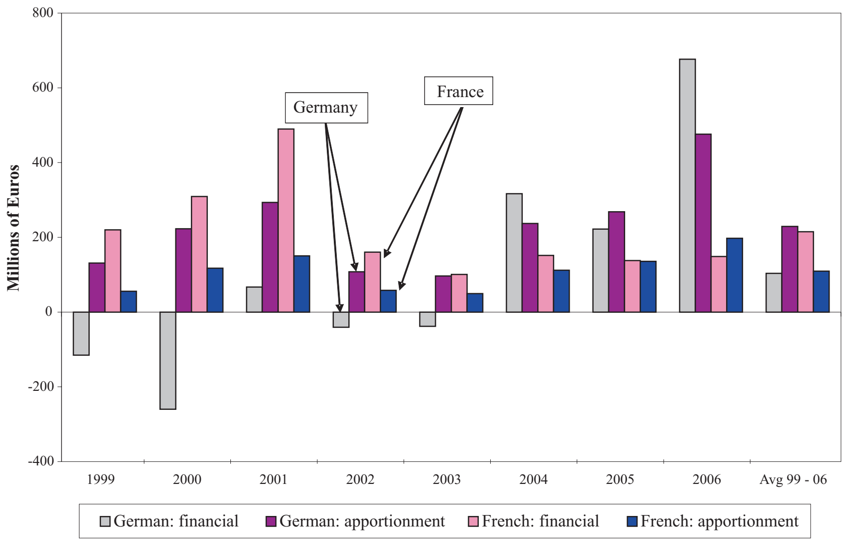
FA creates tax base stability. As the chart on p. 105 shows, as long as a company is profitable overall, FA guarantees each country a positive tax base. By contrast, the tax base measured under financial accounts can swing widely from profit to loss, creating uncertainty for tax authorities and taxpayers alike.

FA promotes competitiveness. Under FA, countries design competitive tax policies, because each country must build a system that encourages companies to locate their factories and employees, not just their income, in the country.

Given those advantages, it is no surprise that senior economists in the Obama administration support FA. National Economic Council Director Lawrence Summers has favored FA for decades. He was Treasury deputy secretary when Treasury held a conference to evaluate FA, where he noted that the U.S. states provide useful experience in thinking of "ways to address the technical problems created by world economic integration." Other senior administration economists, including Jason Furman

Merck Group Consolidated Financial Earnings Before Interest and Taxes and Estimated Apportionment Income

(using an assets, number of employees, and external sales apportionment formula)



Notes: The figure uses Merck's financial accounts to indicate the geographic distribution of the company's group activity. It compares Merck's earnings before interest and taxes from its financial accounts with its income determined under formulary apportionment in Germany and France. The formula is a weighted average of the share of external sales, net operating assets, and number of employees in the country relative to Merck's EU totals.

To illustrate how the income attributed to a country using apportionment can differ from the amount reported in the financial statements, consider Merck's 2002 results. During that year, Merck's German operations lost €41 million according to the company's consolidated financial statements. If Merck had calculated its German income using formulary apportionment for its European profits, its German income would be measured by the share of total European earnings before interest and taxes located in Germany as measured by its share of European operations located in Germany. For example, in 2002 Merck had an average of 40 percent of its assets, sales, and employees in Germany. Merck earned €272 million in profits from its European operations. Thus, under formulary apportionment, Merck would report €108 million in profits in Germany in contrast to the €41 million financial statement loss reported in Germany.

Source: Jack Mintz and Joann M. Weiner, "Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union," 62 *Tax Law Review* 81 (2009).

at the National Economic Council and Austan Goolsbee at the Council of Economic Advisers, have written in favor of FA.

Guidance From the EU

Fortunately, the Obama administration does not have to start from scratch to design an FA system; the European Commission has already done the work. Along with the European Union member states, it drafted an FA system for the EU. The formula would be calculated as ⅓ * property share + ⅓ * sales share + ⅙ * number of employees share + ⅙ * employee compensation share. The tax base would be consolidated at 75 percent ownership. Active foreign earnings would be exempt, subject to a switchover mechanism to a foreign tax credit for low-taxed foreign earnings. Multinational enterprises would work with a single tax authority under a ''one-stop shop'' idea.

FA Is Not Perfect

Because it restricts income shifting, FA will help close the $300 billion tax gap, but it will not create a tax windfall, and it is not problem free. Just like under the current system, intangible property creates difficulties, as does determining the members of the consolidated group. State tax experts are all too aware of how corporations shift income through the strategic use of passive investment companies, real estate investment trusts, and captive insurance companies.

But perfection is not the goal. On balance, FA is superior to the arm's-length method. FA is a simple, flexible, and stable tax method that encourages beneficial tax competition. Rather than rehashing the tired old arguments about capital import and export neutrality, the Obama administration should profit from the expertise of its most senior economists and work with its international trading partners to refine the EU's FA outline and develop an international FA system for the United States and its major trading partners.

There is no time to wait.

References

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