Comments on IMF Tax Spillover Study

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I am pleased to have the opportunity to respond to your request for comments regarding the IMF's current review of economic spillovers in international taxation. Your undertaking of this review represents an important positive step in assisting countries, especially in the developing world, in raising the revenues necessary to fund pressing public needs.

The comments below are organized as brief observations on particular questions which you may find it useful to address in the course of your work. In view of the wide and interdisciplinary scope of the subject matter that you are addressing, these comments do not attempt to be comprehensive. I hope, however, that these comments will be helpful in developing a useful analytical framework for the important study in which you are engaged.

These comments are based in part on work I have been privileged to conduct over the past year on a book-length study of international formulary apportionment, which has been published in a number of installments in the Bloomberg BNA Transfer Pricing Report. The International Centre for Tax and Development (ICTD), University of Sussex, United Kingdom, has provided research support which has helped make this work possible. I am grateful to both ICTD and Bloomberg BNA, as well as to numerous knowledgeable individuals with whom I have had the opportunity to discuss the topics addressed below. These comments, however, express solely my personal views:

1. *Appreciating the importance of the goal of correlation between the location of value-adding activities and income apportionment* – The OECD's recent work on base erosion and profit shifting (BEPS), and the G20 pronouncements accompanying that work, identify as the heart of base erosion the ability of multinational groups, under current international tax laws as

commonly interpreted, to assign to zero- and low-tax jurisdictions taxable income that arises from business activities which group members have performed in other jurisdictions. As a rule, these shifts of taxable income involve the use of contracts of various kinds made among members of the same multinational group, including licenses of intangible property, loan agreements, and contracts assigning the bearing of specified group-wide business risks to particular group members. As a result of the OECD's BEPS analysis, the OECD and G20 conclude that multinational business groups should not be permitted, under a sound tax system, to use intragroup contracts to effectuate divergence between the countries in which income is generated through value-adding activities, and the country in which the income is treated as earned for tax purposes. The OECD's analysis is based on the recognition that a single legal entity, transacting with others at arm's length, could not succeed under prevailing international tax rules in achieving a separation between the locations of in which income is generated and the locations in which the income is taxed. Instead, this kind of separation can be achieved only through contractual arrangements between entities under common control and therefore is inconsistent with the arm's-length principle.

The central principle of the OECD's BEPS analysis is articulated in the Tax Annex to the G20's recent St. Petersburg declaration, which calls for changes to international tax laws in order "to ensure that profits are taxed where economic activities occur and value is created" and "to put an end to the divorce between the location of profits and the location of real activities." The OECD's BEPS analysis advocates retention of the arm's-length principle as the conceptual basis for rules governing the division of income for tax purposes, and the BEPS analyses accordingly would rule out the adoption of explicit rules for formulary apportionment. Nevertheless, the G20 declaration's call for congruence between the locations at which value-adding activities and to

which income is subject to tax articulates not only a criterion for acceptable results under an arm's-length apportionment regime, but also the principle that governs formulary apportionment. Thus, the BEPS analysis can help to dispel what has been, historically, an erroneous perception that the arm's length and formulary approaches to taxation are in principle incompatible. To the contrary, the two approaches to the division of income can be seen as different technical approaches to achieving reasonable conformity between the locations of a taxpayer group's income-producing activities and the international apportionment of the group's income for tax purposes. Recognizing that arm's-length transfer pricing and formulary apportionment constitute different technical means to the same goal may prove helpful in clarifying the analysis of tax spillovers, and particularly in focusing on instrumental objectives rather than historically overdrawn debates over terminology.

2. *The OECD's recommendation to address base erosion through a mixture of anti-avoidance measures is technically sound but may be unrealistic politically* – The OECD would recommend against addressing base erosion through a shift to an explicitly formulary system for dividing income, and recommends instead that countries adopt a variety of anti-avoidance measures. Prominent among the measures proposed by the OECD are (i) the strengthening of controlled foreign corporation (CFC) regimes by countries in which multinational groups are based, and (ii) restrictions on the deduction of interest and certain other payments to related parties which typically are used to facilitate base erosion. If an additional kind of measure of potential use especially to developing countries – namely, a reinvigorated system of withholding taxes – were added to this list, the list would describe a set of measures which, if implemented by many countries around the world, could significantly limit the incidence of profit shifting to group affiliates in zero- or low-tax jurisdictions.

Historical experience, however, counsels caution in attempting to rely on anti-avoidance measures, including CFC rules, deduction limitations and withholding taxes, as means of curtailing base erosion and profit shifting. All of these measures have been well-known around the world for many years, but political considerations – primarily pressures generated by tax competition – generally have prevented countries from applying these kinds of measures with sufficient rigor to curtail the worldwide proliferation of base erosion. For example, those countries which are home to multinational groups often have perceived CFC rules as placing their own multinational groups at a competitive disadvantage with respect to groups based in other countries. The results of this kind of competitive concern have included, in the United States, the near nullification of CFC rules as a result of the "check the box" regulations issued in 1997; and in the United Kingdom recent legislation which has limited the reach of the U.K. CFC rules. Similarly, many countries around the world often have been averse to maintaining other kinds of anti-avoidance measures, such as limitations on deductions for interest and other intragroup payments, and withholding taxes on deductible payments, for fear of losing capital investment to other countries which do not seek to limit tax avoidance through these kinds of rules. There is no reason to expect that the perceived pressures of tax competition, which to date have prevented effective use of CFC rules, deduction limitations and withholding taxes, will dissipate in the near future. Therefore, there is a strong possibility that a successful international effort to curtail base erosion and profit shifting will need to include initiatives which are more fundamental than the encouragement of greater use of CFC rules, deduction limitations and other familiar anti-avoidance measures.

3. *The special vulnerability to base erosion and profit shifting of the poorer developing countries* – The widespread prevalence of base erosion and profit shifting has resulted, in effect,

in the substantial nullification of corporate income taxation in countries around the world, especially on income that is connected with companies' international operations. Although views will differ, some might argue reasonably, from an economic perspective, that the widespread curtailment of corporate income taxation generally can be seen as desirable. Corporate income taxation arguably constrains investment and economic growth more than many alternative forms of taxation; in addition, as the phenomenon of base erosion and profit shifting itself shows, attempting to enforce corporate taxation in an open global economy can be unduly expensive, if it is feasible at all. Therefore, it is perhaps understandable, if not universally seen as desirable, that many countries around the world have essentially acquiesced in the partial nullification of their corporate tax rules through base erosion and profit shifting.

Developing countries, however, typically cannot afford to indulge in the partial nullification of their corporate tax rules. Countries with highly developed economies often place limited reliance on revenues raised from corporate taxation because other sources of revenue, such as individual income taxes and consumption taxes, at least arguably are sufficient to meet national needs. In many developing countries, however, much domestic economic activity occurs informally, with few if any books and records maintained, so that the government's ability to raise revenues from individual income taxes and consumption taxes is severely limited. For these countries, corporate taxation, and especially taxation of income from cross-border operations, represents a substantial portion of the potentially available revenue base. These countries cannot afford to sacrifice large proportions of their corporate tax bases, and the perpetuation of base erosion and profit shifting therefore poses a significant national hardship. Current international efforts to find ways to curtail base erosion therefore can be seen as directed

particularly at improving the well-being of countries which are still in the process of economic development.

The nature of the difficulties faced by many developing countries, coupled with the historical impediments to the enactment and retention of effective measures to prevent international base erosion, also suggest strongly that a high priority continue to be given to efforts, in which the IMF already is deeply involved, to assist developing countries in raising revenues more effectively from their domestic tax bases. Given the current conditions of internal markets for goods and services in many developing countries, this is necessarily a long-term effort. Nevertheless, historical experience suggests that even with effective efforts to improve revenue-raising from cross-border investors, public finance in developing countries will be more secure to the extent that it is possible to rely relatively less on international, and more on domestic, sources of government revenues.

4. *How much improvement can be obtained through incremental changes to existing transfer pricing rules?* Much of the current problem of base erosion and profit shifting can be attributed to the manner in which current arm's-length transfer pricing rules have been interpreted as giving deference to contractual agreements for the shifting of income among different members of commonly controlled groups. In addition, some other technical aspects of current transfer pricing rules have exacerbated countries' vulnerability to income-shifting through contractual arrangements, including (i) one-sided transfer pricing methods such as the comparable profits method (CPM) and the transactional net margin method (TNMM), which have facilitated limiting the incomes of various kinds of entities to "risk-stripped" or "routine" returns, and (ii) profit split methods as currently applied, which have been interpreted as permitting the apportionment of income to a taxpayer based on mere cash contributions to a

group's activities or the legal ownership of intangible assets used in other countries, rather than the actual performance of activities by the taxpayer in the jurisdiction where the taxpayer is subject to taxation.

Meaningful improvements can and should be made to existing, arm's-length transfer pricing rules. In particular, under one-sided transfer pricing method, greater use of safe harbors, with presumptive effects (despite the controversy which presumptive rules may elicit), can help mitigate the often-discussed problems faced by countries in identifying satisfactory data with respect to uncontrolled comparables, and therefore can help deter the use of unrealistically low margins and markups under CPM, TNMM and other one-sided transfer pricing methods. In addition, changes to rules governing profit split methods, to permit income to be apportioned only with respect to a taxpayer's expenses for activities actually performed in the country in which the taxpayer is subject to taxation, could meaningfully reduce the ability of taxpayers to use profit split methods to justify the shifting of income to low- and zero-tax countries.

Nevertheless, while these and other improvements to current transfer pricing rules could improve the rules' performance to a worthwhile extent, it is unlikely that transfer pricing rules following current arm's-length patterns, even improved as suggested, are capable of controlling base erosion and profit shifting to an adequate extent, particularly from the standpoint of developing countries which must rely relatively heavily on corporate tax revenues. Even with improved means of determining adequate margins and markups, one-sided transfer pricing methods, by reason of their structure, will continue to facilitate the shifting of much of a group's income to zero- and low-tax jurisdictions with only a "routine" apportionment to countries in which business actually is conducted. Moreover, one-sided transfer pricing methods have proven unstable in periods of global economic slowdown, in which taxpayers may perceive

themselves as required to impute taxable income in certain countries even when their global operations are operating at losses or at very low levels of profitability.

Profit split methods can and should be improved by requiring that apportionment keys attribute income to different countries based only on indicators of actual business activity conducted within the countries, rather than on amounts expended by a group member in a zero- or low-tax country to support business activities that are in fact conducted elsewhere. This improvement should substantially improve the performance of the profit split method and should be of material practical assistance to countries in countering base erosion. In the long term, however, it is not clear that even an improved profit split method can lead to an adequately functioning system for income apportionment under the current arm's-length model. The current requirement that profit split methods be crafted individually for each of a taxpayer's different operations imposes a large burden of complexity on tax administrations, which is likely to be especially prohibitive for developing countries with limited administrative resources. Moreover, unless profit split methods cover all of a taxpayer's income and expenses in a country – including interest and similar expenses – profit split methods will continue to allow for the leakage of deductible payments to zero- and low-tax countries, resulting in continued problems of base erosion.[1] In order for profit split methods to be effective, they should, therefore, cover all of a taxpayer's income and deductions in a country, and they also should provide for uniform apportionment keys in order to reduce administrative complexity. In sum, while improvements to current profit split methods may provide for worthwhile benefits over the short term, a stable system for income apportionment over the long term may need to take on an explicitly formulary configuration.

[1] In the United States, the general rule (which is required under U.S. constitutional principles) that formulary apportionment for state tax purposes cover only "business" income and expenses, but not investment income and expenses, has led to serious problems of base erosion in state corporate taxation over the years.

4. *To what extent might formulary apportionment have a practical role in efforts to address base erosion, particularly for developing countries?* – A formulary system of income apportionment could operate with respect to base erosion as what economists sometimes call a "constitutional rule." That is, the rules of a formulary system would be based explicitly on the principle that income apportionment should coincide with the locations of value-adding activities, so that departures from this result should be discernible fairly readily by tax authorities, facilitating efficient enforcement. Similarly, legislative or regulatory proposals to create exceptions to the generally applicable formula, in order to facilitate one or another kind of income-shifting transaction, should be readily recognizable as departures from the normative model of correspondence between the locations where business activities are performed and the countries to which income is apportioned. It therefore should be less likely, than under the international tax rules commonly in place around the world today, that legal measures which would facilitate base erosion could pass through the legislative or regulatory process relatively invisibly. In sum, the adoption by a country of a formulary approach to income apportionment would appear to offer a more reliable means of curtailing base erosion, particularly over the long term, than attempting to apply a mixture of politically vulnerable, and often only partially effective, anti-avoidance measures.

Despite the potential promise of formulary apportionment in controlling base erosion and profit shifting, however, countries will need to address a number of important and as yet unresolved technical challenges if formulary apportionment is to be applied effectively in the international sphere. My recent multi-part study of formulary apportionment seeks to identify and analyze these challenges. Some of the most important of these challenges relate to the need, under a system of formulary apportionment, for countries to rely on a taxpayer group's global

financial statements as the basis for apportionment according to the formula adopted by the particular country. The need to convert the group's global financial-statement income into taxable income under each country's separate rules for tax accounting, and the need for individual countries to have practical means of verifying the validity of the group's global financial accounts, raise technical and administrative challenges which will require effort and time to resolve if a formulary system is to work effectively. Quite probably, the resolution of these challenges will require cooperation among countries, including cooperation in achieving greater convergence between book and tax accounting in order to ease problems in the translation of accounts, and also cooperation in examination and enforcement. In particular it would seem sensible for countries to pool their resources in reasonably verifying (perhaps with the assistance of private-sector accountants) taxpayers' global consolidated of financial statements, which will be used simultaneously as the basis for formulary apportionment in a number of different countries. Achieving satisfactory resolution of these and other important practical challenges to formulary apportionment will require at least several years of dedicated work by experienced tax administrators, practitioners, and other professionals, before countries can prudently seek to implement national systems of formulary apportionment.

4. *Conclusion: The IMF might consider a multi-faceted approach to its current review of tax spillovers, with attention to both shorter- and longer-term objectives* – Although formulary apportionment would appear to offer the most effective and durable means of controlling base erosion and profit shifting, the time and resources needed to implement formulary apportionment will require reliance on other anti-avoidance measures at least on an interim basis. In particular, the IMF might urge and assist developing countries to adopt more comprehensive systems of limitations on deductions for payments to related parties, and

strengthened systems of withholding taxes on deductible payments, as well as robust systems of presumptive transfer pricing safe harbors to limit revenue losses through the use of risk-limited subsidiaries. A significant impediment to the adoption of these measures is likely to be fear of tax competition; accordingly, the IMF should encourage governments of developing countries to seek to adopt the necessary anti-avoidance measures on a concerted basis through the intermediation of regional intergovernmental organizations.

In addition, the IMF should consider initiating, ideally in concert with other intergovernmental organizations, a serious and comprehensive exploration of both the promise and the technical challenges of implementing systems of unitary taxation based on formulary apportionment. This work might focus particularly on the prospect of adoption of a formulary approach by regional groups of developing countries which see particularly strong needs to protect their corporate tax bases for the foreseeable future.[2] Implementation of formulary apportionment by a number of countries on a regional basis may help mitigate competitive

[2] In order to achieve effective control of base erosion and profit shifting, regional groups of developing countries will need to adopt formulary apportionment governing not only the division of taxable income among themselves, as is currently envisioned under the European Union proposal for a Common Consolidated Corporate Tax Base, but also for the division of income between the members of the regional group and other countries around the world.

The prospect of one or more regions adopting a system of formulary apportionment with respect to their relations with other countries, while the other countries may continue to use arm's-length transfer pricing rules, might raise concerns about excessive double taxation. The adoption of formulary apportionment rules, however, even by only a few countries or groups of countries, should reduce rather than exacerbate existing problems arising from double taxation. Under today's relatively subjective arm's-length transfer pricing rules, perceived problems of double taxation arise because taxpayers – including potential investors in cross-border ventures – are unable to predict with confidence how the tax authorities of the different countries involved in international transactions will apply the transfer pricing rules. The possibility therefore exists that conflicting after-the-fact interpretations of the different countries might subject the taxpayer to an unanticipatedly high total tax burden; and this uncertainty could well inhibit taxpayers from engaging in cross-border investments, and therefore may have the effect of constraining economic activity and growth. To the extent that even a few countries in the world adopt more predictable formulary rules for the division of income, the overall uncertainty as to the total taxation to be faced by the taxpayer will be reduced, and this reduction of uncertainty should be conducive to international trade and investment. The key is to recognize that the kind of "double taxation" which inhibits trade and growth is *unpredictable* double taxation, and the problem of unpredictable double taxation will be mitigated even if only some countries in the world choose to adopt formulary apportionment. *See generally* Michael C. Durst, "Transfer Pricing and Double Tax: Rethinking Conventional Wisdom," Tax Notes, Oct. 29, 2012.

concerns which might otherwise discourage individual countries from adopting reforms. The same mitigation of competitive concerns through regional cooperation, moreover, might help countries avoid the temptation to adopt single-factor, sales based formulas, which could unduly restrict the available tax bases of developing countries in which inbound investors manufacture products and perform services for export.[3] Historical experience suggests a substantial likelihood that measures short of formulary apportionment will fail over time to curtail base erosion effectively. Those charged with devising and recommending effective tax policies, especially for developing countries, therefore should consider carefully the possibility that a formulary approach can provide protections to fiscal systems which cannot be achieved by other available means. Building on the insights that already have been developed through the recent analyses of base erosion by the OECD and others, it is suggested that the international economic community, including those with special responsibility for economic development, devote the resources necessary to conduct a comprehensive, expert review of the potential that explicitly formulary rules might contribute to a sound system of international taxation, especially for the benefit of developing countries which must continue to rely relatively heavily on revenues from corporate taxation.

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[3] Under the system of formulary apportionment that governs the division of income for tax purposes among the U.S. states, the perceived pressures of tax competition have induced about half the states to adopt single-factor apportionment formulas based on the destinations of a taxpayer's sales. Sales-only apportionment of this kind is seen as encouraging inbound investment to a state, since increases by a taxpayer in productive activities within a state, for example by increasing payroll in that state, will not increase the amount of the taxpayer's income which is apportioned to the state. For many developing countries, however, a sales-only formula would effectively remove from the corporate tax base income derived from the production of goods and services for export, since that kind of economic activity would not generate local sales.

It should nevertheless be recognized that even sales-only apportionment, while not optimal for developing countries, might yield developing countries more revenue than current arm's-length transfer pricing rules. Even sales-only apportionment should be effective in countering base-erosion transactions, which currently appear to be taking a large toll on developing-country tax revenues, so that even for export-oriented countries, sales-only apportionment might yield better revenue results than current arm's-length rules.