THE PROS AND CONS OF FORMULARY APPORTIONMENT

EMIL M. SUNLEY*

The EU Commission report[1] highlights remaining tax obstacles to cross-border economic activities in the Internal Market and proposes a two-track approach of targeted measures for immediate action and comprehensive solutions to launch a wider debate. This report not only will stimulate debate within the EU, as did the Ruding Report of 1992, but also could lay the groundwork for significant reform of corporate income taxation within the EU. Unlike the Ruding Report, the Commission report does not recommend approximation or harmonisation of corporate tax rates.

The Report analyses four comprehensive options: home state taxation, common consolidated base taxation, a European corporate income tax, and compulsory harmonization of existing tax bases. All options could simplify compliance costs for companies by providing a consolidated corporate tax base for EU-wide activities. Cross-border loss offsets would be fully allowed. Except for the European corporate income tax (under which all the revenues would accrue to the EU), all options would require a mechanism, such as formulary apportionment, for allocating the tax base and revenue among Member States.

Formulary apportionment using the same factors would simplify tax compliance

Formulary apportionment, which is used in the United States, Canada and Germany at the subnational level, will not produce an allocation of the tax base that would be the same as that under separate accounting and arm's length pricing. It is for this reason, that the OECD has traditionally been cool to formulary apportionment. In 1979, the OECD Committee on Fiscal Affairs concluded:

> Such method would necessarily be arbitrary, tending to disregard market conditions as well as the particularly circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity which is in truth making losses (or possibly the contrary).[2]

The Report concludes that a major advantage of the comprehensive approaches is that transfer pricing and cost allocation issues would be eliminated. This would provide greater certainty for taxpayers and reduce the compliance costs incurred by taxpayers and the tax authorities.

The EC report suggests that the allocation of income could be based on the taxpayer's value-added within each Member State, and not on sales, property, and labour costs, as in the United States. The allocation could be based on macro data at the Member State level or micro data at the enterprise level. The EC report recognizes that there are a lot of details, including the apportionment factors, to be worked out if formulary apportionment is to be adopted.[3] This probably cannot be done until there is general agreement to apportion income among Member States. The experience of the United States suggests that it would be most important that each Member State uses the same apportionment factors to allocate income among the Member States.

Formulary apportionment would simplify tax compliance for businesses and this would be a significant reform. However, formulary apportionment may increase tax competition and could lead to manipulation of the tax base. Transfer pricing issues will not necessarily go away under formulary apportionment.

* Assistant Director, Fiscal Affairs Department at the International Monetary Fund. The views expressed are the author's alone.

[1] *Towards an Internal Market without Tax Obstacles*, Comm(2001) 582 final.

[2] OECD, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises*, 1979, p. 14.

[3] The paper presented at the conference by Joann Martens Weiner, "Formula apportionment in the European Union: A Dream Come True or the EU's Worst Nightmare" outlines the key technical issues that would need to be addressed.

Under separate accounting and arm's length pricing, countries compete to attract the marginal investment, which brings into the country's tax base the marginal return on that investment. Under formulary apportionment, attracting the marginal investment brings into the country's tax base the average return on investment, as consolidated profits are allocated based on the agreed formula. For example, if profits are allocated based on each company's EU-wide value added, a country would gain if it can attract a low profit labour intensive activity. The additional value added attracted to the country will increase the country's tax base by the average EU-wide profit per unit of value added, which could be considerably greater than the profits attracted to the country when measured under separate accounting..

Formulary apportionment will not eliminate the problems of transfer pricing if either sales or value-added are included in the apportionment factors. If the corporate income tax is administered where the enterprise is headquartered, the home-state country will want its companies to maximize value added (or sales) in the country. This could be done by under-pricing raw materials and other purchases from related parties and over-pricing sales to related parties. As only the home-state country will audit the enterprise, other Member States in which the enterprise operates could be adversely affected without having a seat at the table.

One final point, both home state taxation and common consolidated base taxation would be optional, at the insistence of business representatives on the panel assisting the Commission. Options can be troublesome. There is clearly a risk of adverse selection, reducing revenues for the Member States. Also, options will necessarily add complexity as special rules will be needed when enterprises enter and leave groups of companies. Will enterprises be bound for a period of years by any election to be taxed under home state or common consolidated base taxation?