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Unitary Approaches in International Taxation

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* The views expressed in this paper, though those of a German tax administrator, do not necessarily coincide with those of the German Government. The paper was produced during the author's sojourn as a visiting trainee with the Fiscal Affairs Department of the International Monetary Fund, but the views expressed therein do not necessarily reflect those of the Fund.

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I. Introduction

Over the past decade concern has been voiced time and again by industrial circles investing in the United States with regard to excessive State taxation under so-called "unitary" methods. Criticism has been focused on a method of State taxation commonly referred to as "worldwide unitary combination with formula apportionment." California is one of the more prominent users of this approach. According to this concept, the taxable income of a business entity located in a "unitary" State is determined first by ascertaining the overall (net) income of the unitary business enterprise of which the taxable entity is considered a part. This unitary business enterprise can be made up of one legal entity with various outlets (permanent establishments) or of a group of interrelated or associated corporations. Unitary worldwide combination includes both domestic and foreign parts or members of a unitary business and adds up the combined income of the entire corporate group after intra-group (or intra-business) transactions have been eliminated. As a second step, a portion of the net group income is attributed to the unitary State entity; for this purpose, normally, the ratios which the in-state figures for (third party) sales, payroll, and assets bear to the same factors of the entire group are each applied to one third of combined group income.

Large multinational enterprises (MNEs) as well as business associations have either gone on record themselves deploring unitary taxation, which amounts to a deviation from internationally accepted standards, or have successfully solicited the support of their home governments and international tax law bodies in formulating outspoken positions against worldwide combination and formula apportionment of income. While any resulting multiple tax burden must have been a cost factor in the MNEs' books all along, the opposition to such practices, at least in the Western European tax community, seems to have reached a new dimension only in the past few years. One can but speculate whether this is due to a more aggressive attitude on the part of the States in implementing their laws and/or an increasing weight of any additional cost item in corporate profitability during a recession. Surely, the growing international awareness of transfer pricing issues, together with early signs of economic recovery in the United States, has put the removal of obstacles to a favorable tax environment for renewed investment into the top priorities for corporate lobbying; from a German viewpoint, the still pending renegotiation of the German-U.S. Tax Treaty may appear to those interested to be the right forum to press for solutions on a bilateral level. Moreover, the recent U.S. Supreme Court decision in the <u>Container</u> case can be viewed as granting ample scope for maneuver to those States wishing to maintain or introduce unitary taxation. Although the Court indicated that the treatment of subsidiaries of foreign corporations might well follow different (i.e., more restrictive) rules, the decision has by no means reduced the concern on the part of non-U.S. business circles investing in the United States.

Tax officials representing their administrations in the OECD Committee on Fiscal Affairs expressed their views on "global" profit allocation in the 1979 Report on Transfer Pricing and Multinational Enterprises. Considering the many qualifications, provisos, and caveats which characterize the statements otherwise contained in this report, the stand taken on the issue of global methods is amazingly outspoken and unambiguous in that it clearly rejects the idea of income computation based on formula apportionment as a viable alternative to separate entity approaches on an arm's length basis. 1/ As opposed to unitary combination of income, the arm's length principle calls for a separate entity approach to allocating the taxable income of internationally related enterprises. Under this standard, the "transfer" prices used by the enterprises in their intra-group or intra-business billings are accepted for tax purposes if they correspond to what unrelated parties to a comparable transaction would have agreed upon under comparable circumstances.

Of course, owing to the scope of the OECD Report, 2/ its statements apply primarily to the taxation of separately incorporated, associated enterprises. It should therefore be interpreted as a view which emphasizes the need to respect corporate structures and to refrain from piercing the corporate veil. Apparently the Report does not intend to supersede the views expressed by OECD on the question of apportionment (or "indirect") methods of income allocation between the various parts of one enterprise acting through foreign permanent establishments. 3/ Hence, there is some room for unitary approaches, which, however, are considered an admissible proxy for arm's length standards only if its results approximate "as closely as possible to the figures that would have been produced on a separate accounts basis," 4/ and if it has "as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory." 5/

It is noteworthy that the UN Group of Experts, irrespective of the differences in opinion on other issues of permanent establishment taxation, in their Model Treaty Between Developed and Developing

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1/ See par. 14 of the Report.
2/ See par. 7, footnote 1, of the Report.
3/ See OECD Model 1977, Commentary on Article 7, pars. 24, et seq.
4/ Ibid., par. 26.
5/ Ibid., par. 24.

Countries fully subscribed to the views expressed by OECD on unitary methods. This deserves special attention as the UN Model, though representing a compromise between the rights of residence and source countries, gives more weight to the source principle than the OECD Model does. 1/

With this high degree of consensus reached internationally on the demerits of unitary principles, one might be inclined to simply sit back, accept multiple tax burdens as a fact of life, 2/ and wait for the outcome of the ongoing discussion in the United States. The U.S. administration is caught in the crossfire between State politicians seeking to safeguard their urgently needed State revenues and multinationals either overtly opposing unitary taxation, flexing their muscles in a "just-you-wait" spirit, or hinting at ways to circumvent formula apportionment. However, there is more than one reason for not just assuming a spectator's role vis-à-vis a supposedly "internal" U.S. tax issue, for (a) the use of unitary approaches is not confined to authorities below the national level; (b) the arm's length principle is by no means the panacea for all tax problems inherent to transactions across national borders; (c) formula apportionment may be of attraction to LDCs because it eliminates the problem of inter-company pricing; and (d) more "modern" techniques in the application of the arm's length standard may be available as a compromise between both approaches and as a basis for closer cooperation between the tax authorities of both developed and less developed countries.

II. International Implications of Non-arm's Length Approaches

1. Non-arm's length approaches in sub-national taxation

When the justification for State (income) taxation is examined, the two well-known concepts of residence and source come to mind as an acceptable link between the taxpayer's activities and the entitlement to a government take. 3/

a. Unitary State taxing permanent establishment of German enterprise

In the case of a German-based corporation with a U.S. permanent establishment (p.e.), absent the nexus of "tax home," 4/ the State's entitlement to revenue would appear to be limited to taxation based on the source principle. Unitary States indeed claim that they are exercising their taxation powers within the limits of this principle.

1/ United Nations (1980), p. 5.

2/ Tax Treaties entered into by the United States do not apply to State taxes. Hence, absent unilateral relief granted by the investor's home country, State taxes are not creditable nor are U.S. States restricted by these treaties from including foreign source income in their tax base.

3/ Plasschaert (1981), p. 409.

4/ The place of commercial domicile and/or statutory seat.

It is worth noting that the source principle, while excluding the taxation of worldwide income, does not per se require all income items stemming from abroad to be left untaxed domestically. If there is reasonable connection between the taxing jurisdiction and the activities performed or assets used by the taxable entity in generating the respective income, nothing, in theory, would appear to prevent the State from taxing inflows of income to its jurisdiction irrespective of where the payer is located. Nonresident taxation under German income tax law is based on this principle. The law 1/ enumerates those items of income for which a sufficiently strong connection, in an economic sense, is considered to be present and to justify taxation. The enumeration, on the one hand, does not include all items of income geographically allocable to German territory, and tacitly includes foreign source income, on the other. It is for major foreign source income items that the lawmakers recently felt the necessity to grant unilateral relief in the form of a foreign tax credit. 2/ Double taxation, in this situation, cannot be avoided under tax treaties since a p.e. is not normally eligible for treaty protection. The "source" principle, applied according to this interpretation, is not fully equivalent with "territoriality" although there are overlapping areas.

The practice of some States which include in gross apportionable income dividends received by foreign entities shows that combination of worldwide income of the unitary business and apportionment of some part of it to the p.e. located in the unitary State goes well beyond the (limiting) criterion of "sufficiently strong economic connection." Unitary taxation operates on the basis of various assumptions. One of them is that in a unitary business all operations are conducted to benefit the overall business and that the various parts of that unitary business are dependent upon and contributory to each other. Adequate nexus for the power to tax is therefore established by the mere fact that intra-State activities form part of the unitary business at stake. This basic assumption shows that the unitary rule works on a footing diametrically opposite to arm's length standards. It is fair to say that unitary taxation is not intended to produce figures approximating as closely as possible to arm's length results and therefore does not qualify as an adequate proxy for this method within the meaning of Art. 7(4), OECD Model 1977. Under unitary methods, the separability of items of income follows neither corporate nor political boundary lines; the only source of business income is the unitary business itself no matter where, geographically, contributions to this income were made. A concept of full interchangeability and inseparability of activities and complete fungibility of funds necessarily discards both residence and source considerations in

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1/ See par. 49, Income Tax Law.

2/ See par. 50(6) in conjunction with par. 34c(1)-(3), Income Tax Law.

computing apportionable combined income, and only seemingly fulfills the task it allegedly pursues, that of delineating that portion of combined income which can reasonably be traced back and allocated to the State. If performance by the taxable entity represents a contribution which is inextricably dependent on other entities' performance and the value of which is therefore impossible to assess separately, and if worldwide dispersion of activities by corporate management is viewed as haphazard or based on decisions in part guided by the aim of tax minimization, 1/ it does not appear to be very consistent to link up the tax treatment of the State-based entity to the very same corporate decisions (i.e., those determining the volume of assets and sales and the personnel employed in a given enterprise) in order to ascertain the value of the performance originating in this State's territory.

Unitary apportionment requires further assumptions in computing the allocable portion on the basis of capital, sales, and payroll; the main one here is that all of these factors contribute evenly to the overall success (or failure) of the unitary business no matter in which economic environment they are put to use, in what competitive situation, etc. 2/ Criteria such as location savings, start-up losses, or mismanagement cannot be accounted for. 3/ Sharp geographical differences in profitability are leveled out by the application of the three-factor formula. This process of income allocation siphons away, as it were, profits from other parts of the business to loss-making entities, that, in generating the loss, have themselves operated with assets, have paid salaries, and have recorded third-party business receipts and thus qualify for an allocation of parts of the overall positive results. Special competitive situations show best of all how unitary taxation crosses the dividing line between source and residence taxation and enters extra-jurisdictional territory. With the criteria for delineating a unitary business lacking the possibility of "fine tuning" (e.g., by allowing for the entity operating under such special circumstances to remain outside the scope of the unitary business), the State applying those criteria clearly treads on other jurisdictions' grounds by subjecting their profitable (e.g., conservatively investing) entities' income to taxation in a geographical area where loss-making operations are carried out (e.g., due to

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1/ Church and Pomp (1980), pp. 891 (897).

2/ Palmieri-Egger (1983), pp. 59 (60).

3/ According to reports on the Unitary Task Force's hearings in November 1983, State representatives have begun to realize that flexibility in the apportionment is needed to take proper account of special circumstances of the individual taxpayer; see Sheppard (1983), p. 822.

excessive risks assumed, pricing regulations, etc.). This distortion is only partially offset by the fact that the loss itself reduces the business income before apportionment. 1/

No relief for double taxation resulting from unitary State taxation of a U.S. p.e. of a German enterprise is granted under the German-U.S. Tax Treaty. German unilateral relief measures are generally inapplicable as the p.e.'s income is normally exempted from German tax. There is, however, the option between either claiming a foreign tax credit for State taxes or deducting them from the taxable income of the domestic enterprise (par. 34c(6), 3rd sentence, Income Tax Law) in the case in which a State taxes U.S. branches of German shipping and air transport enterprises (for which Germany has not given up taxing rights under the Treaty).

b. Unitary State taxing subsidiary of German parent

The nexus between a separately incorporated enterprise and State taxation rights appears to be stronger than in the case of a p.e. But even if separate incorporation, albeit under full or substantial control from abroad, was to establish the nexus considered necessary to exercise taxation rights under the residence principle, the same would only justify taxing worldwide income earned by the taxable entity itself (including dividends received from "second-generation" affiliates); it would, however, not appear to give any grounds for combining a U.S.-based controlled corporation's income with that generated by "upstream" non-U.S. affiliates (e.g., that of a parent or sister corporation), as this would result in the taxation of income earned by entities which themselves have no ties with the unitary State sufficient to subject them to that State's tax jurisdiction. An approach that would follow the unitary method's substance-versus-form argument (and disregard the corporate structure) would, in an economic sense, result in the treatment of a foreign-controlled entity as a permanent establishment of the controlling shareholder, 2/

1/ It is conceivable that unitary apportionment might also lead to results to the advantage of the taxpayer, e.g., where a highly profitable entity benefits from the right to offset losses of out-of-State entities against in-State profits. The result may be double exemption of income. See Redmond (1981), p. 99 and infra, p. 26.

2/ Along with an income computation under the "indirect method" within the meaning of Art. 7(4) OECD Model 1977.

a position clearly rejected in Art. 5(7) of the OECD Model 1977 and Art. 5(8) of the UN Model. 1/

For the German parent, relief by Germany is not available with respect to federal or State taxes on the current business income of a U.S. subsidiary. As regards dividends, the U.S.-German Tax Treaty provides for an exemption of foreign source dividends if at least 25 percent 2/ of the shares are held by the parent. Any U.S. withholding tax on dividends and any tax levied on "underlying" income, out of which the distribution was made, becomes final. Hence, any economic burden inflicted by unitary taxation will not be offset by a corresponding reduction of German taxes even though unitary tax may result in taxing portions of income currently earned by non-U.S. entities. 3/ The result is international double taxation.

c. Unitary State taxing State-based enterprise with German permanent establishment

From a German viewpoint, little in theory could be held against a State using the residence principle if the taxable entity, e.g., a corporation, has chosen this State as its "tax home." Under the German system of fiscal federalism, sub-national jurisdictions share in the tax revenue collected under federal rules. 4/ If these rules are based on the residence principle, there remain only technical differences between the State entitlement to tax under a shared-revenues concept and a separate State income tax (over and above a federal tax), on worldwide income.

1/ German High Tax Court jurisprudence favored such an approach called "Filialtheorie" since 1930 when it was first applied in the famous decision on the Shell case. The German-Italian Tax Treaty of 1925 is the only one left which does not contain the equivalent of Art. 5(7) OECD Model 1977, a provision which has been included into other German treaties ever since 1931. See Müller (1970), pp. 145, 156.

2/ Ten percent in taxable year 1984; see par. 26(7) Corporation Tax Law, last amended by Art. 6 of the Steuerentlastungsgesetz 1984 of December 22, 1983 (Bundesgesetzblatt (Federal Law Gazette), Part I (1984), p. 1583).

3/ Kaplan considers the issue of "true tax burdens not offset by reduced taxes elsewhere" one of the real questions involved. See Kaplan (1983), p. 203, and the example on page 24 and Chart III.

4/ The Länder are entitled to 50 percent of the revenue from corporate income tax. Their aggregate share is apportioned to the individual Land according to the same criteria used in apportioning the taxable base of the Trade Tax to eligible municipalities (see infra, pp. 11-12). The Länder's share in revenue from personal income tax amounts to 43 percent; the allocation to the individual Land follows the residence principle. For details, see the Zerlegungsgesetz of March 29, 1952, last amended in 1970 (Bundesgesetzblatt (Federal Law Gazette), Part I (1970), p. 1727).

If the unitary State includes in its tax base foreign source income generated through the activities of a non-U.S. p.e., the typical clash between residence and source taxation occurs. Presuming the source country (host country of the permanent establishment) has computed the p.e.'s income equitably, it is up to the home country or State to relieve double taxation by granting a credit or exempting the foreign income. Where neither a tax treaty nor provisions in the statutes induce such relief, the pressure will normally be on the home jurisdiction(s) to either "do something" or see the corporation move elsewhere.

d. Unitary State taxing State-based corporation with German subsidiary

The situation changes only marginally if the State taxation of a U.S.-based group of corporations is not only extended to non-U.S. p.e.s but also to separately incorporated foreign entities as part of a unitary business. Here unitary taxation with respect to the German entity can result in the immediate inclusion of part of its undistributed income in the tax base apportioned to the U.S.-based business in excess of what would appear appropriate under arm's length standards. 1/ Simultaneously, income earned by the German entity is taxed there under arm's length rules. In some States 2/ this is compounded by the taxation of distributed income in the hands of the State-based parent; in addition, tax is withheld at source in Germany from the dividends paid to the U.S. parent.

In this situation the clash of tax claims occurs between subsidiary country residence and parent corporation residence (State) taxation for the undistributed subsidiary income (which may include fully taxed portfolio dividends received by the German subsidiary), and source and residence taxation with respect to the dividends. The first situation is commonly labeled "economic double taxation" as opposed to "juridical" double taxation in the second case. Again, relief for the resulting multiple tax burden is the task of the group's home jurisdiction(s). Claims against the non-U.S. entity's host country are unjustified because, as seen from this country's

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1/ In a parent-subsidiary context this has the same effect as the elimination of deferral. See Church and Pomp (1980), p. 894.

2/ Some States exempt intra-group distributed income from apportionable group business income and tax dividends--without relief for foreign withholding or other taxes--as nonbusiness income upon distribution, provided the recipient's commercial domicile is in that State. Other States apportion dividends along with all other income. See Redmond (1981), p. 101.

viewpoint, there is no foreign source income which underlies taxes levied by the unitary State. Moreover, it can be argued that the non-U.S. entity is not the one which is left in a competitive disadvantage as the (State's) tax claim, though based on (part of) the income of the non-U.S. entity, economically is a burden on the U.S. parent.

One may conclude that in the case of a U.S.-based corporation or group of corporations, unitary taxation by a U.S. State cannot reasonably give grounds for a sacrifice of revenue or waiver of taxing rights on the part of the non-U.S. jurisdictions. It is up to the corporation's or group's home jurisdiction to tailor its tax system to find an adequate balance between revenue needs and a tax environment prone to attract business. This is not to say, however, that the non-U.S. entity's host government need not be concerned about the whole situation. A possible strategy on the part of the U.S.-based business might be to detour profits away from the non-U.S. entity, instead of trying to minimize taxes in its home country or State, in order to alleviate the multiple tax burden. Thus, unitary taxation, though designed in an effort to counter tax avoidance, may well be enough reason in itself for the shifting of income into tax havens.

e. Formula apportionment for German Trade Tax; treaty implications

The somewhat unsatisfactory result just outlined--tantamount to partially unrelieved double taxation where foreign source income is subject to unitary taxation without allowances made for the equitable exercise of foreign taxing rights--is primarily due to the unitary States' tax statutes. These statutes are not superseded by U.S. tax treaties as these are not applicable to U.S. State income taxes. The U.S.-German Treaty, however, does cover the German Trade Tax (Gewerbesteuer), the revenues of which accrue predominantly to jurisdictions below the federal level, i.e., States (Länder) and municipalities. One may therefore ask whether there is not a built-in inequity in the Treaty itself insofar as U.S.-based enterprises enjoy (partial) relief from Trade Tax whereas unitary State taxes cannot be credited against German trade or corporate taxes in the case of German taxpayers. These questions are so much more justified as the Trade Tax Law also works with formula apportionment.

A factor in any identifiable imbalance under the present Treaty would be the systemic differences between German Trade Tax and unitary State tax. Although there is a very involved system of revenue sharing and transfer payments between the federal, state, and local levels of government in Germany for various types of taxes and levies, the Trade Tax still constitutes an important source of revenue for the municipalities. The justification for its existence is seen in the direct and indirect economic burdens on municipalities caused by business enterprises (construction of roads, parking space, development of industrial zones, public transportation, fire departments, etc.).

The tax has a dual base, namely, business profits and capital invested in the business. The starting point for the determination of the profit component is the net business income determined under the income or corporation tax law (and hence under the arm's length principle, if income allocation between domestic and foreign affiliates is at stake); certain additions to, and deductions from, this figure are made reflecting the tax being based on the earning power of the business as such, irrespective of the earning power of its owners or the personal circumstances of the entrepreneur. One major item to be added to net business income is 60 percent (taxable year 1983) or 50 percent (taxable year 1984) of the interest on long-term loan capital, insofar as the interest was treated as a deduction in arriving at net business income. This addition is supposed to put businesses working with borrowed funds on an equal footing with those with ample equity capital.

The capital component for the tax base is determined on the basis of assessed values for the business entity (normally much lower than the fair market or going concern values). Certain additions and deductions are made. Again, an important addition is 60 percent or 50 percent of the long-term loan capital, provided it was treated as a deductible item in arriving at the assessed value.

The overall tax base is computed for each legal entity located in Germany. German p.e.s of foreign corporations are treated as if they were separately incorporated (domestic) enterprises. Corporate structures are, in principle, respected. Separate legal entities are lumped together only where fiscal unity 1/ exists. Moreover, there are instances where tax planning measures designed to avoid Trade Tax by business split-ups are not recognized under substance-versus-form rules and the split-up is treated as one integrated business.

The overall tax base for the business entity is apportioned to the individual municipalities in which the p.e.s 2/ of the business are located. 3/ For all industries, the p.e.'s payroll over total

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1/ "Organschaft"; there is fiscal unity where a corporation is integrated into another business enterprise. Integration comes about through (a) ownership of the majority of the voting rights, (b) economic, and (c) organizational interdependence. Fiscal unity cannot be construed to exist with foreign enterprises, although integration into a domestic p.e. of a foreign enterprise is possible if certain requirements are met.

2/ In the case of fiscal unity, entities integrated into the controlling business are treated as p.e.s for the purpose of apportionment.

3/ Similar apportionment is necessary where one p.e. is located in more than one municipality.

payroll is used except for retailers in merchandise where half of the taxable portion is arrived at using the payroll ratio and the other half by using a business-receipts ratio. 1/ As the Trade Tax is based on federal law, the apportionment formula is uniform for the whole country. As opposed to the rather mixed tax environment in the United States, created by the individual State income tax laws which differ in spite of the model recommended in the Uniform Division of the Income for Tax Purposes Act (UDITPA), the aggregate of apportioned tax bases cannot exceed 100 percent of the apportionable tax base for one enterpise, or one group of enterprises joined by fiscal unity, under the Trade Tax Law. The municipalities apply their individual percentage rate (Hebesatz) to the apportioned tax base. A municipality is free to legislate on this rate within certain limits set by state law 2/ and the constraints of finding an adequate balance between revenue needs and attracting business.

While some of these features bear a certain resemblance to some U.S. State tax law systems, the important difference is that the German Trade Tax Law provides for the exclusion from the taxable base of major foreign source items, such as income attributable to a foreign p.e., or dividends received from foreign corporations engaged in active trade or business, provided the domestic enterprise holds at least 25 percent (taxable year 1983) or 10 percent (taxable year 1984) of the shares of the foreign entity. Hence, as international double taxation with respect to German enterprises is presently to a large extent avoided due to the mechanism of the Trade Tax Law, no apparent need was felt to provide in the Tax Treaty itself for a credit against Trade Tax for the remainder of cases in which foreign taxes are levied on foreign income not already exempted from Trade Tax. Moreover, where income is not so exempted, a credit for foreign taxes similar in character to German income or corporate income tax is granted against German income or corporation taxes. If taxes, e.g., on foreign nonbusiness income received by a German entity, are absorbed in this way, there would be no apparent need to credit such taxes a second time. Under special circumstances, of course, a loss-making entity might not be able to make full use of such foreign tax credit against its income or corporation tax while still incurring a liability to Trade Tax. The reason for this can be the addition to be made to federal net income in computing the Trade Tax base. An example might be a domestic corporation with substantial foreign portfolio dividends (participation exemption not applicable), which expands its domestic activities, finances this expansion by heavy borrowing and in addition incurs market-penetration losses. If the dividend income is slightly greater than, or equal to, the penetration losses, this company would show a loss for corporation tax purposes and yet, it would carry a

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1/ See par. 29(1), Trade Tax Law.
2/ See par. 16, Trade Tax Law.

Trade Tax burden of roughly 15 percent of the loan interest. In this case a credit against Trade Tax for foreign withholding tax on the portfolio dividends might appear warranted in order to eliminate international double taxation, all the more so, since, lacking a rule for the carry over of foreign tax credit, the double taxation will not be made up for in later years when the corporation, for corporation tax purposes, might show profits again. One reason why no provision was made in the Treaty for a credit against Trade Tax might be that major cuts in Trade Tax revenue would primarily and most heavily affect the budgetary situation of municipalities which are entitled to 60 percent of aggregate Trade Tax collected. It might be feared that the carefully designed system of revenue sharing would be all too easily upset by direct impacts on an important revenue source of the municipalities, with Trade Tax reacting pro-cyclically anyway. The difficulties in administrating such a tax credit as a stand-by relief measure (i.e., contingent on unrelieved double taxation on the income tax level) may be another reason for not granting it at all.

In the bilateral U.S.-German context, all of the above considerations, however, take as a starting point the assumption that State taxes as well as the Trade Tax have to be viewed in the context of revenue sharing with the federal level and that they are designed in an effort to create inter-state equity. The economic and fiscal balance underlying these considerations is upset where sub-national taxation departs from these premises and takes on an international dimension and incidence, thus entering the realm of inter-country equity.

Under the Trade Tax Law, there is combination of domestic entities' income under conditions that the taxpayer can control to a high degree by providing for the contractual or organizational framework in order to enjoy intra-group profit and loss consolidation ("group relief"). On the other hand, there is no combination of domestic entities' income with that of foreign affiliates. Hence, the Trade Tax can be viewed as a surtax at regionally varying rates, levied in addition to, and computed by a certain degree of piggybacking on the tax base of, income/corporation taxes as well as the net wealth tax. It avoids almost entirely any international incidence normally associated with unitary State taxes, as combination ends at "borders' edge" 1/ and the delineation of the apportionable tax base 2/

1/ For a discussion of a "water's edge" concept, which would use apportionment factors to attribute income to various States within the United States but would consider any relationship with foreign entities under the arm's length standard, see Carlson and Galper (forthcoming).

2/ So-called "einheitlicher Steuermessbetrag."

is executed under arm's length standards. This is the reason why the U.S. Federal Government, along the lines of its treaty policy based on the foreign tax credit system, grants a tax credit for that portion of the Trade Tax which is computed on the basis of profits (Art. XV(1)(a) of the U.S.-German Tax Treaty). As opposed to this tax environment for U.S. companies, German enterprises enjoy the benefits of the exemption method with respect to a foreign p.e.'s income and dividends from substantial participations. Where the foreign tax claim is based on income in excess of what can be exempted under internationally recognized attribution rules in Germany, the resulting double tax burden runs counter to the spirit of the Treaty. 1/

By the same token, it is worth taking a second look at a possible international incidence of the Trade Tax. One conceptual weakness of this tax might be seen in the formula apportionment of taxable amounts to the various municipalities. If apportionment is to result in an equitable remuneration for bearing the burden of providing infrastructure, one- or two-factor formulas applied to possibly highly diversified (domestic) corporations and partnerships 2/ operating through (domestic) branches are no guarantee for an adequate yardstick. On the other hand, one may view this as an "internal" problem because serious distortions are not likely to arise due to the formula apportionment being limited to domestic companies. In spite of differential municipal tax levels, domestic businesses operate in a fairly homogeneous environment, one in which differences in payroll and investment costs as well as risk factors are not nearly as significant as in an international context. 3/

Nevertheless, the apportionment, e.g., by means of the payroll ratio, may have an international incidence in the context of the indirect tax credit. 4/ A U.S.-based parent with a German subsidiary corporation (which, in turn, acts through a branch) is eligible for the indirect tax credit upon receipt of dividends from the German subsidiary, and trade tax is likely to be part of the underlying tax,

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1/ This is stated in the official German position on unitary State taxation as submitted to the U.S. Treasury and State Department in November 1983.

2/ Even high diversification of business activities undertaken by corporations or partnerships does not result in the tax treatment of these entities as more than one taxable business enterprise, whereas rules comparable to those which determine a "unitary business" apply in ascertaining the scope of each taxable business venture in the case of a sole proprietorship.

3/ See Palmieri-Egger (1983), p. 393.

4/ See Chart I for an illustration of the following example.

i.e., the tax levied on the subsidiary's earnings and profits out of which the dividend was paid. If the trade tax rate applied by the municipality hosting the subsidiary's branch is significantly lower than that levied at the subsidiary's head office, and if the branch's personnel (smaller in size than that of the subsidiary's head office) is engaged in activities considerably more profitable than those of the subsidiary's head office, then the combination of subsidiary and branch income and subsequent application of the payroll ratio will result in an excessive allocation of income to the high-tax head office municipality. In view of the actual functions performed by the subsidiary, on the one hand, and its branch, on the other, it might, from a U.S. point of view, appear inequitable to grant the indirect tax credit for the full amount of trade tax (on profits) levied in Germany. However, the tax treatment of the German enterprise, in particular the domestic income allocation between headquarters and branch, would not appear to come under the articles of the Tax Treaty *dealing with the international income allocation between headquarters* and branch, or between affiliates. Competent authority consideration would therefore be unlikely. Remedies are, however, available under paragraph 33 of the Trade Tax Law which permits to depart from formula apportionment to reach economically sound results and even provides for a tax computation on the basis of the taxpayer's proposals, provided all municipalities involved agree.

2. Non-arm's length approaches in national taxation

The issue of unitary approaches applied on a national level (as opposed to state or municipal levels) appears to be somewhat more straightforward than that of State taxation reaching across international boundaries. Special complications such as that of a State's entitlement to legislate taxes with an international impact in spite of a federal government's monopoly to regulate foreign commerce do not arise. The same is true for the economic problem of differential tax levels within one nation prone to create misallocation of resources domestically.

Moreover, any double taxation arising, e.g., from the unharmonized application of rules on international income allocation, would, as a rule, be open to competent authority consideration under a tax treaty 1/ whereas this is not the case if the Treaty does not apply to the (State) tax. 2/ Conversely, the fact finding necessary to

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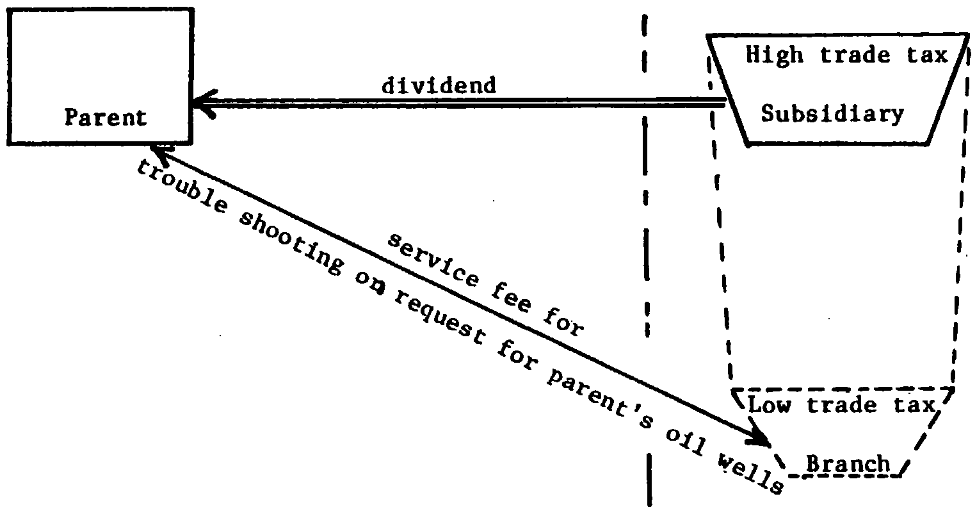
1/ Some countries feel that such cases do not come under the mutual agreement procedure; see OECD (1983), par. 76.

2/ This does not exclude "voluntary" consideration in analogous application of Competent Authority Procedure rules; see par.1.2.4. of the German Administrative Transfer Pricing Regulations (Federal Ministry of Finance Circular of February 23, 1983, Bundessteuerblatt (Federal Tax Gazette), Part I (1983), p. 218; for an English and French translation, see Rädler and Jacob (forthcoming)).

UNITED STATES



GERMANY

Functions	Profits Generated (trade tax)	Payroll	Apport. Profit (trade tax
Holdings Europe -administrative -clerical personnel -low profit	100 (20)	30	750 (150)
Trouble shooting -highly risky -highly trained pers. -very profitable	900 (90)	10	250 (25)
Totals	1,000	40	1,000

Note: Only the profit component of the Trade Tax is considered because IRS only credits this portion of the Trade Tax.

If "high trade tax" amounts to approx. 20 percent of profits and "low trade tax" to approx. 10 percent, the total tax burden under payroll-ratio apportionment is 175 as opposed to 110 under arm's length allocation.

determine double exemptions (created either by avoidance schemes or unharmonized allocation rules) could be executed on the basis of treaty clauses governing the exchange of information whereas information so exchanged may not be available for the implementation of taxes not covered by the treaty. 1/ These "remedial" procedures are more readily available for national than sub-national taxes under a treaty. Therefore, it would appear desirable in the light of the clear preferences expressed internationally for national jurisdictions not to legislate unitary rules to begin with or, at least, not to implement them vis-à-vis a treaty partner, if the treaty contains an equivalent of Art. 9 (or in the case of p.e.s, Art. 7) of the OECD Model. In this context it may appear useful to review a sample of national provisions bearing unitary traits.

a. "Some appropriate method of pricing"

In the discussion between state and federal governments in the United States, the proponents of unitary tax have made the point that the States are merely following the federal government's example of allocating income internationally. Adjustments under Sec. 482 IRC, it is argued, rely heavily on the so-called "fourth method" within the meaning of Reg. par. 1.482-2(e)(1)(iii), and such method is supposed to be predicated on the principles of unitary taxation. 2/ This statement must, of course, be evaluated in its domestic context and would appear to contribute little to validating unitary practices internationally, even if it were correct. An examination of the audit procedures under Sec. 482 IRC conducted by the U.S. General Accounting Office 3/ gives little support to the argument that the majority of federal tax examinations and adjustments follow unitary schemes. What it does illustrate is that only few adjustments were based on comparable uncontrolled prices, that a large percentage took recourse to safe haven rules, and that in many (i.e., the more complex) cases revenue agents had to use "some other" reasonable method. The examples given to illustrate such alternative methods show that combinations of the three "standard" methods 4/ were applied and that analyses of the functions performed by the various group members involved in a transaction were often necessary to arrive at a reasonable third-party profit margin. This figure then was used as a mark-up on cost or as a deduction from gross receipts, depending on the particular circumstances. Nothing in the report indicates that combination of income, supplemented by factor apportionment, was used on the federal

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1/ See Art. 26(1) OECD Model 1977.

2/ See Church and Pomp (1980), p. 891 et seq. (in particular, p. 896).

3/ See The Comptroller General (1981), p. 30 et seq. and Appendices III, IV, and VII.

4/ Comparable uncontrolled price method, resale price method, cost plus method.

level. On the contrary: the absence of such practices constituted one of the reasons why GAO recommended that a study be undertaken to determine whether formula apportionment is a viable alternative to the all-too-burdensome arm's length standard. 1/

b. Special U.S. rules for foreign banks

There are, however, fairly new regulations (Reg. par. 1.882-5) on the deductibility of interest expenses incurred by U.S. branches of foreign corporations including multinational banks. The predecessor of these new rules, Reg. par. 1.861-8 2/ contained the concept of full fungibility of money worldwide. While the computation of interest receipts of a U.S. branch followed the arm's length principle, i.e., was based on the effectively-connected test of whether, and to what extent, the branch contributed to the acquisition of an income-producing asset, the deductibility of interest expenses was based on the idea that it is inappropriate to attempt to "earmark" those funds which were used in financing the lending activities of the branch, to trace them back to individual transactions (including those with the bank's head office or other foreign branches), and to identify market interest rates for each of them. The new regulations extend this concept in what is known as the "separate currency pools method" by modifying it into a theory of "fungibility of money within currencies." The same regulations, however, offer a second method, the "branch book/dollar pool method." Under this method, only the branch's own borrowing from third parties qualifies as interest expenditure at market rates and is used to calculate an average borrowing rate. For any additional intra-bank borrowing a mixed interest rate, representing the average interest rate for all third-party dollar borrowing by the bank, is used, irrespective of the various markets (and interest rates) in which these funds were raised. To arrive at the deductible amount of interest, the interest rates so computed are applied to what is considered the branch's liabilities effectively connected with its U.S. business activities. For this purpose, an appropriate amount deemed to represent interest-free equity capital allocable to the branch is deducted from the branch's assets. Absent a specific computation by the taxpayer of a worldwide liability-to-asset ratio, a safe haven rate of 5 percent of assets is used to allocate equity capital to the branch.

Long before much experience with the new rules and their practical results could be drawn upon, the rationale behind the concept of fungibility had met with severe criticism. One major concern is that a combination of the arm's length standard for the attribution

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1/ See The Comptroller General (1981), pp. 50-54.
2/ For a discussion of the old Regs. see Kaplan (1979), p. 3.

of receipts with a formula approach for the apportionment of expenses, in the view of many observers, will increase the danger of automatic double taxation of certain income elements, or their double exemption, depending on the circumstances of the individual case, if the country in charge of the income allocation for the bank's head office follows the arm's length principle in toto.

The criticism against an allocation of equity capital to the branch is primarily based on the inherent administrative burden of worldwide (re-)computation of ratios (under U.S. accounting standards) and on the fact that the branch's equity capital is an amount imputed for tax purposes only and not one which the bank, as is the case under other countries' banking regulations, is required to actually show in its books so that the bank's customers are protected against unsafe business volumes. In addition, the regulations are criticized for being in contradiction with par. 17 of the Commentary on Art. 7(3) of the OECD Model insofar as the regulations do not take into account payments made between the various parts of a banking business.

The efforts by competent authorities to overcome any resulting overlap of, or substantial gaps between, tax claims on the basis of the arm's length rule contained in the equivalent of Art. 7 of the OECD Model are somewhat overshadowed by the position taken in an earlier Revenue Ruling. 1/ According to this ruling, the predecessor of Reg. par. 1.882-5 was considered not to be superseded by the attribution rule for business income contained in the U.S.-Japanese Tax Treaty.

c. Other alternative methods under German law

(1) Estimates

In the absence of more meaningful data, the income attributable to a domestic entity can be estimated under par. 1(3) of the German International Tax Law (*Aussensteuergesetz*). This provision permits the income allocation to be based on a "normal return on the capital invested in the company," or on the profit on turnover, which can be expected and is customary under the circumstances present. The possibility of profit splits is not specifically addressed in this provision.

1/ Revenue Ruling 78-4236 (1978-2C.B.194); see Kaplan (1979), p. 3.

(2) Profit comparison--apportionment

Under pars. 2.4.5. and 2.4.6. of the German Administrative Transfer Pricing Regulations, 1/ a number of alternative methods are available to serve different purposes.

(a) As a first step the regulations say that back-up material for the purpose of verifying ("double-checking") transfer prices established (and possibly examined) under the "standard" methods can be gathered from an "internal" or "external" comparison of business results. Under the internal comparison concept, gross or net profits are used which the taxpayer or a related party has produced in its dealings with unrelated parties in transactions comparable to those under examination. The external comparison concept proceeds in a similar way using data from transactions between parties neither of which is related to the taxpayer enterprise. Both of these methods can also be used to identify areas which warrant special attention in an ongoing examination.

(b) As a second step the regulations mention the combined results of connected business operations and their apportionment to the individual business operations within a group of enterprises. The use of these figures is permitted for the back-up purposes and the "zeroing-in" on critical areas of transfer pricing just mentioned. Supplementary criteria for the income allocation can, for instance, be usefully collected from amounts so apportioned where, due to pricing regulations in the marketing area or the steady devaluation of the currency used for pricing the product, the sales affiliate, over an extended period of time, shows positive results whereas the manufacturing corporation is left with dwindling profits, and finally negative results, as production costs increase. As the regulations provide for combining the results of connected "business operations" they make for a sufficiently large scope for discretion in choosing whether the results from one product, a product line, an entire corporate division or other economic units should be used in the apportionment. The alternative between "business income" (which is combined and apportioned) and "nonbusiness income" (which is allocated directly) under some States' unitary tax laws seems to be a somewhat coarser and more rigid dividing line, which may not allow distortions to be avoided to the extent possible under the standard of the German regulations.

1/ Bundessteuerblatt (Federal Tax Gazette), Part I (1983), p. 218.

(c) As a third step the regulations permit the income allocation to be based directly either on the internal/external comparison of business results mentioned under (a) or on the combined results of connected business operations and their apportionment to the individual business operations. This, however, is only possible where

-- under the special circumstances of the case the standard methods do not produce satisfactory results (e.g., where owing to a high degree of vertical integration of any business active in the industry, only insignificant quantities of certain raw materials or intermediary products are traded between unrelated parties before the stage of marketing the finished goods to the final consumer);

-- for lack of more meaningful data an estimate (e.g., under par.1(3), International Tax Law) is required; or where

-- the transactions are so unique to groups of enterprises that they are either simply nonexistent between unrelated parties or, if they are encountered outside, are conducted in a way that their commercial content is essentially different. In this last situation, par. 2.4.6. of the regulations, in addition, provides for the possibility of apportioning the income from the overall transactions under the fairness standards of sound business management.

The nuances between the various alternative methods and the preconditions for their use may look academic at first glance. Although no experience from their practical application (and from possible litigation) is yet available, it appears fair to say that their role as a method of last resort is an important factor in ensuring that the arm's length standard is not readily discarded whenever things become complicated. The flexibility built into these rules can be expected to be equally helpful for the avoidance of any extra-jurisdictional taxation and for accommodating solutions obtained by means of cooperating with major treaty partners.

d. Alternative methods under Italian law

Under Chapter III, Part 4a of the Italian Transfer Pricing Provisions, 1/ a possible alternative method is the allocation of overall profits accruing from a sale, or number of sales, made between two associated companies. Under this method, the consolidated profits are prorated according to the costs borne by each of the companies involved. The Provisions expressly recognize the fact that such a profit split takes no account of market conditions and the

1/ For an English translation, see Studio Trivoli (1981).

economic standing of the enterprise, and that such a deviation from the principle of fiscal autonomy of each enterprise is only acceptable if, based on an international agreement, timely coordination with the treaty partner is achieved which ensures an equitable allocation of the overall profits between the countries involved.

Chapter II, Parts 4b, 4c, and 4d of the Italian Provisions contain further rules for alternative approaches, similar to those under the German regulations (comparison of gross profits, profitability of invested capital, gross margins of the economic sector).

e. Less developed countries (LDCs)

There are only very few cases of LDCs using a combination-and-apportionment system similar to the type discussed under 1.a-1.d with respect to nonresidents or resident affiliates of foreign entities. According to Sec. 2(3) of Ghana's Income Tax Decree 1975, the profits of a branch, subsidiary or associated company of a nonresident company are deemed to be not less than the proportion of the total profits of the whole group of companies, both resident and nonresident, that the turnover of the company in Ghana bears to the total turnover of the group; the Commissioner may, however, where he is satisfied with the results of the Ghana branch or company, compute its profits without reference to the total group profits. In addition, according to Sec. 9(2)(b) non-arm's length dealings between controlling and controlled companies or persons are deemed to be artificial or fictitious, and the Commissioner has the power to disregard such transactions.

Under Chilean law, the Chilean source of income of a domestic branch of a foreign entity may be determined either by applying to the branch's gross receipts the same ratio which exists between the gross receipts and the net income of the enterprise's head office, or by applying to the branch's overall assets the ratio between gross assets and net income of the head office, provided that the branch's accounting records are inadequate to determine the economic results of the branch's activities. 1/ This precondition as well as the possibility, in the case of Ghana, of basing the tax claims against the domestic entity on its own income rather than on the combined group results (possibly in conjunction with adjustments for non-arm's length transactions) show that these rules cannot be characterized as straightforward and cogent unitary schemes. They are a mixture of alternative methods and menacing stick meant to increase taxpayer compliance domestically. 2/ It is difficult to ascertain how much leverage these provisions create in practice.

1/ See also Casanegra de Jantscher (1980), p. 22.
2/ See Mutén (1981), p. 203.

LDCs would probably find themselves in a dilemma trying to improve their ability to implement unitary approaches by means of a tax treaty. On the one hand, such a treaty would normally include an exchange of information clause and would therefore theoretically give the LDC access to some of the figures needed to compute group sales, income, assets, etc. On the other hand, an industrialized country as a potential treaty partner would most likely seek to incorporate in the double taxation agreement language that would correspond to the arm's length standard of the OECD and UN Models. In the absence of concessions, such a treaty rule would supersede any unitary concept contained in the LDC's national law if used as a prime approach of income allocation and would leave room for the "indirect method" only as an auxiliary yardstick to delineate branch income.

In order to avoid the difficult task of evaluating factual *circumstances abroad, LDCs, in order to safeguard their interests as* capital importing and source countries, rely heavily on tax schemes which are administratively easy to implement. A fair amount of LDCs' source taxation is based on figures which are readily available and verifiable within the territory of the taxing jurisdiction, i.e., gross sales, receipts, or billings. Sometimes this tax base includes receipts for activities which, economically, do not involve the territory of the taxing jurisdiction at all. In the Philippines, for instance, foreign carriers are taxed at 2.5 percent of their gross Philippine billings. As opposed to cargo and mail transports, services performed in consideration of the ticket price need not involve operations to and from Philippine territory in the case of passenger transportation; the mere fact that the ticket was sold there is considered a sufficient nexus for the power to tax.

Such practices can be viewed under several angles: they amount to a (gross) sales tax (as opposed to a (net) value-added tax) which does not follow the internationally accepted destination principle, in view of the fact that no relief is granted for amounts paid in consideration of services performed abroad. It can also be construed as a flat-rate schedular tax on domestic income, with such income being arrived at by applying a fixed percentage for imputed expenses as a deduction from gross income. 1/ It is interesting to note that the Philippine Tax Code, before the change to a gross income approach, contained provisions allowing as a deduction from gross Philippine source income earned by foreign steamship companies a portion of the foreign company's worldwide expenses and losses from comparable activities. The portion was determined by using a sales ratio, i.e., Philippine source income over worldwide receipts from all

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1/ See The Philippines (1983).

ports of all vessels, including receipts incidental to the shipping industry. Due to the lack of verifiability of these data, which were located abroad and were not comparable as they were reported to different tax jurisdictions, this unitary approach of cost allocation, on the basis of the so-called "Massachusetts Formula," was abolished.

Other countries use systems predicated even more distinctly on schedular traits. At the same time, such tax systems can often be assimilated to taxes on gross receipts. A case in point here is the Venezuelan formula calculation of presumed income. Under this system differential percentage rates are applied to gross revenue from different types of income, and varying withholding tax rates are then applied to these amounts, in taxing nonresident corporations or individuals. The problem with these taxes is twofold: relief measures (for instance, a foreign tax credit) granted by residence countries will often require the identification of the net income sourceable to the LDC, based on an arm's length standard in the case of branch income, or otherwise, a test of economic connection of both receipts and expenses with the activity carried out in the source country. In the residence country's view certain taxes, although designed in an effort to approximate net income computation either by a low tax rate or by a percentage imputation of expenses, are ineligible for relief altogether because their sales tax characteristics are considered to be predominant. In less serious cases, a clash will occur between the source rules of both countries if the nexus for the LDC's tax claim is a weak one (Philippine example) or if the LDC goes overboard in its extrajurisdictional claims, for instance, because income arising from the mere delivery of goods to customers in the foreign country is taxed. 1/

3. Results of formula apportionment and unharmonized approaches for the international income allocation

The following, substantially simplified, example 2/ shows the distortions which can arise when formula apportionment is used, due to differential levels of profitability, labor cost, and business volume. A bank has its head office in country HQ. Its debt claims acquired and held in HQ yield an average interest of 10 percent, which is higher than normal rates in HQ's market because the bank specializes in highly risky but so far successful lending activities. Because of a favorable banking legislation and an over-liquidity position of risk-averse investors in its market area, HQ can borrow at low interest

1/ This type of Liefergewinnbesteuerung (taxation of delivery profits) occurs frequently where assembly projects are undertaken, although the problem is not limited to this situation.

2/ See also Chart II.

		Worldwide	HQ	BR	Share in profits (HQ/BR) according to arm's length	sales ratio	asset ratio	payroll ratio	3-fact. ratio
1)	Assets (debt claims)	52,500	40,000	12,500					
2)	Interest received	5,000	4,000	1,000					
3)	Interest payable	3,800	3,000	800					
4)	Payroll expenses	400	280	120					
5)	Allocable profit arm's length	800	720	80	90/10				
6)	Profit/turnover		18%	8%					
7)	Apportioned profit sales ratio	800	640	160		80/20			
8)	Profit/turnover		16%	16%					
9)	Apportioned profit assets ratio	800	608	192			76/24		
10)	Profit/turnover		15%	19%					
11)	Apportioned profit payroll ratio	800	560	240				70/30	
12)	Profit/turnover		14%	24%					
13)	Apportioned profit 3-factor-ratio	266	213	53		80/20			
		267	203	64			76/24		
		267	187	80				70/30	
		800	603	197					76/24
14)	Profit/turnover		15%	20%					

rates leaving it with the tremendous gross profit margin of 25 percent of receipts. The bank's only branch in country BR operates in a less favorable environment. The average interest which its debt claims yield is 8 percent, partly because banking regulations require the branch to stay out of last-resort lending. The minimum reserve requirements of BR have increased the costs of funds borrowed to an extent that the branch's gross margin is "only" 20 percent of receipts. And because of all the red tape involved in running a banking business in BR, along with the tough competition for new customers with a good credit standing, its personnel costs are comparatively higher than those of the head office: although HQ's debt claims are well over three times as high as BR's, HQ's personnel costs are only slightly more than double of what BR has to spend. 1/ All lending and borrowing by both BR and HQ is conducted with unrelated parties at market rates.

The computation of the profits of the banking enterprise based on the arm's length principle reflects the higher profitability of HQ and allocates to it 90 percent of the overall profit. If the sales ratio is used, that portion drops to 80 percent; this is primarily due to the fact that the market forces in HQ, which account for HQ's low borrowing rates, are not reflected in the volume of lending. If the assets ratio is used, HQ's share drops by another 4 percentage points because the relatively high yield (25 percent higher than that of BR's yield) carried by the debt claims is not reflected in their respective size. If the payroll ratio is used, HQ's share drops to 70 percent of profits because of the relatively higher cost of manpower in BR. Without having to refer to the payroll cost per employee, the payroll cost differential can be explained as follows: HQ acquired some 40 percent more assets per dollar spent for personnel and its staff generated over four times as much profit per manpower dollar spent than BR. If an equal-weight sales-assets-payroll factor is used, roughly the same profit apportionment occurs as under the assets ratio. Lines 6, 8, 10, 12, and 14 of Chart II show the changes in profit-over-turnover ratios depending on the apportionment formula used.

Supposing BR's tax administration proceeded to tax the branch under any of the non-arm's length methods mentioned in Chart II, the resulting changes in apportioned profits will be of concern not only to the bank but also to HQ's Treasury as the bank will probably ask its tax authorities to exempt more branch income or to grant additional foreign tax credit. If both countries can agree on a uniform approach, the bank is not likely to complain if taxes in BR are not considerably higher than in HQ. If BR insists on the use of the unitary approach, and HQ is not inclined to reduce the income computed under the arm's length method correspondingly, double taxation occurs. As shown in Chart III, the effects of double taxation ("overtaxation") based on a

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1/ In the example, expenses other than payroll and assets other than debt claims are disregarded for simplification.

50 percent average tax rate in HQ and, initially, also in BR ("BR(A)") would be eliminated if BR, simultaneously with the changeover to a unitary tax system, lowered its average tax rate ("BR(B)") by approximately one half or three quarters, depending on the apportionment formula used. BR would then still be confronted with the criticism that double taxation of income persisted under its tax system, but the bank would not be exposed to any greater tax burden worldwide than before the change. The same revenue as under a unitary system along with a 50 percent tax rate would accrue to BR if it abolished net income taxation of nonresident corporations altogether and introduced a tax on gross receipts accruing to domestic entities (including branches). Column 10 of Chart III shows the tax rates necessary to generate the same amount of revenue. Assuming that the new tax on gross receipts was not in itself discriminatory, BR's government would not be exposed to the criticism of creating double taxation contrary to an existing tax treaty. Double taxation would occur between income taxes and taxes on gross receipts (turnover) to which any conventional income tax treaty between HQ and BR--in the absence of special bilateral arrangements--would not normally apply. 1/ The resulting overtaxation of the bank would depend on the method of avoiding double taxation under the treaty. If HQ exempts BR-branch income, the resulting worldwide tax burden is equal to the situation under a unitary system in BR with a 50 percent tax rate. If the treaty is based on the foreign tax credit method, HQ may not 2/ grant the same if it views BR's levy as a sales tax. 3/ The bank would then

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1/ Art. 2 of the OECD Model 1977 does not address the issue explicitly as to where the borderline between the two types of taxation should be drawn. Par. 3 of the Commentary on Art. 2 seems to suggest a fairly broad understanding of income taxes as it includes, for instance, the German Lohnsummensteuer (payroll tax), a component of the Trade Tax base eventually abolished because of its "job-killing" effects in times of a recession.

2/ Under proposed IRS-Reg. par. 1.901-2(b)(4) the tax, in order to meet the "net income requirement," would have to provide for a reduction from gross receipts to permit the recovery of significant costs and expenses attributable to such receipts, or for other compensation as a proxy to such recovery. A gross "bank tax," according to par. 1.901-2(b)(4)(iv) example (1), would not satisfy the net income requirement. A foreign tax credit might nevertheless be available if other income taxes are generally applied, the bank is exempted from them, and taxation on a gross basis occurs "in lieu of income taxes"; see IRS-Reg. par. 1.903-1(a).

3/ According to Mutén (1982), p. 263 (266), assumed or minimum profits taxes, based on some percentage of turnover, might qualify as profit taxes if they affect only part of the market participants so that the price finding mechanisms of a specific market could in theory remain free of distortions engendered by the need of those firms which are exposed to turnover-related assessments to shift the tax burden through their pricing.

In HQ	In BR	Profits earned worldw. (1)	Doubly taxed in add. (2)	Taxable profits HQ (3)	Taxable profits BR (4)	Tax 50% HQ (5)	Tax 50% BR(A) (6)	Total tax worldw. (7)	Result, over-taxat. (8)	No over-taxat. if BR(B) is (9)	BR gets same revenue as under col. 6 if gross rec. taxed at (amount col. 6 ·/· 1,000) (10)
Income allocation											
according to											
arm's l.	arm's l.	800	0	720	80	360	40	400	0	--	4.0%
arm's l.	sales r.	800	80	720	160	360	80	440	40	25.0%	8.0%
arm's l.	asset r.	800	112	720	192	360	96	456	56	20.8%	9.6%
arm's l.	payr. r.	800	160	720	240	360	120	480	80	12.5%	12.0%
arm's l.	3-fact. r.	800	117	720	197	360	98	458	58	20.3%	9.8%

have to pay additional domestic taxes to HQ on its foreign branch income; in computing it, the bank would probably be able to deduct BR's tax as an expense.

These alternatives point to two aspects of unitary taxation: (1) While a unitary system does not necessarily increase the overall tax burden for a multinational, compared to an arm's length system, it can have the effect of a surtax on multinationals in the country of its application. This is shown in Chart III: while the lower nominal tax rates in column 9 economically amount to a 50 percent tax rate on the BR-source arm's length profits of the multinational bank (due to the income situation of that bank outside of BR being taken into consideration), they do not constitute the same high burden for businesses which are only active within BR's territory. (2) Taxes on gross receipts can have the same revenue results as a unitary tax, yet can be designed without reference to elements located outside the taxing jurisdiction, thus avoiding the discriminatory penalties for "being multinational."

The example also shows that unitary taxation could work to the disadvantage of a taxing jurisdiction: if it were country HQ instead of BR which were to change over to a formula apportionment system, this would considerably reduce its part of the overall tax claim due to the combination of its profitable domestic taxpayer's income with that of a less profitable foreign business entity. Furthermore, a considerable bonus would be awarded to the multinational taxpayer if BR maintained an arm's length standard while HQ was adopting unitary apportionment, as the uncoordinated simultaneous application of both concepts would lead to double-exempted income internationally. In country HQ the discriminated enterprises would then be the nonmultinationals, that would not enjoy the blessings of consolidation with foreign loss-making entities ("international group relief").

III. Unitary Taxation: An Alternative for LDCs?

As previously mentioned, full-fledged unitary systems as a first approach to international income allocation have not been adopted by LDCs. There are, however, indications that this situation might change in the future. At least two developing countries, Kenya and Egypt, have taken steps bilaterally to safeguard their power to use unitary approaches. In the case of Kenya, this was done by including the equivalent of Art. 7(4) OECD Model 1977 into the new income tax treaty with Canada. Any decision by an LDC as to whether it should depart from the international consensus already reached would have to be based on a thorough weighing of the weaknesses of arm's length taxation against the possibility of improving the LDC's position by choosing worldwide formula apportionment as an alternative.

1. Rationale of transactional arm's length approach

An alleged theoretical weakness of arm's length is that it has to work with the false assumption that a market price can always be established whereas unitary apportionment can do without this assumption as its computations are based solely on data derived from transactions with unrelated parties. Along the same lines, some view worldwide combination and apportionment as the more straightforward economic approach as it need not take recourse to an "as-if" determination of constructive or fictitious prices where the painstaking task of price comparison, and price adjustment to make allowances for dissimilarities between the transfer and the market price, has not lead to a satisfactory result. By taking into consideration only transactions between truly unrelated businesses, it is argued, unitary methods adequately deal with the economic reality that intercorporate transactions generate no real economic gain or loss.

It is true that finding a comparable price or, at least, profit margin in a certain market or industry becomes increasingly difficult, and the constraints of arm's length become more obvious the less standardized and the more sophisticated a product or a service is. However, economic reality also shows that groups of enterprises are often organized in such a way that their freedom to shop and transact outside the group--even where the same or similar products or services are available from affiliates--can be quite considerable if not unlimited (so-called "profit-center approach"). 1/ In such a situation, intra-group transfers do lead to genuine gains or losses and should not be disregarded a priori. The main task of the examiner may then shift from price finding and price comparison to the thornier issue of allocating overhead expenses or central costs for intangibles, as the group member, while freer in its decisions in one area, may be subjected to "corporate loyalty" in another and may be required to make use of certain group transfers to enhance economies of scale.

One of the areas in which a certain degree of artificiality in the arm's length standard cannot be denied is that of enterprises economically unable to exist without group affiliation. An example for situations of this kind is given in the OECD Transfer Pricing Report: 2/ it may occur that the members of a group are so specialized in their activities and so closely integrated into the production of a range of products that all of the products are needed for the group to make profits overall; however, only some of these products

1/ Casanegra de Jantscher (1980), p. 5.
2/ OECD (1979), par. 42(e).

would be profitable to produce on an arm's length basis and some would not. 1/ If a group member in one country produces only the loss-making products in the range whereas profitable goods are produced elsewhere, the arm's length approach to correcting this situation for tax purposes would be to compare the position of the loss-making affiliate with that of an independent party; if the latter continuously were to make losses by charging market prices it would be viewed as producing not for its own benefit but for that of others. This activity of the affiliate is then construed to be of service to the rest of the group for which an adequate fee--over and above the sales price for the product--would be chargeable. This transactional approach would appear to be somewhat fictitious and incongruent with economic reality.

A more realistic equivalent in a market situation would be that of a contract manufacturer. Under this approach a fair manufacturing profit on a cost-plus basis would be allocated to the subcontractor with its limited range of production, and the marketing operation would be deemed to take place under a buy-back arrangement with the entity controlling the various group members and marketing the final product. Possible losses from acquiring the product at subcontractor's cost-plus price and selling at (lower) market rate would then be set off against the revenues from more profitable products having taken a comparable route. The various subcontractors would then be left with a profit level commensurate to their functions. The weakness of this scheme would be, however, that only the central entity would be fully exposed to the ups and downs of market forces, whereas the subcontractors' mark-up on cost would have to reflect the functions performed by independent subcontractors of the same industry. Hence, the mark-up would not necessarily reflect the average earning power and profitability of the group as a whole. Because the entity performs contract manufacturer functions as an integral part of the group "for better or for worse," the unitariness of the business would economically appear to warrant some kind of profit split, care being taken that the use of apportionment factors does not have distortive effects internationally.

The example shows that the arm's length principle, due to its transactional approach, may well "stand in its own way" when it comes to cases that economically call for unitary treatment while availability of data from third-party arrangements makes it difficult to justify such treatment. These obstacles would appear to be particularly

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1/ A practical case would be that of a group producing and marketing brand name automobile tires. Its customers expect the outlets of the owner of the trademark to carry, and have available at short notice, all sizes from truck to compact car. Only a certain cross-section of medium sizes are profitable because they can be produced in sufficiently large numbers. These products have to recoup the costs for the slow-moving stock-in-trade on both ends of the product range.

serious where rules for the application of the arm's length standard prescribe a definite sequence of methods to be used, such as IRS-Reg. par. 1.482.

2. Systemic deficiencies of unitary apportionment

While proponents of arm's length would therefore need to admit that in certain situations unitary approaches may economically be a more adequate tool to deal with highly integrated and interdependent enterprises, it must be pointed out that under the existing unitary systems important practical pitfalls exist with respect to identifying just those cases for which unitary profit splits would adequately reflect the inseparability of business activities. In order to pay due regard to the high degree of diversification that many multinational businesses have reached, the definition of "unitary business" would have to use far more sophisticated criteria than those presently available. The U.S. Supreme Court decision according to which not all group members, in order to be included in the unitary business, have to be unitary vis-à-vis every other group member so included 1/ would appear to be an imprecise standard, conducive to serious distortions internationally. An economically realistic grouping of unitary versus nonunitary members, based on more concrete criteria 2/ than a mere ownership test, the existence in general of economies of scale through shared facilities, the vague test of "flows of value," etc., would , however, presuppose complicated functional analyses with respect to all worldwide entities that might possibly qualify for inclusion. An LDC, already faced with considerable problems in applying an arm's length test on a transactional basis, would need to go into far deeper scrutiny with respect to foreign business entities, which may not be linked to the LDC-based entity transactionally but possibly functionally via several other interposed group members. The constraints of administrative simplicity would therefore require fairly coarse standards for delineating the scope of a unitary business. Those, in turn, would be conducive to avoidance techniques.

3. Legal and economic uncertainty

Another argument frequently raised against arm's length taxation is that it leaves corporations with a high degree of uncertainty concerning their pricing and creates unproductive costs to both corporations and tax officials. Unitary taxation, in contrast, is supposed to reduce the uncertainty because the factors leading to the ultimate profit attribution are known beforehand so that once a business is determined to be unitary all administrative discretion is removed. 3/

1/ See Container Corporation vs. Franchise Tax Board, State of California, 463 US __, 103 S. Ct. 2933 (June 27, 1983).

2/ For a three-level test to be applied in determining unitariness, see McLure (forthcoming).

3/ See Harley (1981), p. 1563 (1567).

For an LDC the aspect of uncertainty would appear to be of concern from both an economic and an administrative viewpoint. The economic consideration is that its tax regime would need to complement other measures and economic policies aimed at attracting investment. When generous tax holidays and accelerated depreciation are granted this will attract but the fly-by-night type of investor if at the conclusion of the start-up period tax burdens are unforeseeable and erratic. The future investor would be better off knowing that he will be subject to a fairly high but determinable tax claim than having to reckon with a multitude of factors which will influence his tax base. In this respect arm's length, for a number of reasons, appears to provide for economically more sound terms of reference than unitary taxation.

a. Origin of data used for arm's length and unitary taxation

Arm's length pricing is based on data generally available in the relevant market and to which business management of the enterprises involved in the transaction has access or to which it may be expected to have access if acting bona fide. 1/ Where quoted market prices are not available, but at least mark the upper and lower limits of a price range, a consistent pricing policy will not be subject to adjustments--just because the "exact" price was not used--unless the enterprises involved exploit the situation by fixing the price schematically at the lower or upper limit of the range without sound business reasons. 2/ A realistic assessment of arm's length pricing, however, cannot overlook the fact that an LDC will often simply have no market besides the transactions under consideration. Price determination based on market data will be even more difficult with respect to intangibles and services. Requests for information and administrative assistance will often be a means of last resort, though no guarantee for success. The LDC, although it could theoretically use market or market-derived data in calculating a net profit for the entity in its jurisdiction, will therefore have to rely heavily on taxation on gross receipts.

It would, however, be a mistake to assume that this situation would drastically improve if a unitary tax system were adopted. Unitary taxation works with data which need not have anything to do with the respective market, for instance, because a group member executes no other than intra-group transactions. For instance, one function typically assumed by LDC-based entities, whose labor costs are relatively low, is that of a contract manufacturer. Both the purchase and the sale of the goods processed may involve controlled transactions. In calculating the apportionable tax base under today's unitary systems none of the market data obtaining in the LDC's jurisdiction

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1/ See par. 2.1.8. of the German Administrative Transfer Pricing Regulations, Bundessteuerblatt (Federal Tax Gazette), Part I (1983), p. 218.

2/ Ibid., par. 2.1.9., example 1.

would be a factor as all intra-group transactions have to be eliminated. The same would be true for the sales factor in the apportionment formula as the LDC has no third-party transactions. 1/ The only relevant data derived from the LDC's entity are assets, if any, and payroll. All other factors to be included will come from business dealings which may occur in different parts of the world under market conditions totally alien to the LDCs market and not verifiable through administrative assistance as LDCs tend not to dispose of extended treaty networks. The LDC under a unitary approach would therefore typically not be in a position to use figures which are readily available and verifiable within its territory as crucial elements of its systems, 2/ whereas such information would be of certain value, e.g., in the previous contract-manufacturer example (price determination on a cost-plus basis).

From the standpoint of a future investor in an LDC, the example of the Royal-Dutch Shell case, 3/ in which the California affiliate was required to combine the income of some 900 other group affiliates worldwide before apportionment, demonstrates quite well the uncertainty faced by the business management of the California affiliate involved in conducting day-to-day business under a unitary system, for instance, when estimating future tax costs for third-party price determination.

b. Elimination of administrative discretion

The alleged advantage of unitary taxation eliminating administrative discretion, viewed by some as inherent to arm's length, does not appear convincing. The decision as to which entities' income should be combined in a unitary business involves considerable judgment in the absence of hard and fast rules based on ownership or certain percentages of transactional links. On the other hand, it is true that, as opposed to arm's length, under a unitary system the difficult task of allocating overhead, general administrative costs, or centralized services need not be addressed as these figures are "self-adjusting" due to the formula apportionment. This simplification, as welcome as it is in a water's edge system of combination and apportionment, can lead to terrific misallocations internationally as no consistent application in the countries involved would be possible in today's

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1/ Mutén (1981) seems to infer that " non-arm's length " export sales would be subject to the "risk of underpricing." Under a unitary system such as that of California controlled sales would be totally excluded from the sales factor. See WhiteNack (1983), p. 771, footnote at asterisk.

2/ Supra, p. 22.

3/ See Shell Petroleum NV vs. Franchise Tax Board, State of California, No. C 81 4302 MHP (N.D. Cal.).

tax world in order to overcome economic incomparability of apportionment factors. 1/ Even if central group management submitted to all administrations concerned a uniform worldwide concept 2/ which would help eliminate overlaps and gaps in tax claims, the unitary state would not be in a position to even consider such a concept as it would have to disregard all intra-group transactions. A proposal offered by proponents of unitary apportionment to avoid international distortions would be to adjust apportionment factors by using comparability tables and indexation. Here, too, considerable judgment—no less than in arm's length overhead allocation—would be involved in establishing the necessary degree of comparability between a multitude of group members, all of which factors would need to be put on an equal footing.

c. Eliminating the effects of currency fluctuations

The impact of currency fluctuations, which would influence both the computation of combined income and of apportionment factors, for all of which a common unit of measurement has to be found, appears to be of greater importance under unitary than under arm's length approaches and would appear to reduce the predictability of tax claims under the former method.

On the level of adding combined group income, the question as to what currency should be used as a common denominator needs to be resolved. The assessing country would naturally require the computation to be based on its national currency, but other jurisdictions would not be very likely to follow suit. 3/ If the currencies involved are both strong and weak ones, a multinational might well show global profits in the depreciated currency and losses if it reports in the appreciated one, 4/ and this might be due exclusively to currency fluctuations and would not necessarily presuppose varying levels of profitability in the various entities' economic activities which generated the combined income.

In intra-group transactions involving foreign currencies, a criterion to be considered under arm's length standards (one which is of no concern under a unitary approach) would be whether the parties to the transaction equitably distributed the exchange risks among

1/ See Kopits and Mutén (forthcoming), p. 7.

2/ Such as a cost sharing contract; see infra, Part IV.

3/ See Kopits and Mutén (forthcoming), p. 5. For a more optimistic vision of "world taxation" by single assessment and allocation by the home country's administration, see Plasschaert (1981), p. 414.

4/ See Mutén (1983), p. 324.

themselves, i.e., in a way which also independent parties would have agreed to. 1/ If the parties therefore do not illicitly exploit this discretionary scope in order to reduce their overall tax burden, their hedging and forward exchange measures are likely to produce more predictable results than under a unitary approach, where similar measures would not appear to have any mitigating impact on how volatile exchange rates affect the factors used in the apportionment formula. 2/

d. The administrative dimension

The administrative aspect of how to determine the tax under a unitary system has already been touched upon in the context of delineating the scope of a unitary business. Another practical consideration of even more concern to LDCs would be that of securing a realistic degree of compliance. Coming back to the typical example of contract manufacturing by an LDC entity, under an arm's length approach the relatively straightforward transactional pattern parent-subsidiary-parent would be the subject of a tax examination. The enterprises involved would need to be prepared to furnish information relevant to, at most, these entities. Under a unitary approach the information necessary to arrive at the taxable base would involve a considerably larger volume of data, depending on the size of the group and the degree of precision the examining authorities try to achieve. As their ambitiousness will invariably clash with feasibility constraints, a certain amount of administrative discretion will need to be applied in the decision as to what and how much information and documentation is to be submitted. It is not clear that unitary approaches would offer a distinct advantage over arm's length taxation in this respect.

4. Revenue considerations

Unitary taxation may appear attractive to LDCs with a view to its revenue results. Although it is about as difficult to compile aggregate data on the differential tax effect of currently applied unitary State taxation compared to separate entity approaches as it is to comply with that tax, certain mechanisms are likely to work both to the short-term advantage and the long-term disadvantage of an LDC.

1/ See pars. 3.1.2.1. and 4.2.3., German Administrative Transfer Pricing Regulations, Bundessteuerblatt (Federal Tax Gazette), Part I (1983), p. 218.

2/ It is unclear how measures to reduce exchange rate fluctuations are technically treated by the administrations currently using a unitary approach in the context of calculating the sales factor.

(i) As unitary taxation cannot adequately deal with the economic results of start-up or expansionary phases, an LDC business entity forming part of a group that is already successfully active worldwide and is expanding its business into an LDC's market, would show positive taxable income from the outset although, economically, it would have to get past a period of increased costs and reduced receipts before reaching a stable market position after the investment phase.

(ii) In the long run the revenue result is likely to turn into a disadvantage for the LDC. Listening to the arguments against U.S. State taxation raised by investors from industrialized countries, one must conclude that the likelihood of State unitary taxation resulting in an overstatement of State-source income is just as great as the propensity of unitary apportionment to lead to an understatement of an LDC's share in the income. This is due to the factors used in the apportionment of worldwide income and the imbalances which exist between the values of factors and their respective costs between industrialized and developing countries. 1/ If it takes four times the value of assets and twice the amount of sales and payroll to generate the same profit within the United States as in a developing country, 2/ an equal-weight three-factor formula would only apportion less than 30 percent of the total profits to the LDC. This would be out of line with economic reality as multinationals have to allocate a fairly high return to their LDC pricing in order to account for the risk factors involved. 3/ This risk premium would result in a high mark-up on, e.g., costs of goods sold and would be reflected in the sales carried out by the LDC entity. If, however, the LDC-based entity's transactions are only controlled transactions, not even the sales component of the apportionment formula could result in a commensurate apportionment of group income to the LDC as only third-party sales would qualify for inclusion in the sales ratio.

(iii) The revenue results of unitary taxation for LDCs would therefore only work to the LDC's advantage during a limited start-up phase. 4/ Collecting this revenue would, however, not be of prime interest to the LDC and could even be counterproductive to other measures intended to attract business and investment, such as tax incentives. 5/

1/ See Kogels (1983), p. 65 (66).

2/ This is a figure that has been quoted by representatives of the corporate sector.

3/ See Kopits and Mutén (forthcoming), p. 15.

4/ Ibid., p. 20. The authors suggest a capital-based formula to reduce the negative revenue incidence of unitary taxation for LDCs.

5/ Ibid., p. 18.

5. Administrative burden

The administrative burden that an LDC will have to face in applying arm's length or unitary approaches and has already been discussed to some extent. It can be summarized as follows. In order to contain a fairly high potential of tax avoidance through controlled transactions a representative sample of intra-group dealings needs to be examined under the arm's length standard and a corresponding force of trained manpower will be required. 1/ Proponents of the unitary system claim that less monitoring than under arm's length will be required as all intra-group transactions are disregarded. However, reporting, combining, and apportioning worldwide group income--along with defining the scope of the unitary business--represent a tremendous compliance task to the taxpayer; unless this compliance burden is matched by efficient control mechanisms, statutory compliance rules will be viewed as a paper tiger and as an invitation to abuse. The same is true if measures designed to relax compliance, and correspondingly to simplify the administrative burdens, are taken, e.g., by relying more heavily on financial reporting mandatory under various countries' commercial codes, stock exchange supervisory laws, and similar publication and filing requirements. 2/ Such a practice would add another dimension of uncertainty and incomparability in the absence of worldwide harmonized accounting standards. Administrative problems would grow even more if the proposal to refine and improve on today's unitary systems were followed up, for instance, by introducing more elaborate rules on the scope of the unitary business. Due to the worldwide dimension of unitary audits--as opposed to the transactional scope of an arm's length audit--examiners would be tied up in considerably more work in obtaining and verifying data needed to reach satisfactory results.

6. Tax havens

The problem of counteracting tax evasion and avoidance is of foremost importance to industrialized countries, especially where income is channeled through a tax haven in transactions originating and ending in high tax jurisdictions. Developing countries that have been able to attract investment and to modernize their tax administration are beginning to face similar problems. Proponents of the unitary standard argue that arm's length helps to reinforce the insulation effects of tax haven corporations; to counter it, special "look-through" provisions, often extremely complicated ones, are required. As the most important effect of unitary taxation is the

1/ Part IV will discuss ways for LDCs to reduce this burden by cooperating with industrialized countries.
2/ See Kopits and Mutén (forthcoming), p. 6.

elimination of deferral and the piercing of the corporate veil, it is felt that special provisions such as those in Subpart F of the Internal Revenue Code or in the German International Tax Law (Aussensteuergesetz) are superfluous when group income is allocated on a unitary footing. Such reasoning, however, overlooks the fact that unitary apportionment has not gone as far as totally denying the existence of tax haven entities affiliated with a multinational group. Although unitary apportionment does eliminate the blessings of detouring income to a tax haven corporation whose sole function is that of an invoicing agent or conduit company--a result which under the arm's length principle would require possibly involved functional analyses and exploration of the factual circumstances--it cannot totally avoid the attribution of some group income to a tax haven entity where the same deals with third parties. If a considerable volume of third-party transactions on behalf of the group as a whole is done out of a tax haven entity, possibly after some minor functions have been performed in the tax haven country turning the semi-finished product into a marketable good, the tax haven entity is eligible for apportionment, most likely with small amounts for the asset and payroll factors and possibly overwhelming amounts for the sales factor. The income attributable under such an approach may well exceed what would otherwise be allocable on the basis of a functional analysis using the arm's length standard.

Furthermore, certain unitary methods may make the use of a tax haven recommendable in order effectively to shield income and to counter the elimination of deferral. If the unitary system does not combine all group income but works with the distinction, existing for instance under California law, between "business income" (which is combined and apportioned) and "passive investment" (nonbusiness income which is allocated to its recipient upon disbursement), business income might easily be shielded in a tax haven. The unitary structure would be bisected by putting the ownership in and management of active foreign subsidiaries into a tax haven corporation. The ultimate parent would then hold the stock in that holding and management entity and might occasionally receive nonbusiness income, within the meaning of the unitary provisions, in the form of dividends. 1/ In order to crack down on such benefits, unitary taxation would either need to draw on substance-versus-form or look-through provisions (provisions which it supposedly can do without) or apply fairly coarse ownership tests and waive the distinction between various types of income.

To conclude: an LDC would not be very likely to draw substantial administrative or revenue benefits from the adoption of a unitary tax system as a prime approach to the international income allocation.

1/ See WhiteNack (1983), p. 783.

By departing from the arm's length standard that is backed by broad international consensus, it would impair its prospects of cooperating with industrialized nations in a common effort to counter tax evasion and to find coordinated standards of income attribution.

IV. Combining the Features of Both Approaches

1. Cost sharing as a compromise between two extremes

The main argument of those favoring unitary taxation is that a direct allocation of profits becomes arbitrary where certain structural interdependencies between group members exist which, economically, turn the dividing lines between legal entities into mere silhouettes. Such structural linkage is viewed to exist for instance if there are within the group economies of scale (through horizontal integration) or of scope (through vertical integration). Shared costs of management and centralized research and development (R & D) are other examples. 1/

Aside from these conceptual aspects, quite a practical consideration would be to suspect that certain group structures offer a gamut of options that are almost seductively conducive to abuse and too good to pass by.

Proponents of the arm's length principle will readily admit that the direct allocation of costs and other expenses, with respect to centralized administrative services and intangibles, cause tremendous problems of valuation and attribution especially if an attempt is made strictly to adhere to the transactional approach. It would appear to be utterly impossible, both for an enterprise and a tax examiner, for instance to find an adequate market service fee for each and every time an employee of group headquarters' support division makes a phone call to one of the subsidiaries to pass on information or to give advice. If the caller was not a staff member but happened to be a board member, the decision whether he was acting in that capacity (exercising shareholder functions in protecting and administering the parent's investments) or as an advisor to the subsidiary would complicate the allocation problem. The other extreme would be totally to disregard such intra-group activities and apportion expenses related thereto along with all other expenses by reference to sales, payroll, and assets, irrespective of the degree to which one or the other group member benefited from centralized services.

1/ See Musgrave (forthcoming).

A possible compromise betwen the two extremes might be to try to avoid the distortive effects of unitary apportionment without "atomizing" a group center's overhead expenses in an attempt to trace all cost items back to each and every transaction. The main feature of such a compromise, on an arm's length footing, is the treatment of the affiliates sharing centralized services as separately incorporated entities, which are assumed to have severed some of their activities from their own businesses and to have asked a separate enterprise or a central division to conduct these activities for them. Although the character of such an arrangement under civil law is somewhat foggy, the economic rationale is that of pooled resources. Full-fledged pool arrangements between otherwise unrelated parties might be considered an adequate yardstick for comparison although intra-group sharing arrangements have their specific features.

2. Rules on cost sharing under German Administrative *Transfer Pricing Regulations*

Legal provisions addressing such cost sharing arrangements with respect to financing intangible property can be found in IRS-Regs. pars. 1.482-2(d)(4). The OECD Transfer Pricing Report describes the practice of multinationals which finance R & D by way of "cost contribution" arrangements. The German Administrative Transfer Pricing Regulations 1/ contain fairly detailed rules on cost sharing contracts, the scope of which goes beyond the financing of R & D and encompasses expenses incurred for rendering administrative services. In these rules it is recognized that the allocation of shared costs by apportionment can be accepted if the related enterprises base such apportionment on a contractual framework satisfiying the standards of the regulations, provided that separate attribution of costs to individual services and transfers would be too burdensome (par. 7.1.1.). 2/ This prefatory provision points to three important aspects:

(i) the rules on cost sharing contracts are intended to provide for administrative simplicity as well as for a reduced burden of compliance;

(ii) they are intended to address both the recovery of expenses for centralized services by suppliers (income side) and the deduction by recipients (expense side);

(iii) the fairly detailed rules covering the contractual framework and organizational set-up required for the sharing arrangement to be acceptable are designed in an effort to set high quality standards which,

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1/ Bundessteuerblatt (Federal Tax Gazette), Part I (1983), p. 218; see Intertax (5/1983), p. 165, for a translated excerpt which reproduces the rules on cost sharing contracts.

2/ Paragraphs quoted in parentheses refer to sections of the German Regulations.

when met, will assure the taxpayer enterprise of noninterference by the tax authorities with thousands of inter-corporate transactions. If the taxpayer is not prepared to enter into a cost sharing agreement he is free to use a separate transactions approach. The rules are therefore not primarily intended as a sword of the examiners but as a shield for the taxpayer, provided he follows the rules of the game.

The technique of cost sharing basically involves two steps: first, the compilation of costs incurred in rendering the services and in creating the intangibles transferred, that come under the agreement; second, the apportionment of the aggregate of these costs to the beneficiaries of those services and transfers.

The first step involves the compilation of all costs actually incurred in and attributable to the provision of those services and transfers covered by the arrangement. The compilation of all eligible expenses in one set of books is essential to avoid problems of the kind described in the Philippine example. 1/ The regulations therefore require that costs arising outside a central service entity from complementary or supporting activities of the same kind be aggregated within the central service entity.

A mere estimate of the costs to be shared, for instance, based on a certain percentage of group entities' turnover, will not be accepted (par. 7.1.2., 3rd. sentence). Separate charges, for instance, in the form of a fee or royalty, for services and transfers covered by the arrangement, will not be allowed over and above the amount to be shared (pars. 7.1.3. and 7.3.2.).

In a second step, the costs so compiled are apportioned to users of services or to the transferees of intangibles. Eligible users are those entities in whose interest services are actually provided; eligible transferees are those enterprises to whose commercial activity the R & D undertaken actually relates or will relate and who actually use, or can reasonably be expected to use, the results of the R & D (par. 7.2.1. No. 1). No provision is made for specific factors to be used in the apportionment formula. It is, however, required that the formula reflect the extent to which the taxpayer enterprise actually benefits, or can be expected to benefit, from the results of the R & D which it helps to finance, and from the administrative services provided within the group. A turnover ratio may be used provided it adequately reflects actual or expected benefits.

1/ See supra, pp. 21-22.

The arrangement has to be based on a contractual relationship predicated on reciprocity: the contract must establish on the part of the payor a specific right, definite both in nature and scope, to benefit from the activities of the entity providing centralized services, including the right to request services or to give instructions (par. 7.2.1. No. 2). In order to avoid abuse, the regulations specify that, for tax purposes, cost sharing has to be based on a contract which was concluded beforehand in clear and unambiguous terms (par. 7.1.5.). 1/

A clause intended to ensure the coordinated application of a cost sharing scheme internationally requires not only the entities claiming shared costs as a deduction but also the entity performing the central services to incorporate the amounts of shared costs in its business accounts and computations of tax liability. For a German entity this would also imply an inclusion of the amounts in the books and records kept for financial reporting because the commercial balance sheet, as a general rule, has a binding effect for the tax balance sheet. 2/ Although these requirements do not necessarily ensure an equal treatment of the tax effects of a cost sharing contract by all administrations hosting the parties to the agreement, they would appear to be helpful in avoiding a situation such as the one under IRS-Regs. par. 1.882-5 3/ where one country insists on a formula apportionment of expenses and the other on separate billings for individual services and transfers on a straightforward arm's length footing.

3. Areas of concern for tax administrations; international cooperation

In order to allow cost sharing contracts as a basis for expense deductions, the tax administration responsible for the payor entity must be satisfied that the aggregate of apportionable costs is not excessive, that no double charges are made for the same costs, and that the apportionment formula is equitable. Conversely, an administration in charge of taxing the payee entity, which provides services and conducts centralized R & D, must be convinced that there is no flow of value to the benefit of other group members without fair remuneration. The country hosting the entity which provides the benefits to the rest of the group will normally be in the best position to verify all of the above. Germany, which is both a capital exporting country and one which depends on foreign investment in its territory, hosts about as many affiliates of foreign groups as German parents of

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1/ Par. 10 contains transitional rules.
2/ So-called Massgeblichkeitsprinzip.
3/ See supra, p. 18.

multinationals. Its finance administration must therefore take great care to find an appropriate balance between requests for outside help and its own ability to furnish similar information. At the same time, this balance must be reflected in its rules governing the area of cost sharing, as maintaining double standards in the long run would hamper and eventually disrupt international administrative cooperation. In all modesty it might be added that an LDC would not run great risks in trusting a tax administration such as that of the Federal Republic to find and maintain this balance and apply it consistently. In quite practical terms this might be phrased in a recommendation to LDCs:

(i) not to venture into uncharted territory by adopting unitary tax rules; and

(ii) to turn to developed countries' tax audit services with requests for administrative assistance in reviewing charges made by parent corporations under cost sharing arrangements with the understanding that, for instance, the German administration will not require a German parent to charge more than it would accept as deductible expenses in the case of payments made by a German affiliate to a foreign parent under a comparable arrangement.

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