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# THE QUEST TO TAX FINANCIAL INCOME IN A GLOBAL ECONOMY: EMERGING TO AN ALLOCATION PHASE

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THE QUEST TO TAX FINANCIAL INCOME  
IN A GLOBAL ECONOMY:  
EMERGING TO AN ALLOCATION PHASE

*Ilan Benshalom*\*

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## I. INTRODUCTION

The greatest foe of good tax reforms is the ambition to establish a perfect tax reform.

This article proposes to reform the current income tax conventions that currently tax income generated from financial holdings and transactions (“financial income”) in the growing global finance industry.

In promoting its proposal, the article advances both a descriptive argument and a normative one. The first, descriptive, argument traces the development of sourcing conceptions in the international income tax regime (IITR). It identifies policymakers’ growing readiness in recent years to reformulate the obsolete conventions according to which the financial income of multinational enterprises (MNEs) is allocated between sovereigns. The article claims that some of these reformulations, although still in their preliminary stages, may mark the beginning of a new Allocation Phase era in the IITR. In this era, the need to prevent abuse by MNEs may drive policymakers to consider abandoning current formalistic sourcing conventions. Instead, they may seek more administratively sound tax sourcing rules for financial transactions of MNEs that better adhere to the economic reality of the evolving global corporate business structure.

The article’s second, normative, argument is that the main challenge for the IITR is to adequately source affiliated transactions occurring within integrated MNE business structures. The article focuses on financial transactions that take place in the integrated global financial market. This integrated setting makes it difficult for

tax authorities to rely on old sourcing conventions, which require using the arm's-length standard and reporting transactions among affiliates as if they were priced and structured by unrelated parties. This idea of arm's-length reporting is deficient where it is difficult to price the transactions or to validate their structure. This article focuses on the validation-of-structure problem, stressing that, in the case of finance, tax law has not come anywhere close to determining the "proper" structure of financial transactions. Tax law relies on legal formalism to categorize financial transactions, an approach that allows taxpayers considerable flexibility in controlling the tax consequences of these transactions. Thus, tax authorities' attempts to prevent abuse by scrutinizing affiliated financial transactions through arm's-length lenses cannot promote any policy objective of equitable or efficient taxation. This article contributes an innovative and comprehensive answer to this problem, arguing that, at least in the case of MNEs that are financial intermediaries (FMNEs) and earn primarily financial income, income should not be sourced through transactional arm's-length methods. Instead, the article suggests that FMNE financial income should be computed as a whole and then allocated to the different jurisdictions where it operates according to a formula. The formula it proposes relies on hard-to-manipulate factors that indicate the geographic location where FMNE financial income has been generated. These measures net the financial income of an FMNE and allocate it among the different jurisdictions in which it operates. The allocation should be done according to a formula employing immobile and difficult-to-manipulate indicators that track the volume of an FMNE's activities in each jurisdiction in which it operates.

Part II of the article puts the issue in context by presenting the basic structure of the IITR and the difficulties tax authorities face when seeking to tax financial income. This part then identifies the four key problems with the taxation of financial income: income shifting, deferral, excessive credit repatriation, and evasion. Part III develops the descriptive claim of the article. Following up on previous research,<sup>1</sup> the article demonstrates policymakers' growing readiness to admit the limitations of the arm's-length approach and to consider new formulary allocation methods of sourcing MNEs' financial income. The article substantiates this claim by examining recent developments in a number of thin-capitalization regimes and Organization of Economic Co-operation and Development (OECD)

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<sup>1</sup> Ilan Benshalom, *The Quest to Tax Interest Income: Stages in the Development of International Taxation*, 27 VA. TAX REV. 631 (2008).

branch allocation guidelines. Part IV offers a proposal for sourcing financial income through formulary methods. To elucidate the principles of its proposal, this part assumes an “ideal” reality in which all MNE income is financial income, there is a multilateral agreement, and the boundaries of MNEs are not in dispute. Part V presents the article’s conclusions.

## II. THE ISSUE IN CONTEXT

### A. *The Basic Setting of the IITR*

The IITR comprises two different types of income taxes: those imposed by the source jurisdiction (where income is formed through the productive activity of tangible and intangible assets, human capital, and capital investments) and those imposed by the residence jurisdiction (where the individual or corporate investor resides).<sup>2</sup> Formally, source jurisdictions have the right to first levy taxes on any type of income. However, in the case of income derived from financial assets, the taxing rights of source jurisdictions are often severely eroded in favor of those of residence jurisdictions.<sup>3</sup>

There are two relevant types of source taxes on foreign corporate investments: the corporate income tax and withholding taxes.<sup>4</sup> Corporate tax is laid on the net taxable income of a corporate entity. If the corporation derives income from domestic *and* foreign sources, the corporate tax is applied as a source tax (on the income raised by domestic operations) *and* as a residency tax (on income generated abroad). In contrast, withholding taxes are laid on different types of payments (e.g., dividends, royalties, and interest) made by domestic taxpayers to foreign investors and trading partners; that is,

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<sup>2</sup> A residence country’s entitlement to tax the income of one of its residents is generally secondary to the source country’s right to tax that same income. If the residence jurisdiction levies a tax, it customarily offers some type of relief for taxes paid in the source jurisdiction. See Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1760–81 (1995) (providing a good summary of the United States’s foreign tax-credit system); Stephen E. Shay et al., “What’s Source Got to Do with It?” *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81, 83 (2002).

<sup>3</sup> See generally Roin, *supra* note 2, at 1760–62 (summarizing the main arguments in favor of source and residence taxation).

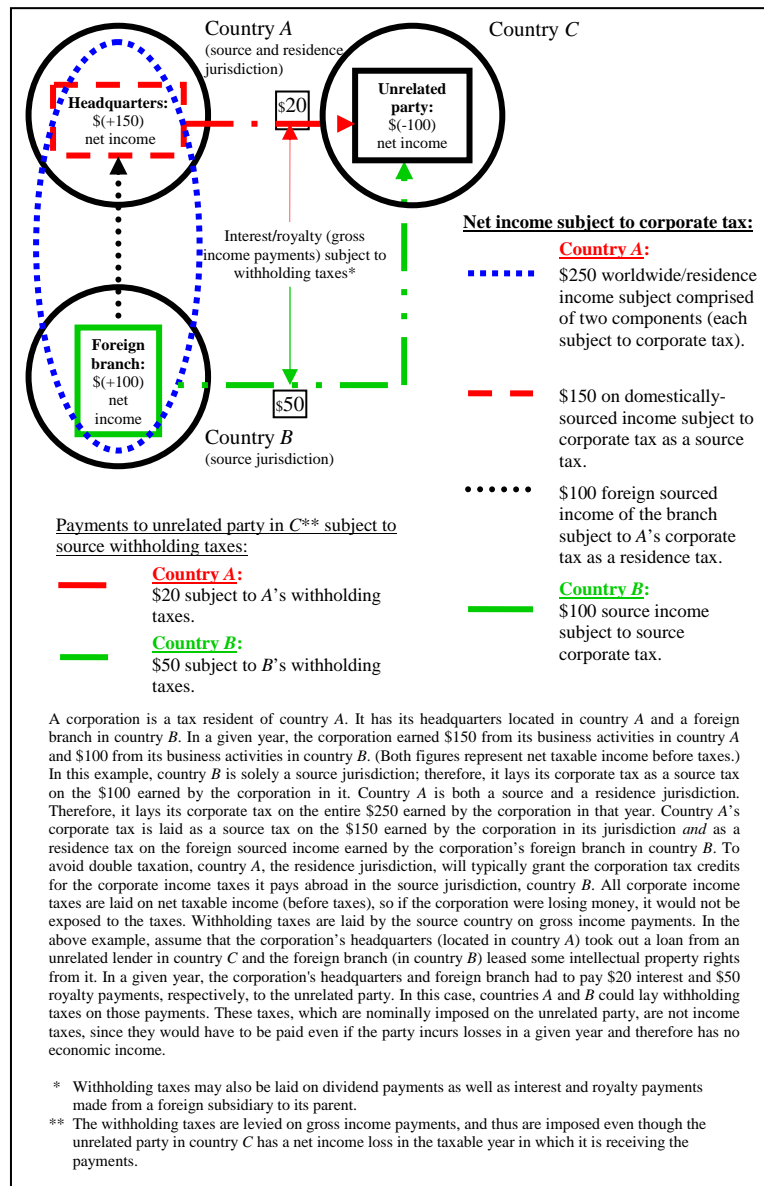
<sup>4</sup> Although much of this article’s discussion is relevant outside the corporate framework, this article limits its analysis to corporations, since international commerce is overwhelmingly conducted by them. Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 131 (2001).

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withholding taxes are laid on sources of gross income and not upon net taxable income. Federal statutory law in the United States prescribes that every interest payment made to nonresidents that is not effectively connected with a trade or business in the United States is subject to a statutory withholding tax rate of 30% unless it qualifies for an exception.<sup>5</sup>

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<sup>5</sup> I.R.C. §§ 861(a), 862(a)(1), 871(a), 881(a)(1).

FIGURE 1. A TAXONOMY OF THE IITR TAXES<sup>6</sup>

### B. The Difficult Terrain of Taxing Financial Income

The attempt by tax authorities to tax income derived from modern financial activities comprehensively and equitably is a Herculean task. The article refers to this income as “financial income.” (Part V.A., *infra*, presents a more detailed analysis about the

<sup>6</sup> This figure and example were both used in Benshalom, *supra* note 1, at 638–39.

precise definition of this term). The accelerating velocity of changes in financial markets imposes a heavy burden on legislators and tax authorities trying to formulate effective rules and enforcement policies. These changes can be separated crudely into a number of interwoven layers. First, the post-industrial economy is becoming a more service-laden one in which the overall value and volume of informational assets is constantly increasing.<sup>7</sup> The value of these assets (e.g., intangibles and financial assets), which do not have any tangible location, mainly comprises the human capital resources invested in their formation and deployment. The difficulty of valuing information assets and the growing mobility of these assets make it difficult for tax authorities to place and value significant sources of income.<sup>8</sup>

Second, technological advancements, particularly in the fields of computers and telecommunication, have been constantly changing the platforms on which financial commercial activity takes place. This “change in platforms” bundles together a number of different aspects. Finance activities are taking place today in international markets (a trend that started most notably with the development of the Eurobond markets<sup>9</sup>), which are much more loosely regulated than traditional domestic ones. These markets offer their investors a wide range of volatile, readily tradable portfolio investment alternatives, which deviate considerably from traditional foreign direct investment practices.<sup>10</sup> Modern markets operate in electronic venues and are monitored by investors and issuers that reside in developed countries. Communication technologies also allowed financial intermediaries to expand and to offer a wider range of end services in numerous jurisdictions.<sup>11</sup> Computer technologies even created new types of

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<sup>7</sup> David R. Hardy, *Assignment of Corporate Opportunities — The Migration of Intangibles*, 100 TAX NOTES 527, 527 (July 28, 2003).

<sup>8</sup> See Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 317 (2001); Hardy, *supra* note 7.

<sup>9</sup> James P. Holden, Jr., Note and Comment, *Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing*, 5 VA. TAX REV. 375, 383 (1985) (describing the development and attributes of Eurobond markets and the manner by which they insure investors' anonymity and withholding free returns).

<sup>10</sup> For instance, an American issuer on the Eurobond market will typically avoid the regulatory constraints of making a public offering. The issuer will know very little about the identity of the bond purchasers. In the case of financial institutions operating from offshore financial centers, the Eurobond markets offer a platform in which they can operate with little or no reserve requirements.

<sup>11</sup> See generally Peter Athanas, *Permanent Establishments of Banks, Insurance*



electronic currencies.<sup>12</sup> In light of these technology-driven changes, financial transactions occur quickly and without leaving a paper trail. This renders tax (and regulatory) monitoring of financial activities difficult.

Third, the use of innovative financial derivative instruments grew significantly in the last quarter of a century — a development, which was catalyzed by the increasing sophistication of international financial markets.<sup>13</sup> These finance instruments are often engineered contractually to provide taxpayers with timing and character tax arbitrages. Timing arbitrage reflects a taxpayer's ability to defer or accelerate income or deductions. Character tax arbitrage is a taxpayer's ability to translate any type of highly-taxed investment into a different, yet economically near-equivalent investment instrument (or array of instruments), effectively subject to a lower tax rate.<sup>14</sup> Taxpayers are therefore able to manipulate the classification of a certain profit or loss on the instrument and its proceeds as either capital gains or ordinary income.<sup>15</sup>

Fourth, another important shift is the migration of financial assets and activities to offshore financial tax havens.<sup>16</sup> The unregulated and

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*Companies and Other Financial Institutions*, 81 CAHIERS DE DROIT FISCAL INTERNATIONAL 1, 71 (1996) [hereinafter IFA].

<sup>12</sup> Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Terminals*, 26 BROOK. J. INT'L L. 1261, 1267–68 (2001).

<sup>13</sup> Financial derivatives sometimes include indices that represent a composite price mechanism rather than a specific type of asset. Accordingly, derivatives allow cash commutation of the values of capital, commodities, and intangibles without an actual exchange taking place in the ownership of the underlying assets. See TIM EDGAR, *THE INCOME TAX TREATMENT OF FINANCIAL INSTRUMENTS: THEORY AND PRACTICE* (2000).

<sup>14</sup> Character arbitrage into two different types: first, the ability to characterize net gains or losses as ordinary income, short capital gains, and long capital gains; and second, the ability to characterize financial instruments as equity or debt (in the latter case, making payments deductible).

<sup>15</sup> See Jeffrey M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, U. ILL. L. REV. 775, 778 (1999); Edgar, *supra* note 13 (providing a comprehensive account of the law and economics of various financial instruments and explaining the role of hybrids and synthetic instruments as well as the difficulty of taxing them under existing cubbyhole tax conventions); Robert H. Scarborough, *How Derivatives Use Affects Double Taxation of Corporate Income*, 55 TAX L. REV. 465 (2002) (demonstrating how financial innovations could be used to avoid corporate tax while providing quasi-equity interests to their holders); Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 HARV. L. REV. 460 (1993).

<sup>16</sup> Tanzi, *supra* note 12, at 1271–72, 1279.

untaxed offshore financial sector has developed gradually in the shadows of emerging global financial markets, with the implicit consent of developed countries.<sup>17</sup> The lack of regulatory and tax costs in tax havens allows investors to pool and utilize their capital resources efficiently.<sup>18</sup> Additionally, such tax havens offer taxpayers fertile grounds for tax planning, avoidance, and deferral opportunities.<sup>19</sup> More importantly, they provide individuals and businesses with significant evasion opportunities.<sup>20</sup> These evasion opportunities are a byproduct of low tax rates and bank and corporate secrecy laws in tax havens. The widespread use of the Internet plays an important role in the offshore industry. The Internet protects evading taxpayers' anonymity,<sup>21</sup> eases their communication with offshore promoters, and allows them to transfer funds and control investment vehicles (e.g., trusts, accounts, and corporations) in tax havens. Taxpayers often fail to report their income from investments in those jurisdictions, and tax authorities do not devote the necessary resources to obtain information about evaders or to prosecute them.<sup>22</sup> Consequently, offshore financial tax havens flourish by attracting capital flights from high-tax countries.<sup>23</sup> This results in significant revenue losses, major inefficiencies of investment allocation, and a shield for illicit money laundering activities.<sup>24</sup>

Fifth, there has been a salient shift in the business culture with

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<sup>17</sup> See generally SOL PICCIOTTO, *INTERNATIONAL BUSINESS TAXATION* 117 (1992).

<sup>18</sup> Yesim Yilmaz, *Tax Havens, Tax Competition, and Economic Performance*, 43 *TAX NOTES INT'L* 587, 592 (Aug. 14, 2006).

<sup>19</sup> See generally *id.* at 590.

<sup>20</sup> See Douglas J. Workman, *The Use of Offshore Tax Havens for the Purpose of Criminally Evading Income Taxes*, 73 *J. CRIM. L. & CRIMINOLOGY* 675, 681–86 (1982); Cono R. Namorato & Scott D. Michel, *International Criminal Tax Cases*, 50 *U. MIAMI L. REV.* 617, 621 (1996) (explaining how phony deductible business expenses to foreign corporations could be used to transfer money to accounts at offshore financial centers); Thomas W. Ostrander, *The Offshore Credit Card and Financial Arrangement Probe: Fraught with Danger for Taxpayers*, 99 *J. TAX'N* 113, 113–15 (2003) (explaining how evaders cash out hidden offshore financial assets through electronic payment devices and exploring the Service's attempts to trace such payments).

<sup>21</sup> See Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws*, 34 *CONN. L. REV.* 333, 343–45 (2002).

<sup>22</sup> See Pamela H. Bucy, *Criminal Tax Fraud: The Downfall of Murderers, Madams and Thieves*, 29 *ARIZ. ST. L.J.* 639, 640 (1997).

<sup>23</sup> See Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will It Last? Will It Work?*, 9 *STAN. J.L. BUS. & FIN.* 37, 40–41 (2003) (providing a brilliant taxonomy of tax havens).

<sup>24</sup> *Id.* at 41–42, 44–45.

regard to tax planning. This trend began in the 1970s when United States corporations formed foreign subsidiaries to overcome tax and regulatory access barriers to the Eurobonds markets. This practice, along with early tax legislation of the Reagan Administration that encouraged tax planning, induced an ever-growing hunger in the corporate sector for tax arbitrage profits during the early 1980s.<sup>25</sup> This desire for easy tax profitability escalated as the liberalization and competitiveness of the global economy increased. Recently, the tax planning industry developed a number of aggressive, yet effective, tax planning techniques that exploit the “check the box” regulations and the use of hybrid entities. These techniques allow MNEs to repatriate excessive foreign tax credits and avoid taxation of holding companies in low-tax jurisdictions under Subpart F.<sup>26</sup>

Sixth, the arm’s-length standard is a transaction-based convention applied to source transactions between affiliated parties.<sup>27</sup> Through a set of transfer-pricing rules, it inquires how hypothetical unrelated parties would price a certain transaction,<sup>28</sup> requiring each corporate entity within an MNE group to report accordingly.<sup>29</sup> In the related party finance realm, it is virtually impossible for tax authorities to unveil and systemize MNEs’ financial structures according to the arm’s-length standard. Pricing the “proper” interest rate of a specific related debt transaction is a feasible task for the tax authorities of developed countries. However, tax authorities have no conceptual benchmark for determining whether the debt form of the transaction

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<sup>25</sup> Michael J. Graetz, *Your Tax Dollars at Work: Why U.S. Tax Law Needs to Be Changed*, 48 EMORY L.J. 849, 857 (1999).

<sup>26</sup> Lawrence Lokken, *Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)*, 59 SMU L. REV. 751, 759–63 (2006) (showing how MNEs use hybrid entities for importing tax credits); Yilmaz, *supra* note 18, at 590 (claiming that holding hybrid entities in tax havens are used by United States MNEs to reduce foreign subsidiaries tax liabilities while avoiding exposure to Subpart F liabilities).

<sup>27</sup> See Roin, *supra* note 2, at 1787 (suggesting that the United States may be losing significant revenues because of related party transactions).

<sup>28</sup> David H. Rosenbloom, *Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt*, 26 SYDNEY L. REV. 17, 27 (2004) (arguing that hypothetical tests are needed in the income tax because contractual fictions allow for many situations in which transactions cannot be accepted at face value).

<sup>29</sup> Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 45–47 (1993); Joann M. Weiner, *U.S. Treasury Office of Tax Analysis Paper Considers States’ Experience Regarding Formula Apportionment*, 1999 WTD 182-23 (Sept. 21, 1999).

is proper, given the numerous alternatives available to taxpayers for mobilizing and repackaging fungible capital assets. MNEs' flexibility in arranging their capital structure allows them to locate their capital assets (and derivative income proceeds) in low-tax jurisdictions and their finance expenses in high-tax jurisdictions. The arm's-length standard cannot source coherently affiliated financial transactions because there is no one "correct" and objective standard for allocating financial risks.<sup>30</sup> Capital's tax-sensitivity, mobility, and homogeneous nature<sup>31</sup> make it possible and profitable for taxpayers to manipulate their earnings — a reality that tax authorities find difficult to confront given their limited audit and litigation resources.<sup>32</sup>

Another source of difficulty is the gradual erosion of withholding taxes over the course of the last fifty years. There have been two main sources of this erosion. The first source is the gradual reciprocal reduction of withholding taxes through double taxation treaties (DTTs). Countries entering into DTTs tend to reduce their statutory withholding tax rates, because withholding tax rates on gross income are considered an impediment to foreign investments and trade relations. The impact of these DTTs is intensified through a practice known as treaty shopping. Treaty shopping occurs when (sophisticated) taxpayers channel financial flows through conduit entities in jurisdictions with favorable DTT-networks to avoid unfavorable withholding taxes levied upon payments to nonresidents.<sup>33</sup> This way, taxpayers are able to extend withholding tax reductions, attained through such "DTT-havens," to entities in jurisdictions with more conservative DTT policies. In response to these abuses of the DTT-network, it has become common practice for some nations, most notably the United States, to enter limitation of

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<sup>30</sup> Gary D. Sprague, *Application of Transfer Pricing Rules to Branches and Permanent Establishments — Electronic Commerce and Intangible Property Aspects*, 10 GEO. MASON L. REV. 971, 988 (2002).

<sup>31</sup> See Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals*, 54 TAX L. REV. 353, 393–95 (2001).

<sup>32</sup> An illustration of this issue is the difficulty of allocating profits to foreign branches of banks. See IFA, *supra* note 11, at 72; Peter Randall, *Attribution of Profits to Permanent Establishments of Financial Institutions*, 10 GEO. MASON L. REV. 875 (2002).

<sup>33</sup> These practices are facilitated mainly through developed countries with extensive DTT-networks (e.g., the United Kingdom and the Netherlands). MNEs and other international equity and debt investors may create conduit entities in such "DTT-havens" to transfer funds through them. See Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1275 (1981).

benefits clauses<sup>34</sup> into their DTTs and to enact anti-conduit statutory legislation.<sup>35</sup> Doubt, however, has arisen over the effective enforcement of these arrangements.<sup>36</sup> The second source of withholding tax erosion is source countries' withholding tax exemptions on income derived from elastic and tax-sensitive capital investments (e.g., portfolio investments and bank accounts).<sup>37</sup> Source countries typically grant these exemptions as broad unilateral measures. The high demand for foreign investments dictates that, lacking any cartelized multilateral coordination, these types of mobile investments are subject to extensive tax competition. International investors often use the high demand for their investments to shift withholding tax burdens to debtors in source countries — rendering it difficult politically to sustain these taxes.

Finally, and perhaps most importantly, the above-mentioned attributes, along with the financial and monetary liberalization in the post-Cold War globalization era, have enhanced tax competition over now-elastic capital resources and financial activities. Subject to inferior information and to prisoner's dilemma constraints,<sup>38</sup> loosely-

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<sup>34</sup> See, e.g., United States Model Income Tax Convention art. 22, Sept. 20, 1996; JOSEPH ISENBURG, INTERNATIONAL TAXATION 245–46 (2000); David R. Tillinghast, *Tax Treaty Issues*, 50 U. MIAMI L. REV. 455, 465–66 (1996) (mentioning that having a limitation of benefits provision has become an inflexible demand of the United States in DTT negotiations).

<sup>35</sup> I.R.C. § 7701(l); Treas. Reg. § 1.881-3 (1998) (combating back-to-back loans).

<sup>36</sup> This doubt results from the high negotiation costs, complexity, and enormous information-finding and litigation costs that tax authorities are not able to cover.

<sup>37</sup> Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 547–54 (2003) (providing the key distinctions between direct and portfolio investments and arguing that the latter is more short term and volatile, thus responding with greater mobility to bottom-line changes in expected returns and to changes in the financial markets).

<sup>38</sup> The following table shows the tax competition grid. Assume a world with only two countries, *A* and *B*, which share materially equivalent investment attributes for mobile capital assets. Each country wants to attract investments and levy income taxes on its proceeds. The prisoner's dilemma table includes two parameters, amounts of investments and of revenue:

coordinated governments are motivated to try to attract investments from international taxpayers (such as MNEs).<sup>39</sup> MNEs' ability to pressure governments for tax concessions makes it difficult to identify whether the source of the effective reduction in their tax liabilities is a result of aggressive planning or of deliberate governmental attempts to compete for their activities by reducing their effective tax rates.<sup>40</sup> MNEs' perceived responsiveness to skew their financial activities according to tax incentives<sup>41</sup> encourages governments, not

	State B imposes high taxes on mobile capital assets	State B does not impose taxes on mobile capital assets
State A imposes high taxes on mobile capital assets	$A = In(50\%), Rev(high)$ $B = In(50\%), Rev(high)$	$A = In(0\%), Rev(0)$ $B = In(100\%), Rev(0)$
State A does not impose taxes on mobile capital assets	$A = In(100\%), Rev(0)$ $B = In(0\%), Rev(0)$	$A = In(50\%), Rev(0)$ $B = In(50\%), Rev(0)$

<sup>39</sup>Michael S. Lebovitz & Theodore P. Seto, *The Fundamental Problem of International Taxation*, 23 LOY. L.A. INT'L & COMP. L. REV. 529, 535 (2001). This taxpayers' group comprises mainly commercial parties that operate in several jurisdictions and also, to a lesser extent, affluent individuals with liquid or mobile assets. Such actors are able to utilize the loss of regulatory control on domestic capital resources to induce sovereigns to compete for foreign investment by eroding traditionally "fixed (political) costs" of conducting business. Understood in the context of global regulation, competition through tax policy — once considered a symbol of national sovereignty — may be perceived not as an exception, but rather as an indication of the peak of the regulatory competition trend. See J. Hackett, *Overview and Summary of Discussions on the Policy Implications of Recent Tax Reforms on Investment Flows Between Member and Non-Member Countries*, in TAXATION AND INTERNATIONAL CAPITAL FLOWS 72, 73 (1990); Malcolm Gammie, *International Tax Avoidance: A UK Perspective*, 28 INTERTAX 267, 274 (2000).

<sup>40</sup>Harry Grubert, *Tax Planning by Companies and Tax Competition by Government*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 113, 115 (James R. Hines Jr. ed., 2001).

<sup>41</sup>Rosanne Altshuler et al., *Has U.S. Investment Abroad Become More Sensitive to Tax Rates?*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 9 (James R. Hines Jr. ed., 2001) (suggesting that there was a growing Foreign Direct Investment sensitivity to effective corporate tax rates during the 1984–1992 period); James R. Hines, Jr., *Introduction*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 1, 7 (James R. Hines, Jr. ed., 2001). Cf. Jack M. Mintz, *Has U.S. Investment Abroad Become More Sensitive to Tax Rates? Comment*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 32 (James R. Hines Jr. ed., 2001) (suggesting that the optimal evaluation standard of the analysis presented in the previous study should have been the effective tax rate on marginal investment rather than the average effective tax rate).

traditionally perceived as tax havens, to take tax competition considerations into account when formulating their tax systems.

### *C. Four Key Problems in Taxing Financial Income*

The accelerating mobility of assets during the last fifty years is an inevitable byproduct of a number of overall positive developments. These developments include the aforementioned telecommunication and computation advancements, overall pro-capitalist political stability, and the expansion of international financial markets. They allow taxpayers to place financial assets in one jurisdiction while controlling them from another. These developments, however, negatively impact tax authorities' ability to levy taxes on financial assets. This article identifies four main problems derived directly from the mobility of financial assets in the global economy.<sup>42</sup>

First, MNEs defer taxation on financial assets held by subsidiaries in low-tax jurisdictions. By avoiding repatriation of subsidiaries' earnings, and by using hybrid entities to avoid Subpart F anti-deferral legislation, MNEs are able to transfer liquid financial assets of their foreign subsidiaries through low-tax havens.

Second, MNEs use sophisticated networks of hybrid entities and financial flows to repatriate excessive tax credits.<sup>43</sup> Under section 902, the foreign tax credit attached to subsidiaries' dividends is determined as their total uncredited post-1986 tax liability multiplied by the amount of dividends and divided by their total post-1986 earnings and profits (E&P). This reveals a simple, yet interesting mathematical relationship: when a subsidiary's E&P decreases, the proportion of foreign taxes (and foreign tax credits) attached to its dividends increases. Therefore, to generate excessive foreign credit capacity, MNEs try to have as much of their income as possible classified as foreign sourced by manipulating the source rules.<sup>44</sup> This change of

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<sup>42</sup> There are other major tax avoidance avenues — such as inversion transactions intended to avoid residency taxation and the creation of artificial losses — that this article does not address. While these techniques definitely involve the deployment of financial assets, the core abuse is not associated with the mobility of financial assets, but with the uneconomic substance of the corporate residency concept (which allows corporations to escape residency taxation easily) and the incongruence between financial and tax accounting, which enhance the profitability of tax losses.

<sup>43</sup> See Paul W. Osterhuis, *The Evolution of International Tax Policy — What Would Larry Say?*, 33 OHIO N.U. L. REV. 1, 10 (2007) (explaining how MNEs used hybrids to avoid Subpart F anti-deferral rules).

<sup>44</sup> For example, taxpayers can use section 863(b)(2) to assure that a higher percentage of the income they derive from their exports is foreign sourced. By

classification in and of itself does not reduce MNEs' tax liabilities because MNEs are subject to tax on their worldwide income. However, it creates an income source that "could be credited" with foreign tax credits.<sup>45</sup> This type of planning requires MNEs to take advantage of numerous incongruencies between United States and foreign tax accounting rules to develop techniques for reducing their subsidiaries' E&P. To achieve this E&P reduction, MNEs utilize affiliated financial transactions extensively. This allows them to create "pockets" of subsidiaries with low and high E&Ps. Finally, MNEs repatriate dividends selectively — only from those subsidiaries that, as a result of planning, have low E&P *and* paid a lot of foreign taxes in the past. When dividends are paid from these subsidiaries, a small amount of dividends "carry" with them substantial tax credits. With these (artificial) credits, MNEs reduce taxes on income from foreign sources (e.g., royalties and sales) of corporate entities that are United States tax residents. To the extent that MNEs exercise all three planning components effectively, they can credit much of their tax liability. Financial transactions are not the only way MNEs generate excessive tax credits. MNEs can use an array of tax planning tools to manipulate their foreign subsidiaries' E&P and tax pools to generate higher foreign tax credits capacity. However, financial assets' mobility and fungibility make related financial transactions the cheapest, most readily available, and most effective planning tool for this type of credit-generating technique.

Third, MNEs utilize capital fungibility to structure related financial transactions with favorable tax results. By controlling their internal financial structures, MNEs shift income to jurisdictions where they face low effective tax rates and deductions to jurisdictions where they face high effective tax rates. This problem is connected with MNEs' ability to avoid withholding taxes on these related financial transactions.

Finally, taxpayers evade tax by investing financial holdings in offshore centers without reporting earnings on these holdings to their residence jurisdictions. This problem connects directly to taxpayers' ability to avoid withholding source taxes on their portfolio investments and foreign bank account holdings. The following table

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formulating a related partnership that buys the exports (from the MNE) and sells them as inventory to consumers abroad, an MNE can improve on the 50/50 rule prescribed under the regulations of section 865.

<sup>45</sup> Once the relative amount of foreign-sourced income increases, there is also an increase in the foreign tax credit limitation determined by section 904 — so that MNEs can claim a larger amount of foreign tax credits overall.



provides a taxonomy of the aforementioned issues according to factors that will be significant in the article's subsequent analysis.

TABLE 1. TAXONOMY OF THE FOUR MAJOR PROBLEMS  
IN TAXING FINANCIAL INCOME

	Carries criminal liability?*	Primarily sourcing or residency tax issue?	Primarily associated with MNEs?
Deferral	No	Residency	Yes
Credit repatriation	No	Residency	Yes
Related transactions	No	Sourcing	Yes
Unreported income	Yes	Residency	No

\* This category deals with *per se* criminality. Nevertheless, some of the categories mentioned as not triggering criminal liabilities may be executed in an aggressive way recognized as a criminal violation of the tax law.

Of the four aforementioned problems, that of unreported income is somewhat confined by a number of factors. First, although MNEs may engage in tax evasion, the problem of evasion is not categorically related to MNEs. Second, the remedy — extensive multilateral information sharing — has been known from the very beginning of the IITR. This is not to suggest that implementing a multilateral information sharing policy is easy. It does suggest, however, that the major advancement on this issue is most likely to be made on political and technological levels rather than on an analytical level.<sup>46</sup> While this article refrains from addressing the tax evasion issue directly, it is

<sup>46</sup> See generally Cynthia Blum, *Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 FLA. TAX REV. 579, 598 (2004) (mentioning that tax havens with bank secrecy laws play an important role in concealing illegitimate transactions); G. Scott Dowling, *Fatal Broadside: The Demise of Caribbean Offshore Financial Confidentiality Post USA PATRIOT Act*, 17 TRANSNAT'L LAW 259, 285–93 (2004) (explaining how fear of being associated with terrorism motivates tax-havens to erode their bank secrecy laws); Suzanne Walsh, *Taxation of Cross-Border Interest Flows: The Promises and Failures of the European Union Approach*, 37 GEO. WASH. INT'L L. REV. 251 (2005) (arguing that there is a convergence of interests — ranging from money laundering and anti-terrorism to tax evasion — that motivates Western countries to obtain information about offshore financial centers); Bruce Zagaris, *Increasing Cooperation of International Tax Enforcement and Anti-Money-Laundering Enforcement*, 32 TAX NOTES INT'L 649, 659 (Nov. 17, 2003) (describing how major information sharing provisions were enacted as part of the PATRIOT Act).

important to connect its information sharing remedy with the remedies to the other three problems. As in the case of tax evasion, any attempt to counter the other three problems of taxing financial income would have to establish, as a prerequisite, a framework of cooperation between sovereigns. This cooperation should facilitate transparency with regard to financial holdings of the vast majority of international investors. Hence, while the problem of tax evasion could be separated analytically, from a practical perspective its solution intertwines with measures that the article offers to redress other issues identified in this section.

In the next part, the article analyzes important developments related to the problem of income shifting. In subsequent parts, the article offers its alternative proposal for dealing with the problem of income shifting. The article's analysis also discusses how its proposal redresses the other two problems this part identifies: deferral and excessive credit repatriation.

### III. PICKING UP THE GAUNTLET? THE RUDIMENTS OF AN ALLOCATION PHASE REGARDING FINANCIAL INCOME

#### A. *Stages in the Development of Interest Taxation*

This part addresses the descriptive claim of the article that there is a growing readiness among different policymakers to consider methods that depart from current IITR conventions for sourcing MNEs' interest and financial income. The article refers to this readiness as the possible emergence of an Allocation Phase. It is an expansion of the historical argument made in a previous article, which claims that the source tax base of capital income has been eroded because of considerations that focused too strongly on the importance of trade enhancement.<sup>47</sup> It further claims that after the Cold War, tax authorities developed a new anti-avoidance paradigm that tried to combat source tax erosion by distinguishing between legitimate and abusive tax planning. This paradigm has been unsuccessful in reversing or slowing down source erosion tendencies for two reasons. First, tax authorities lack a conceptual base through which they could determine coherently what the fair source-base allocation for inbound investments should be. Second, the methodologies developed by tax authorities to filter abusive transactions are ineffective because they are based on the arm's-length standard. The transactional emphasis of this standard necessitates a lot of *ad hoc*, fact-laden, case-specific

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<sup>47</sup> Benschalom, *supra* note 1.

inquiries with grave administrative (and compliance) costs.

This part traces a new tendency in the IITR's policy-making regarding the taxation of financial income. It surveys briefly the reformulation of the rules intended to combat thin-capitalization of MNEs' subsidiaries in high-tax jurisdictions. It labels this potentially new policy trend as the Allocation Phase, hoping that it represents the beginning of an emerging new sourcing paradigm in the IITR. The features of this phase reflect IITR policymakers' recognition that the main challenge and duty of the IITR is not to eliminate abusive transactions but to develop economically sound, administrable, and fair sourcing allocation methods of financial income. This part focuses on income shifting, which is considered a key issue because of the broad scope of abuse and the enormous compliance and administrative burdens it imposes.

*B. Earnings-Stripping/Thin-Capitalization Case Study:  
Some Winds of Change*

The issue of thin-capitalization (or earnings-stripping, as it is called in the United States) was addressed by the previously mentioned research as a case study for the inadequacies of the anti-avoidance paradigm.<sup>48</sup> It is, therefore, worthwhile to review briefly the distinctive features of the thin-capitalization problem as well as tax authorities' attempts to address it.

Relatively low (source) withholding taxes laid upon proceeds of debt transactions make the economics of those debt transactions lucrative every time there is a jurisdictional mismatch, in which the lender is a tax resident of a jurisdiction with lower tax rates than the debtor. This is a combination of two factors. First, the debtor is able to deduct the interest it pays from its otherwise highly-taxed income. Second, the lender is subject only to low (or nonexistent) withholding taxes (on the gross interest payments) on the source level and low income taxes (on its net taxable income) in its country of residence. From taxpayers' perspectives, this finance structure offers a lower (tax) cost for capital and is therefore superior to an equivalent domestic debt transaction (in which the lender is exposed to high income taxes) and to domestic and foreign equity investments.<sup>49</sup>

This reveals the *prima facie* appeal of related debt financing due

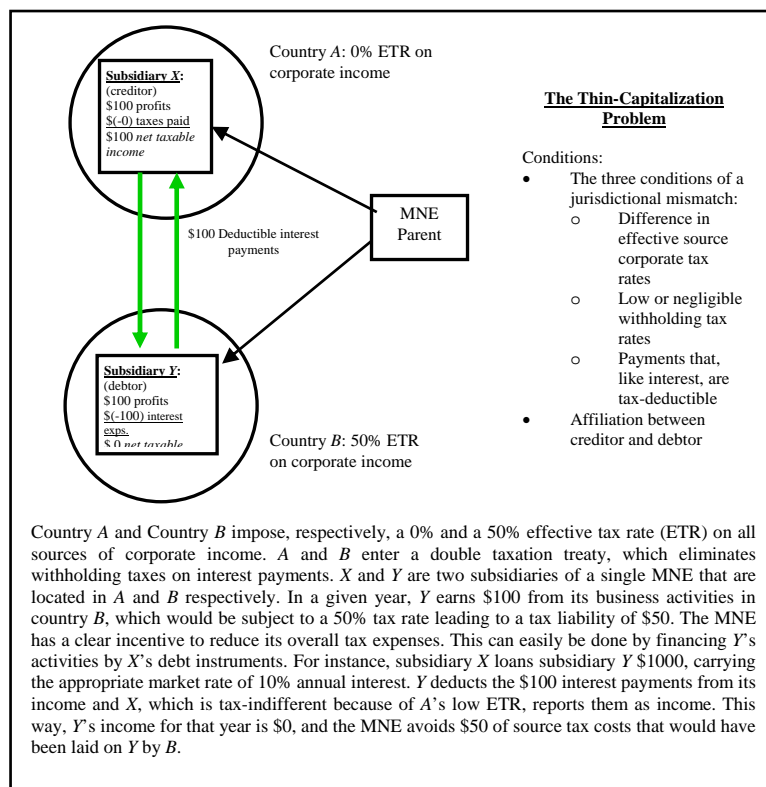
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<sup>48</sup> *Id.*

<sup>49</sup> In the case of equity investments, shareholder-investors bear at least some of the corporate tax burden and are exposed to higher income and/or withholding tax rates.

to potential jurisdictional mismatches between the locations where interest deductions and proceeds are recognized. By leveraging operations in high-tax jurisdictions and borrowing from low-taxed lenders, taxpayers may take advantage of interest expense deductibility and negligible withholding taxes on interest to reduce finance costs. This possibility is especially lucrative for MNEs, which can engage in related debt transactions to finance subsidiaries in high-tax jurisdictions while retaining corporate control. This loophole stands at the center of this subpart's analysis.

FIGURE 2. THE THIN-CAPITALIZATION TECHNIQUE<sup>50</sup>



Tax authorities have developed methods limiting different variations of this source tax avoidance scheme. These regimes typically involve some hypothetical inquiries as to whether unrelated parties would have entered into these types of financial transactions. In cases where it is determined that unrelated parties would not have entered into these transactions, the deduction of the interest payments is disallowed.<sup>51</sup> While the actual regimes differ substantially,<sup>52</sup> they all

<sup>50</sup> This figure was used in Benshalom, *supra* note 1, at 678.

<sup>51</sup> Sometimes these interest payments are re-characterized as returns on equity

suffer from the same fundamental problem. The arm's-length standard scalpels used by these regimes limit their ability to analyze the problem of thin-capitalization. As an analytical tool, the arm's-length standard is a useful pricing technique that compares related transactions to similar unrelated ones. It fails to provide a benchmark for what the correct legal form of a related financial transaction should be because there is no one "correct" form. Furthermore, as a normative matter, the arm's-length standard does not explain why related creditors should be subject to the same favorable tax consequences granted to unrelated creditors, when the former are not truly subject to the high risks, especially credit risks, faced by the latter.<sup>53</sup>

The prevalent feeling that there are overwhelming cases of tax abuse involving international transactions, along with the slim chance that the anti-avoidance paradigm will ever overcome its throes, have led some tax authorities to experiment with innovative anti-thin-capitalization regimes. Sailing to *terra incognita*, some of these experiments have abandoned traditional IITR arm's-length conventions. To avert the anti-avoidance pitfalls, these experiments sought to anchor their decisive factors on the cruder attributes of MNEs' financial structure.

A number of tax authorities have been willing to re-encapsulate their anti-thin-capitalization regimes while disregarding the fundamental cornerstones of the anti-avoidance approach, which distinguishes both between related and unrelated debt and between foreign and domestic debt. This section explores these experimentations briefly. The next section discusses whether they mark a new phase in the IITR's treatment of financial income.

### 1. The Attempt to Change the United States' Earnings-Stripping Regime

The discussion of the United States earnings-stripping regime surfaced in light of the relatively high number of tax-motivated corporate inversion transactions executed in 2002.<sup>54</sup> These

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and thus subjected to corporate tax and, possibly, to different withholding tax rates.

<sup>52</sup> Some rely on methods that emphasize the need for case-by-case inquiries; others rely on the corporate debt-equity ratios as benchmarks; yet others scrutinize shareholder debt-equity ratios. See Benschalom, *supra* note 1, at 683–85.

<sup>53</sup> *Id.* (developing this point in much more detail).

<sup>54</sup> See Mihir A. Desai & James R. Hines Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions* (Univ. of Mich. Ross

transactions involved a replacement of an American parent corporation with a foreign surrogate that was a resident of a tax haven. The ability of the foreign surrogate to engage in earnings-stripping by injecting related party debt into the former United States parent and its subsidiaries was perceived as one of corporations' long term tax savings from the inversion.<sup>55</sup> This provoked bipartisan political attempts to amend the United States earnings-stripping regime.<sup>56</sup> These attempts were eventually abandoned after encountering harsh opposition from taxpayers' lobbies.<sup>57</sup>

Of the various attempts to reform the United States earnings-stripping regime, the article focuses only upon one specific aspect of the Bush Administration's proposal. The Administration's proposal would have complemented the United States earnings-stripping regime with an innovative interest-disallowance rule, which was unrelated to the arm's-length inquiry. This disallowance rule would have been triggered every time a United States subsidiary was found to be "disproportionately leveraged" in comparison with the entire MNE group. Once triggered, the rule would have disallowed the deduction of certain interest payments that the United States

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Sch. of Bus. Office of Tax Policy Research, Working Paper Series No. 2002-04, June 2002), available at <http://www.bus.umich.edu/otpr/expatriationsubmission.pdf>; Hal Hicks III, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, 30 TAX NOTES INT'L 899 (June 2, 2003) (analyzing the main features of the 2002 inversion waves and stressing that, unlike inversions in earlier years, recent inversions are characterized by the willingness of shareholders to realize capital gain taxes to attain long term benefits of avoiding United States residency taxation); Carol P. Tello, *Inversion Transactions: New Style Transactions Raise New Policy Issues*, 43 TAX MGMT. MEMORANDUM 211 (2002) (providing a thorough description of inversion transactions and some of the means by which policy-makers sought to counter them).

<sup>55</sup> Hicks, *supra* note 54, at 907, 915-16; *Developments in the Law — Jobs and Borders*, 118 HARV. L. REV. 2171, 2278 (2005).

<sup>56</sup> STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., TECHNICAL EXPLANATION OF H.R. 2896, THE "AMERICAN JOBS CREATION ACT OF 2003", at 76-78 (Joint Comm. Print Aug. 13, 2003), available at <http://www.house.gov/jct/x-72-03.pdf>; Diana L. Wollman, *Recent U.S. Earning Stripping Proposals: Why Were the Doctors Called and Is the Medicine Worse than the Disease?*, 30 TAX NOTES INT'L 483, 494-96 (May 5, 2003) (describing the original "Thomas proposal," which included a disproportionate indebtedness test based on the worldwide leverage test).

<sup>57</sup> See Mikael Norman & Mark Russell, *Company Criticizes Earnings Stripping Provisions*, 2003 TNT 99-28 (Mar. 18, 2003); Organization for International Investment, *OFII White Paper on Related-Party Interest Payments*, 2003 TNT 154-53 (Apr. 7, 2003).

subsidiary made to related parties.<sup>58</sup> The notion behind this measure was that MNEs abuse the tax system even when they finance United States activities with unrelated debt while financing other operations in low-tax jurisdictions with equity investments. The underlying idea seemed to be that MNEs use the deductibility of interest payments to *unfairly* avoid the relatively high United States corporate tax rates on their source income.

Unrelated parties that enter a debt transaction do not compare a subsidiary's level of leverage with that of the entire MNE group. Hence, the Administration's proposal anchored the abusiveness of its disallowance rule to the notion of MNE managements' control over their entire pools of financial assets. This rule encapsulates the idea that it is unfair for MNEs to disproportionately debt finance their United States operations and deduct interest to reduce their United States source income tax liabilities.

This article deviates from the general line of criticism against the Administration's proposal.<sup>59</sup> It argues that the Administration's proposal was too limited because, even though it adopted a *disproportional leverage test*, it resulted only in disallowing the deduction of *interest payments made to related parties*. This combination is inconsistent. The disproportional leverage test added by the Administration's proposal was innovative and challenging precisely because it had nothing to do with related party transactions. Therefore, it should not have been limited to disallowing only the deduction of interest payments to related parties. Derivatively, the new disallowance rule would have entailed enormous compliance, Administration, and short term transition costs in return for a relatively modest yield of expected revenues. The lesson is that, since

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<sup>58</sup> The disallowed interest was intended to be only the proportional amount of related debt that would have been extracted from the disproportional leverage.

<sup>59</sup> As many of its critics noted, the proposal involved a massive increase in tax compliance costs. Additionally, some of its critics suggested that its deviation from the arm's-length standard discriminated against foreign MNEs. This concern was partly justified because the new disallowance rule took into account only gross interest payments of the United States subsidiaries when determining their disallowance. This may have led to severe disallowance of interest expenses even in fiscal years when taxpayers had a positive net interest income (this concern was valid mainly with regard to the financial sector). These commentators further claimed that this type of discrimination overrides United States anti-discrimination obligation under various DTTs. See Harry L. Gutman et al., *KPMG Urges Reconsideration of Proposals Regarding Earnings-Stripping Provision*, 2003 TNT 83-13 (May 1, 2003); Lawrence R. Uhlick, *Banking Group Discusses Earnings Stripping Proposal*, 2003 TNT 59-33 (Feb. 14, 2003).

the reformulations of IITR conventions are costly, tax reformers should aspire to turn the tide rather than to do things in halves.

## 2. Australia and New Zealand's Anti-Thin-Capitalization Legislation

New Zealand enacted its unique anti-thin-capitalization legislation in 1996. In doing so, it was aware of the multiple forms in which earnings-stripping may take place, as well as the difficulty of separating transactions motivated by tax avoidance from "legitimate" commercial ones. Accordingly, while restricted to deal with subsidiaries of foreign investors, it was not restricted to examine related debt exclusively.<sup>60</sup> Rather, under the New Zealand thin-capitalization rules, the interest deduction disallowance is triggered when a subsidiary debt-asset ratio exceeds 3:4 and its indebtedness is greater than 110% of the MNE's overall indebtedness.<sup>61</sup> The overwhelming majority of companies avoid the compliance hurdles of the thin-capitalization regime by meeting the debt-asset ratio.<sup>62</sup>

In 2001, as part of a general revision of its income taxation of business enterprises, Australia reformulated its anti-thin-capitalization legislation along the general lines of the New Zealand thin-capitalization rules.<sup>63</sup> Interestingly, the Australian Treasury

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<sup>60</sup> Andrew M. C. Smith, *New Zealand's Thin Capitalization Rules*, 44 CAN. TAX J. 1525, 1525 (1996).

<sup>61</sup> Grant Richardson et al., *Thin Capitalization Rules: An Anglo-American Comparison*, 24 INT'L TAX J. 36, 48 (1998). Taxpayers are granted great flexibility in choosing the manner by which this comparative indebtedness is calculated. Smith, *supra* note 60, at 1540.

<sup>62</sup> Richardson, *supra* note 61, at 50 (arguing that more than anything, New Zealand's thin-capitalization regime was intended to convey a clear message to MNEs not to exceed the debt-asset ratio); Andrew M. C. Smith & Paul V. Dunmore, *New Zealand's Thin Capitalization Rules and the Arm's-Length Principle*, 57 BULL. INT'L FISCAL DOCUMENTATION 503, 510 (2003) (mentioning that, even before the thin-capitalization legislation was enacted, most nonresident companies would not have fallen within its ambit); Smith, *supra* note 60, at 1547.

<sup>63</sup> The Australian legislation had a few exceptions. First, it provided a more lenient ratio for financial institutions. Second, it covered parent corporations of Australian MNEs, which were exempt under the former anti-thin-capitalization legislation. REVIEW OF BUSINESS TAXATION, A TAX SYSTEM REDESIGNED 664 (1999), available at [http://www.rbt.treasury.gov.au/publications/paper4/download/Section22\\_P.pdf](http://www.rbt.treasury.gov.au/publications/paper4/download/Section22_P.pdf) (mentioning that the reason to include parent corporations of Australian MNEs was motivated by the belief that those corporations could allocate disproportionately excessive debt to their Australian operations). Finally, it provided relief to taxpayers who could prove that their financial transactions would have been undertaken by unrelated parties operating at arm's-length. See generally Michael Wachtel,



justified the reform by claiming that former thin-capitalization rules, which scrutinized related foreign debt through arm's-length lenses, were unable to deal with problems associated with the major issue of disproportionate leverage.<sup>64</sup>

### 3. The European Experience with Member States' Anti-Thin-Capitalization Legislation

In the EU context, the attempt to limit the deduction of interest payments to related parties presents an oddity. It runs against the Commission's directives that limit source taxation by prohibiting withholding taxes on related dividend, interest, and royalty payments between related parties that are residents of Member States.<sup>65</sup> Member States' anti-thin-capitalization regimes clash with the EU's broader objective to reduce tax costs on financial flows in the internal market. Thus, thin-capitalization rules aim to prevent the deduction of the same interest payments that were exempt from withholding taxes by the directives.

The most important development on this issue is the verdict issued by the European Court of Justice (ECJ) in *Lankhorst-Hohorst GmbH*.<sup>66</sup> The ECJ found that the German anti-thin-capitalization legislation infringed upon the Rome Treaty's Freedom of Establishment Clause and found no persuasive argument why, in the case of thin-capitalization, Germany should be exempted from the clause's general application.<sup>67</sup> In its decision, the ECJ seemed to have

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*Australia's New Thin Capitalization Regime*, 55 BULL. INT'L FISCAL DOCUMENTATION 380, 381, 387 (2003).

<sup>64</sup> See generally REVIEW OF BUSINESS TAXATION, *supra* note 63, at 659 ("Australia's current thin capitalization provisions are not fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals because they refer only to foreign related party debt and foreign debt covered by a formal guarantee rather than total debt.").

<sup>65</sup> Council Directive 90/435/EEC, 1990 O.J. (L 225) (EC); Council Directive 2003/49/EC, 2003 O.J. (L 157) (EU). The objective of thin-capitalization legislation — to differentiate between domestic and foreign investment — may also seem inconsistent with the EU's kingpins of (free-trade related) free flow of capital and freedom-of-establishment rights. See generally Markus Ernst, *Toward a Level Playing Field for Thin Capitalization: German and U.S. Approaches*, 43 TAX NOTES INT'L 657, 659, 661 (Aug. 21, 2006) (discussing the European Court of Justice's *Lankhorst-Hohorst GmbH* decision).

<sup>66</sup> Case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, 2002 E.C.R. I-11779.

<sup>67</sup> Alex Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on Lankhorst-Hohorst*

conveyed a clear message to the EU's national legislators that thin-capitalization cannot automatically be equated with tax avoidance.<sup>68</sup> To comply with the ECJ's ruling, Germany has extended the application of its thin-capitalization rules to all corporate entities and to their debts — including to creditors that are tax residents of Germany (where there is no concern of jurisdictional mismatch problems).<sup>69</sup> Recently, United Kingdom tax authorities proposed changing their thin-capitalization rules along these lines.<sup>70</sup>

### *C. The OECD and the Allocation of Profits for Branches of Financial Institutions*

Thin-capitalization is not the only example that suggests that policymakers around the world recognize that the arm's-length standard is impractical in sourcing financial activities and preventing income shifting. As elaborated upon in Part V.A, this difficulty materializes at its extreme with respect to FMNEs (MNEs that are financial intermediaries). Since FMNEs engage primarily in financial transactions, tax authorities cannot break down their activities using arm's-length methodologies. Consequently, the OECD recognized that the issue of allocating income from FMNE-affiliated transactions

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GmbH, 43 EUR. TAX'N 102, 111–12 (2003); Lars-Erik Wenehed, *Thin Capitalization and EC Law*, 30 TAX NOTES INT'L 1145, 1146 (June 16, 2003) (noting that “[a]ccording to the ECJ, the German thin-capitalization legislation does not have a specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation, from attracting a tax benefit, but applies generally to any situation in which the parent company is resident outside Germany.”).

<sup>68</sup> Adam Craig et al., *ECJ Renders Wide-Reaching Decision on German Thin Capitalization Rules*, WORLDWIDE TAX DAILY 2002 WTD 240-2 (Dec. 13, 2002). This broad interpretation of the Freedom-of-Establishment Clause places former German anti-thin-capitalization legislation and similar Member State legislation in question. *Id.*; see Oliver Roumelian, *The End of French Thin Capitalization Rules?*, 31 INTERTAX 244, 246–47 (2003). For a more general discussion of the impact of the ECJ's anti-discrimination tax jurisprudence, see Michael J. Graetz & Alvin C. Warren Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186 (2006).

<sup>69</sup> Ernst, *supra* note 65, at 661; see Rolf Schonbrodt & Uwe Woywode, *Treatment of Secured Unrelated-Party Loans Under German Thin Capitalization Rules*, 38 TAX NOTES INT'L 145 (Apr. 11, 2005) (describing how the thin-capitalization legislation, specifically Section 8aKStG, was expanded to both resident and nonresident shareholders, related parties, third party lenders, and debtor companies as of 2004).

<sup>70</sup> HM TREASURY, TAXATION OF COMPANIES' FOREIGN PROFITS: DISCUSSION DOCUMENT 19 (2007), available at [http://www.hm-treasury.go.uk/media/E/9/consult\\_foreign\\_profits020707.pdf](http://www.hm-treasury.go.uk/media/E/9/consult_foreign_profits020707.pdf).

could not be left in its currently incoherent and arbitrary state.

In 1998, the OECD issued a report addressing the sourcing of FMNEs engaged in global trading of securities and financial instruments.<sup>71</sup> In that report, the OECD recognizes the difficulty of applying traditional arm's-length methods that depend on the existence of market comparables to affiliated transactions within functionally integrated FMNEs.<sup>72</sup> In particular, the 1998 OECD Report identifies the problems associated with sourcing the residual income from FMNEs, which is the income generated from the cost savings associated with the integrated structure of FMNEs. Additionally, it recognizes the difficulty of pricing accurately and coherently the growing volume of FMNE-affiliated transactions.<sup>73</sup> Despite these observations, the 1998 OECD Report clings to the traditional transactional transfer-pricing methods and restrains tax authorities' ability to use profit-allocation methods.<sup>74</sup> Much in line with the ideas expressed in the 1998 OECD Report, the United States Treasury issued the proposed dealing regulations concerned with taxing FMNEs engaged in securities dealing.<sup>75</sup>

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<sup>71</sup> The OECD Report begins by defining entities engaged in "global trading" as those who have "the capacity . . . to execute customers' orders in financial products [and sometimes to manage their own proprietary portfolios] in markets around the world and/or around the clock." ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT [OECD], THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS 12 (Mar. 4, 1998). The OECD Report further elaborates on three different models by which FMNEs may conduct their trading operations: (1) integrated trading, in which an FMNE has a single trading book passed between different locations; (2) centralized product management, in which an FMNE assigns all market risks for a particular line of products to a specific location while allowing the marketing of that asset to take place also in other locations; and (3) separate enterprise trading, in which each branch and entity within an FMNE has its own trading and proprietary books. *Id.* at 19–20.

<sup>72</sup> *Id.* at 29–30.

<sup>73</sup> *Id.* at 42.

<sup>74</sup> The OECD report stresses that the profit-split method, the only method that allocates income by net profits and is not based on market comparables, is to be used only as an option of last resort. *Id.* at 53–56. It distinguishes between two types of profit-splits: net profit-split and residual profit-split. *Id.* at 43 (providing that, while under the net profit-split the entire profit will be allocated by the profit-split formula, the residual profit-split method will first reward less integrated functions according to transactional transfer-pricing methodologies).

<sup>75</sup> The Proposed Dealing Regulations (Proposed Regulations) set out to resolve a number of features (e.g., the broad definition of effectively connected income and the nonrecognition of transactions with foreign branches), but most of them were not directly related to the dilemma of whether an arm's-length standard is a suitable mechanism for sourcing these transactions. The Proposed Regulations apply four

The 1998 OECD Report was followed by a series of reports that dealt with the attribution of profits to branches. Unlike other types of MNEs, FMNEs operate through branches rather than subsidiaries for better compliance with financial regulations.<sup>76</sup> Accordingly, in 2006, the OECD issued another report (the Report), which contained a general part and two parts that address banking and financial instrument trading.<sup>77</sup> The final version of the fourth (and last) part of the Report, dealing with the insurance sector, is scheduled to be published soon.

No new canon emerged from the Report. Its working hypothesis is that branches should be treated as if they were functionally separate entities. This, by and large, aligns with traditional arm's-length inquiries as to how to isolate branches as if they were entities and how to price branch dealings, both with the parent company and with other branches. Derivatively, it engages in a lot of arm's-length inquiries as

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transfer-pricing methodologies and adhere to the best-method rule. Prop. Treas. Reg. § 1.482-8(a)(1), 63 Fed Reg. 11177 (Mar. 6, 1998). The first three methods are not fundamentally different from traditional arm's-length transfer-pricing methods. See Prop. Treas. Reg. § 1.482-8(b)-(d), 63 Fed Reg. 11177 (Mar. 6, 1998). The fourth method is an elaborated profit-split allocation methodology, which contains examples specifically tailored to various dealing operations. It prescribes that the net income of the activity should be attributed to each jurisdiction according to the contribution of each branch/entity. Prop. Treas. Reg. § 1.482-8(e), 63 Fed Reg. 11177 (Mar. 6, 1998). The term "contribution" is not defined in the Proposed Regulations and is therefore to be determined on a case-by-case basis. Prop. Treas. Reg. § 1.482-8(e)(3), 63 Fed Reg. 11177 (Mar. 6, 1998). It also suggests a residual profit-split method, which requires that routine contributions be compensated under ordinary transactional transfer-pricing methods prior to the formulary allocation of net profits among participants. Unlike other expenses, interest expenses are sourced through an asset-based formula to be attributed against foreign income, as prescribed by Code section 864(e) and the relevant regulations.

<sup>76</sup> Most MNEs do not operate through branches (unless they have losses) because operating through subsidiaries provides them with limited liability, tax deferral, and foreign credit planning opportunities. On the other hand, FMNEs tend to operate through branches because of the capital adequacy requirements of financial regulation (CARs). These regulations require that a financial institution have a minimal amount of equity capital to support its operation in order to reduce financial institutions' incentives to over-leverage their operations. The CARs reduce financial instability and the chances of systemic collapse. To arrange their assets flexibly, an FMNE typically operates as one legal entity so that its equity supports its worldwide operations.

<sup>77</sup> OECD, REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS PARTS I (GENERAL CONSIDERATIONS), II (BANKS) AND III (GLOBAL TRADING) (2006), available at <http://www.oecd.org/dataoecd/55/14/37861293.pdf>.

to how to determine the branch's risk exposure, creditworthiness, and freestanding capital.

However, while adhering to "old" arm's-length rhetoric, the OECD inserted two somewhat subversive notions in the Report, which erode the arm's-length paradigm. First, the Report states that tax authorities should allocate functions to FMNE branches according to the "significant people" operating in each branch.<sup>78</sup> Second, the Report ties the first step and the attribution of income generating assets to the branches. The combination of these two steps highlights the importance of allocating functions to a branch according to its "significant people" in determining the income allocated to it. It further mentions that this asset allocation would reflect the relative share of each branch in overall FMNE income.<sup>79</sup> From this emerges an innovative idea that deviates from the arm's-length standard. It suggests that income should be allocated according to the functions that people in different branches perform, and not according to risk shifting contractual settings that unrelated parties may have endorsed. However, after introducing this idea, the Report retreats. It states that once functions and assets have been identified, the internal dealings among the branches should be sourced according to old transfer-pricing methods — cumbersome and futile as they have proven to be.

To date, it is difficult to assess the impact of the Report on future sourcing of FMNEs. The Report leaves taxpayers and sovereigns much flexibility and discretion in implementing the rules. Hence, it is difficult to know which idea will leave its mark: the old rhetoric or the new allocation-by-significant-people method. Nevertheless, the Report shows that the OECD clings to its "better the devil we know" transfer-pricing policy by rejecting any serious evaluation of comprehensive unitary or formulary solutions. It is doubtful that OECD officials believed it feasible to break down the enormous volumes of affiliated transactions within FMNEs on a transactional basis.<sup>80</sup> This adherence to the status quo could be explained by the OECD's tendency to exercise political caution as a response to the strong opposition of the financial sector to any mandatory unitary (or profit-splitting) allocation mechanisms.<sup>81</sup> Nevertheless, even though

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<sup>78</sup> *Id.* at 14–15.

<sup>79</sup> *Id.*

<sup>80</sup> Lee A. Sheppard, *Gremlins in the Global U.S. Dealing Regulations*, 25 TAX NOTES INT'L 431, 434 (Feb. 4, 2002).

<sup>81</sup> American Bankers Association, *American Bankers Association Comments on Discussion Draft on the Taxation of Global Trading of Financial Instruments*, 14 TAX NOTES INT'L 2011 (June 16, 1997) (stressing the importance of respecting the form of

the OECD initiatives avoid any serious consideration of the arm's-length standard, they also promote the notion that allocation of financial income requires a broad-reaching and practical solution in the *near future*. Even though not explicitly stated, it is also evident that this solution is not to be found in traditional arm's-length standard inquiries.

#### *D. Allocation Phase: Some Final Remarks*

The Allocation Phase is in the initial stages of taking form. Nevertheless, the development in thin-capitalization and branch allocation rules reviewed by this part reflects the recognition that the problem of sourcing financial income may not be solved on the quicksand of the *ad hoc* arm's-length standard approach. Furthermore, the thin-capitalization example suggests that the different sourcing problems associated with MNEs' financial structures (e.g., affiliated lending and disproportional leverage) cannot be insulated from one another.

While the problems of the arm's-length approach are not confined to the taxation of financial income, this article explores whether the allocation of financial income within related settings could be addressed separately. Policymakers' growing recognition that MNEs' manipulation of financial assets is a major source of abuse motivates the article's agenda. Its analysis offers a comprehensive multi-layered reform of this specific issue and hopes to contribute to a reform process that may occur in the foreseeable future.

### IV. FRAMING THE PROBLEM: WHY ARE FINANCIAL TRANSACTIONS SPECIAL?

#### *A. The Unique Characteristics of Mobility and Fungibility*

Financial transactions are unique in practice but not in theory. In theory, almost every type of tax reduction plan that uses affiliated financial transactions could be executed via other types of affiliated transactions. For example, MNEs can strip income through leasing transactions; they can shift income by inflating prices and risks associated with non-financial affiliated transactions.

In practice, however, a few unique features make the sourcing of

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the transactions themselves, and objecting to the emphasis of the OECD Paper on the factor of human capital, which, as discussed later, is a classical unitary factor for the purpose of profit-split allocation).

financial transactions the spinal column of many tax planning transactions: their mobility, their fungibility, and the tax-sensitivity of financial markets.

With the exception of intangibles, a topic this author addressed in a different paper,<sup>82</sup> financial assets are the most mobile assets. They are costless to deploy and store and therefore could be utilized from almost any jurisdiction with stable political, monetary, and financial regulatory regimes. Furthermore, financial assets are used by every type of business and are executed through sophisticated and tax-efficient financial markets.<sup>83</sup> Professionals operating in financial markets have developed tax planning cultures, where they market their expertise to create products that attain tax planning objectives as an inherent part of their services.

As described in Part II.B, the fungibility of financial assets nullifies tax authorities' attempt to determine the appropriate price for financial transactions. Taxpayers can hybridize, bifurcate, and synthesize similar financial flows in numerous ways to attain the most tax-efficient results. The business integration of many MNEs hedges contractual risk shifting by affiliated financial transactions. Unlike unrelated parties, between which the consequences of risk shifting through financial engineering may be vital,<sup>84</sup> and therefore costly, MNEs may inflate the price of certain transactions, knowing that the risk borne by them would not change as a whole. With few exceptions,<sup>85</sup> MNEs bear *no substantial* economic costs of structuring their internal financial flows one way or the other. Tax authorities do not have the resources to audit the increasing volumes of affiliated financial transactions because the arm's-length standard requires them to find the proper market comparables of specifically tailored financial flows.

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<sup>82</sup> Ilan Benschalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631 (2007).

<sup>83</sup> In this environment, professionals specialize in designing the most tax-favorable instruments for different taxpayers — often through the use of financial intermediaries and taxpayers with low (or no) tax-sensitivity (e.g., tax-exempt foreign residents or Marked-to-Market taxpayers).

<sup>84</sup> For example, when parties construct equity derivatives, those derivatives typically face different credit risks and different rights in insolvency, and do not entail shareholder voting power. These different features affect the risk and price that parties undertake when buying these derivatives as opposed to equity derivatives.

<sup>85</sup> For example, consider cases of insolvency and cases where the subsidiaries have to comply with debt-equity regulations (such as the CAR regulations in the financial sector).

To summarize this point, for MNEs, affiliated financial instruments are the ultimate tax planning device. They could be used by entities at any place operating in any line of business. The engineering possibilities are endless, their economic and audit risks exposure is negligible, and the tax planning expertise for these transactions is readily available. As a result, MNEs can manipulate the sourcing of income derived from affiliated financial transactions and use them, almost freely, for stripping and deferring income as well as for generating foreign tax credits. What could possibly be better?

### *B. Framing the Solution*

The solution advocated by this article challenges the traditional convention, which regards the two methods by which MNEs' affiliated transactions are sourced: the arm's-length standard and the unitary/formulary methods, as almost mutually exclusive.<sup>86</sup> The article argues that tax authorities should source MNEs using both arm's-length and formulary methods. Arm's-length methods adequately source most MNE non-financial affiliated transactions, which have market comparables; therefore, tax authorities have a legitimate interest in continuing to use them for these types of transactions. However, because of their unique features, affiliated financial transactions should instead be sourced through unitary or formulary sourcing conventions.

Under unitary methods, an MNE's total taxable income is aggregated and then sourced by an allocation formula among the jurisdictions in which it operates. Formulary methods allocate income in a similar way, although they do not aggregate MNEs' entire income, but only income derived from specific sources. While the mechanics of the unitary and formulary arrangements are described in the following parts, the evaluation of the article's analysis requires elucidating the normative framework of the unitary/formulary alternative beforehand. The article justifies the shift from arm's-length to formulary methods due to the following four reasons.

First, the unitary sourcing method taxes income on a territorial rather than on a worldwide basis. After the entire income of an MNE is aggregated, it is allocated to the different jurisdictions where it is

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<sup>86</sup> The binary distinction between these two alternatives favors the status quo, in which the arm's-length standard is used. While there is consensus about the deficiencies of the arm's-length standard, the impracticality of a multilateral or unilateral implementation of a unitary system garners even more consensus.



taxed once.<sup>87</sup> Any shift to a formulary sourcing arrangement strengthens the concept of source over residency taxation. This shift toward a more territorial system merits discussion. As the author has written elsewhere,<sup>88</sup> scholars and politicians still debate whether income tax should be imposed on a worldwide or territorial basis. However, from a realist political perspective, it seems as though the issue has already been resolved in the United States in favor of territorialism. The recent ITR tax reform proposal of the Bush Administration emphasized the shift to a simpler territorial dividend exemption tax regime to increase revenues and competitiveness for United States businesses. This aligns well with other recent years' Code amendments that erode residency taxation.<sup>89</sup> Although there have also been some recent proposals to reduce deferral and expand worldwide taxation,<sup>90</sup> these proposals suffer from low political viability because they go against sovereigns' growing tendency to erode residency taxation. Thus, even if the United States had the political will, it might not succeed in changing the international current. Unless the United States can swim against this current by itself, it seems likely that the present United States ITR will be replaced with a much more territorial tax regime. Nonetheless, there is no guarantee that such a reform will take place in the near future. This article does not directly address whether there is a normative justification for taxing foreign sourced income through a residual residence tax. However, the low political viability of the residual worldwide tax, along with its extremely low revenue yields, lead the article to conclude that it is worthwhile to start thinking about how a viable territorial sourcing regime should operate. The article's formulary methods offer a viable and more territorial alternative to the current tax regime that resonates well with contemporary political currents.

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<sup>87</sup> Even though all unitary systems operating today are territorial, a unitary method does not have to be purely territorial. Theoretically, the allocation formula can also account for factors that indicate corporate residency such as the location of headquarters or place of incorporation.

<sup>88</sup> Benschalom, *supra* note 82, at 633–34.

<sup>89</sup> Robert J. Peroni et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 492 (1999) (claiming that, since 1996, the subpart F anti-deferral regime provides taxpayers with an ever-expanding deferral privilege); see I.R.C. §§ 954(c)(6), 965; see also I.R.C. § 904(d)(1) (eliminating, as of 2007, the eight-basket system in favor of a two-basket system that allows much more cross-crediting, which will reduce the actual taxes levied from residents' foreign income).

<sup>90</sup> Reuven Avi-Yonah, *The Ingenious Kerry Tax Plan*, 103 TAX NOTES 477 (Apr. 26, 2004) (describing the Kerry plan to curb deferral).

Second, the current ITR treatment of affiliated financial transactions is broken beyond repair. In fact, the arm's-length standard is so inept at dealing with these transactions that tax authorities already employ quasi-unitary alternatives. One alternative used frequently is the profit-split transfer-pricing method. Tax authorities use this method to bifurcate the income of functionally integrated MNEs. It requires the different MNE entities to split the total income derived from an activity according to each party's contribution. It aggregates the income derived from the activity and then divides this aggregated figure among the relevant parties. This is very different from the traditional arm's-length inquiry, which hypothesizes how unrelated parties would price the transaction. Compliance with this nontransparent case-by-case formulary allocation mechanism is costly for both taxpayers and tax authorities because it is amorphous as a matter of policy design. It depends on documentation and fact-finding requirements. It is also biased in favor of taxpayers, given tax authorities' inferior information and lack of audit and litigation resources. Furthermore, the particularity of the profit-split analysis, as well as taxpayers' ability to partially control whether and how to apply it, render it difficult to generate any general principles out of it. As mentioned earlier, the OECD also deviates from the arm's-length standard in its discussion of the branch allocation rules.<sup>91</sup>

Tax authorities have *de facto* abandoned traditional arm's-length standard methods with regard to the hard-to-source income generating activities of MNEs.<sup>92</sup> Hence, they have a lot to gain and little to lose by making this explicit and shifting to formulary allocation. A unitary proposal would use general, transparent, hard-to-manipulate and easy-to-observe indicators to determine the relative volume of an MNE's activities in each jurisdiction in which it operates. It would reduce taxpayers' ability to shift income as well as the compliance costs of transfer-pricing. To be sure, unitary arrangements are not free from compliance costs, tax reduction possibilities, or investment distortions. However, *compared to the current transfer-pricing regime*, the formulary arrangements proposed by this article provide equitable and coherent sourcing arrangements with low compliance costs.

Third, the unitary system incentivizes MNEs to utilize their

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<sup>91</sup> See OECD, *supra* note 79 and accompanying text.

<sup>92</sup> For example, the proposed dealing regulations emphasize the use of the profit-split method. Prop. Treas. Reg. § 1.482-8(e), 63 Fed. Reg. 11177 (Mar. 6, 1998).

resources flexibly and in a centralized and efficient manner. Formulary allocation methods allocate MNEs' income by relying on hard-to-manipulate indicators tied to specific geographic locations. If MNEs cannot escape the taxes on their financial activities by sheltering them in low-tax jurisdictions or by avoiding repatriating funds, they are free to utilize their assets efficiently without taking tax considerations into account. Thus, once fiscal ownership is fixed, MNEs would be able to utilize their financial assets in a centralized (tax-indifferent) manner. A difficult-to-manipulate and easy-to-comply-with unitary regime would thus reduce both compliance costs and post-investment tax distortions. This article does not participate in what is essentially a political debate over the proper effective tax rate that should be imposed on income derived from financial activities and financial assets. It does, however, suggest that the proper way sovereigns should determine MNEs' effective tax burden is by instituting tax-rate adjustments and not by creating blemish source rules that erode the MNE tax base.

Fourth, unitary systems disregard affiliated transactions. In the context of affiliated financial transactions, this feature of the unitary formula means that financial transactions could not be used in MNEs' tax planning schemes. As established in the previous section, this will not prevent MNEs from engaging in intra-group tax planning, but it will deprive them of the most useful tool for doing so. The shift to a unitary system has important positive externalities beyond the prevention of income shifting. This shift would make many of the current schemes, which rely on affiliated financial transactions, less available, less effective, and more costly so that they are not as lucrative for MNEs to pursue.

This article's argument that tax authorities should source affiliated financial transactions through formulary rather than arm's-length methods depends primarily on one key issue: the nature of the allocation formula. This formula should strike a careful balance between concerns about audit accuracy, anti-abuse, and tax administration. There is an inevitable tension between concerns of tax administration, which require simplicity of rules, and concerns of audit accuracy, which require adjustability and particularity. Anti-abuse concerns sometimes require broad and simplified rules to prevent an array of potential abuses. On other occasions, they require adjustability so as to counter innovative tax planning schemes. The following parts' analysis explores this tension in great detail. When exploring the outstanding issues through which this balance comes to the fore, this article adheres to the following framework. First, it

identifies the most accurate way to conduct the audit. Second, it makes a number of assumptions as to how the specific aspects of the formula should be modified to be reasonably administrated. Third, it tries to examine the impact of simplification through anti-avoidance lenses and makes the proper adjustments. Finally, it examines whether the overall solution it recommends produces intuitively correct allocation results.

### *C. The Unitary Alternative to the Arm's-Length Standard*

The unitary system comprises two separate steps. The first is an income calculation step. In the unitary system, income is calculated jointly for an entire MNE and not separately for each of its branches and entities. To calculate their income, MNEs' tax filings include a consolidated report of their entire earnings rather than separate reports for each of their entities. This consolidated reporting effectively disregards affiliated transactions. After MNEs' income is calculated comes the second income allocation step. Here, MNEs' income is distributed among the different jurisdictions in which they operate according to an appropriation formula. This formula adopts what may seem to be easy-to-observe and difficult-to-manipulate factors (e.g., the amount of sales, payroll, and assets) as indicators of the relative share of MNEs' economic activity taking place in each jurisdiction.<sup>93</sup> Unitary systems do not prescribe identical tax rates among different jurisdictions.<sup>94</sup>

The underlying core idea of the unitary system is that there is no one magic metric that penetrates the opaque process through which MNEs generate their profitability. This opaqueness prescribes that factors of the appropriation formula represent policy choices about how to allocate tax rather than precise economic indicators of how MNEs generate income. Unlike the arm's-length standard, which tries to source according to market benchmarks (of what unrelated parties would do), the unitary sourcing regime aspires to tax MNEs' income only in near approximation. Tax authorities' formulary determinations of the proportional contribution of different factors to

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<sup>93</sup> Christina M. Lyons, *The Constitutionality of the Worldwide Combined Reporting Method of Taxation of Multinational Corporations: Barclays Bank v. Franchise Tax Board*, 37 B.C. L. REV. 183, 187–88 (1995).

<sup>94</sup> See Peggy B. Musgrave, *Sovereignty, Entitlement, and Cooperation in International Taxation*, 26 BROOK. J. INT'L L. 1335, 1344–46 (2001) (arguing for an agreed-upon rate range to reduce incentives for source tax competition between jurisdictions).

MNEs' profitability are by definition arbitrary. Furthermore, unitary system sourcing is a crude averaging mechanism, disregarding the different risk propensities and other distinctive circumstances of various MNE investments.<sup>95</sup> For example, under a unitary system it is impossible for a profitable MNE to recognize loss in a specific jurisdiction no matter how bad its performance is in that jurisdiction.

The most conceptually intriguing issue in the policy design of a unitary system is the composition of the formula. To avoid the daunting problems of the arm's-length standard, the formulary factors should be connected to immobile indicators of economic activity. As previously mentioned, these factors may only serve as proxies for the economic activity being taxed.<sup>96</sup> Further, as with any tax assessment criteria, the identification of formulary factors provides taxpayers with the incentives to manipulate the indicators to minimize tax liability.<sup>97</sup>

In the case of financial income, it is difficult to identify easy-to-observe and difficult-to-manipulate formulary indicators that correlate with the conduct of economic activity. Indeed, the system employed by the United States — a federal nation — to allocate corporate income to different state governments refrains from including financial income as part of the unitary tax base.<sup>98</sup> This article argues that this approach is wrong. Its main thesis is that the unitary system would be most effective if employed to source hard-to-locate financial activities.

Policymakers and academics often suggest formulary factors that fail to meet the above-mentioned goals with regard to financial income. For instance, FMNEs can easily manipulate one of the most frequently mentioned formulary factors: sales.<sup>99</sup> Because financial

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<sup>95</sup> Robert Ackerman & Elizabeth Chovrat, *Modern Financial Theory and Transfer-Pricing*, 10 GEO. MASON L. REV. 637, 655–56 (2002).

<sup>96</sup> See generally Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1349 (1996) (arguing that from a tax perspective the jurisdiction of incorporation is a meaningless distinction).

<sup>97</sup> See Jack M. Mintz, *Globalizing the Corporate Income Tax: The Use of Allocation*, 56 FINANZARCHIV 388, 414–18 (1999).

<sup>98</sup> UNIF. DIVISION OF INCOME FOR TAX PURPOSES ACT § 7 (1956); Walter Hellerstein & Charles E. McLure, Jr., *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States*, 11 INT'L TAX AND PUB. FIN. 199, 202 (2004).

<sup>99</sup> Kimberly A. Clausing & Reuven S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* 14, 20 (The Brookings Inst., The Hamilton Project, Discussion Paper No. 2007-08, 2007); see Charles E. McLure, *Replacing Separate Entity Accounting and the Arm's Length Standard with Formulary Apportionment*, 56 BULL. INT'L FISCAL DOCUMENTATION

assets are mobile, sale transactions may be executed legally from any of the locations in which a given FMNE is operating. A formulary allocation method relying on sales would provide taxpayers with incentives to finalize deals in tax havens. Tax authorities would find it practically impossible to track where the economic sale of each transaction occurred. This analysis has one important exception: retail (lending and financial) services to individuals. It is relatively easy to observe the location of retail transactions because the vast majority of individuals borrow, lend, and consume financial services where they live. This is very different from corporations, which can create subsidiaries anywhere without incurring substantial costs.<sup>100</sup> Derivatively, when FMNEs contract with individuals, it is easy to determine the geographic location of the sale. Audit accuracy, with regard to income generated through FMNE retail activities, requires that sales be part of the allocation formula. This way the formula would reflect the geographic allocation of MNEs' consumer-based intangibles in different jurisdictions.<sup>101</sup> The problem with this approach is that it requires taxpayers and tax authorities to bifurcate FMNEs' total income into the portion generated from individuals and the portion generated from businesses. This would obviously create potential compliance hurdles and, more importantly, allow FMNEs to shift income between these two types of activities. Therefore, the desirability of having two formulas — one to allocate income that FMNEs derive from businesses and one to deal with income that they derive from individuals (which would include sales) — is questionable. Because tax authorities can not isolate these two sources of income without generating too many compliance costs and abuse possibilities. This article takes the view that this separation is too costly to maintain. Furthermore, in the case of FMNEs, the article argues that adding a sales factor is unnecessary because the factors on which it chooses to focus — tangible property and payroll — reflect, to a certain degree, FMNE retail activities. Simply put, while some financial services could be executed from foreign countries, if FMNEs wish to reach individual clients in high-tax jurisdictions, they *still* have to

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586, 593 (2002).

<sup>100</sup> See, e.g., Benschalom, *supra* note 1, at 694 n.214 (reviewing the way corporations created subsidiaries in the Netherlands Antilles to issue bonds to the Eurobond markets while enjoying a low withholding tax rate that was reduced by the double taxation treaty).

<sup>101</sup> For example, FMNEs invest a lot to create consumer-based intangibles such as goodwill. The best indicator of where this goodwill is located is the amount of sales in each jurisdiction.

invest in tangible property and experienced workforces in that jurisdiction to run the operation. This may change over time as internet banking becomes more popular. To the extent that this shift takes place, it may be necessary to account for retail activity in a different way.

Property and, moreover, financial assets are also considered frequently as possible formulary benchmarks.<sup>102</sup> When adopted as a sourcing formulary factor, property should be attributed to the location where it is employed rather than where it is owned, because legal ownership is contractually mobile.<sup>103</sup> Determining the geographic location where assets are economically employed is extremely difficult for intangibles and even more so for financial assets. It is doubtful whether the ownership and risk-bearing propensities of these assets could in fact be sourced analytically to a specific branch or entity within an integrated MNE. Accordingly, while tangible property may be attributed to various geographic locations, a different indicator would have to be used to source the income derived out of an MNE's main pool of assets, which comprises capital and intangible assets.

The last indicator typically considered a formulary factor is payroll. This factor assumes a correlation between income generated and payroll costs incurred in a specific location. This article stresses the importance of payroll as a key indicator of its appropriation formulas. Like retail sales, the payroll factor is the aggregation of relatively easy-to-observe contracts between MNEs and individuals. However, unlike sales, payroll cannot be manipulated through nonretail transactions because it could only be paid to individuals (this article addresses the issue of outsourcing in detail later). In the absence of a sales factor, payroll emerges as an important indicator as to where MNE intangibles are geographically allocated. Goodwill, successful retail activity, and production-based intangibles developed by MNEs (e.g., risk management computer software) all require human capital that to a great degree is reflected in the payroll factor. To be sure, the payroll factor is not a perfect match to the sales factor in determining the value of consumer-based intangibles. However, MNEs' ability to manipulate sales makes payroll the most attractive alternative.

Ideally, the definition of the payroll factor should be broad in two

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<sup>102</sup> McLure, *supra* note 99, at 593; OECD, *supra* note 77 at 15–16 (tying much of its analysis to the attribution of capital financial assets and risks).

<sup>103</sup> See Charles E. McLure, *Corporate Tax Harmonization in the European Union: The Commission's Proposals*, 36 TAX NOTES INT'L 775, 786 (Aug. 31, 2004).

important respects. First, it should encompass the compensation paid by MNEs for a broad range of services provided by their employees, as well as independent contractors. Second, the calculation of payroll should include all types of costs associated with labor, including costs of benefits and social security contributions. This broadness guarantees that the payroll factor reflects the actual level of economic activity taking place in specific jurisdictions. If tax authorities treat independent contractors and employees differently, MNEs would manipulate these categories. For example, if compensation for independent contractors is not included in the unitary calculations, MNEs will reduce their tax liabilities in high-tax countries by outsourcing many services they purchase. The same is true if tax authorities treat various types of compensation differently. If, for instance, compensation in the form of stock options is excluded from the formula, MNEs will start granting more of it to their employees in high-tax jurisdictions. However, as this article demonstrates below, administrative and anti-abuse concerns may require limiting the payroll factor. For instance, the difficulty of determining compensation for services rendered by independent contractors may dictate that the payroll factor be limited to employees or even to specific types of employees.

#### V. THE ALLOCATION PHASE IN AN (ALMOST) “IDEAL” REALITY: FMNES’ INCOME

##### A. *The Financial Sectors and Financial MNEs — A Story of Integration*

Financial intermediaries provide a number of vital functions in the modern economy.<sup>104</sup> In recent years, as a result of the liberalization of monetary and financial regulatory regimes around the world, financial markets witnessed an onslaught of cross-border and cross-sector integration.<sup>105</sup> Financial firms developed new instruments and services and began to operate in new geographic locations to meet

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<sup>104</sup> These functions include funding, saving facilities, financial services (transfers of funds), trading services, insurance underwriting, and hedging contracts.

<sup>105</sup> See CHARLES GOODHART, *FINANCIAL REGULATION: WHY, HOW AND WHERE NOW?* (1998) (discussing some of the financial regulatory implications of such integration trends).” Traditionally, the financial sector has comprised three legally distinct sub-sectors: banking, securities trading, and insurance. See JONATHAN R. MACEY, *BANKING LAW AND REGULATION* 511 (3d ed. 2001). Most banks and their foreign branches do not limit their activities to any specific type of financial activity. IFA, *supra* note 11, at 83.



the changing demands of their clients.<sup>106</sup> The integration of financial markets served as a platform for the rise of new competitive business structures of FMNEs, which are essentially MNEs that carry out most of their business activities within the financial markets. FMNEs utilize their multi-sector and multi-jurisdictional spectrum to better employ an economy of both scope and scale.<sup>107</sup>

In their operation, FMNEs manifest many of the global market's advantages. However, as the recent financial crises suggest, they also exemplify sovereigns' difficulties in imposing effective economic and fiscal regulation.<sup>108</sup> FMNEs are uniquely positioned to avoid income taxes by shifting their income to low-tax jurisdictions.<sup>109</sup> Tax authorities experience difficulties in penetrating FMNEs' business structures, because of their extensive interrelatedness and because they involve deployments of services and capital assets rather than of tangible goods.<sup>110</sup> Each of the branches and entities of such financial Goliaths may, under different capacities, offer all of the FMNEs' end services out of its general pool of human and capital assets.<sup>111</sup> This

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<sup>106</sup> John Neighbour, *The Taxation of Global Trading of Financial Instruments*, 16 TAX NOTES INT'L 1269, 1269 (Apr. 20, 1998).

<sup>107</sup> In what is an informational market, FMNEs are able to create specialized and centralized services, to develop finer human capital expertise and reduce operational costs; to obtain, analyze, and use information more efficiently; and most importantly, to endure a higher risk exposure because of their portfolio and activity diversification and reliance on less risky affiliate transactions. American Bankers Association, *supra* note 81; Charles T. Plambeck, *Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives*, 74 TAXES 1129, 1132, 1135 (1996); Charles T. Plambeck, *The Taxation Implications of Global Trading*, 44 BULL. INT'L FISCAL DOCUMENTATION 527, 529 (1990) (mentioning competitive advantages of conducting a global-centralized dealing operation).

<sup>108</sup> The international network of FMNEs is thus a source of concern with regard to many issues (e.g., financial stability of global markets and criminal-fund money laundering).

<sup>109</sup> See IFA, *supra* note 11, at 81 (mentioning that some of the OECD guidelines on banks include factors such as the location of where the terms were negotiated, where the decision of granting the loan was made, where the contract was agreed upon, and where the loan is administered); Ben Seesse, *The Bermuda Reinsurance "Loophole": A Case Study of Tax Shelters and Tax Havens in the Globalizing Economy*, 32 U. MIAMI INTER-AM. L. REV. 541 (2001) (demonstrating the unique position of FMNEs that allows them to pursue tax avoidance plans).

<sup>110</sup> MATTIAS LEVIN & PEER RITTER, TAXATION OF FINANCIAL INTERMEDIATION IN INDUSTRIAL COUNTRIES, in TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 197, 228 (Patrick Honohan, ed. 2003); IFA, *supra* note 11, at 71-72, 87.

<sup>111</sup> OECD, *supra* note 77, at 28 (stressing that this is indeed the case with global trading of financial instruments).

process is very difficult to reconcile with transfer-pricing's traditional paradigm, which assumes a distinctive structural production chain in which activities with an identified home location add value to the product.<sup>112</sup> This gap between the "traditional" paradigm and how FMNEs actually operate puts tax authorities at a disadvantage.<sup>113</sup> The revenue implications of these concerns may be horrendous, given the ever-growing volume of mobile sophisticated capital assets that FMNEs channel in their activities.<sup>114</sup> The profound functional integration of FMNEs fuses the risks and interests of their branches and entities.<sup>115</sup> Hence, the main difficulty tax authorities face is how to price and restructure uniquely tailored related transactions within FMNEs, and whether to respect the face value of those transactions' contractual risk allocations.<sup>116</sup>

### *B. Delineating the Scope of the Article's Proposal in an "Ideal" Reality*

Financial institutions offer an "ideal" setting for experimenting with innovative tax allocation techniques for financial income because their business activities involve primarily two types of assets: human capital and financial assets.<sup>117</sup> FMNEs utilize almost all of their human capital assets to service financial assets. Hence, basically all of FMNEs' income could be categorized as financial income. FMNEs are therefore the plain vanilla case for the study's inquiry of seeking a

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<sup>112</sup> Andrew M. Snyder, *Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology*, 48 *TAX LAW* 1057, 1059 (1995).

<sup>113</sup> See Susan C. Borkowski, *Global Trading of Financial Instruments and Transfer Pricing: A Brief History and Exploratory Study*, 29 *INT'L TAX J.* 22, 36 (2003) (showing that, due to the difficulty of auditing financial institutions there is an "audit gap" with regard to the ability of tax authorities to effectively monitor their operations).

<sup>114</sup> This concern may be amplified given that FMNEs are typically among the most affluent and well-advised taxpayers.

<sup>115</sup> Randall, *supra* note 32, at 885 (suggesting that this makes the risk component difficult to assign to any specific location).

<sup>116</sup> IFA, *supra* note 11, at 87; Sheppard, *supra* note 80, at 434 (pointing out that unrelated party finance involves more risk — especially credit risk — than related transactions, and that this divergence of risks affects the price of transactions, making it difficult to compare them to unrelated transactions).

<sup>117</sup> These assets are packaged in many different legal forms. Human capital may be provided as services, production intangibles (e.g., risk assessment software), or marketing consumer-based intangibles (e.g., goodwill). Financial assets may have different physical forms (e.g., cash, notes, e-money) or legal definitions (e.g., stock, bonds, swaps, futures, or options — all of them could be replicated by other instruments). See *supra* note 15.

better alternative for sourcing MNEs' financial income.

Additionally, as mentioned above, the transactional fact-based arm's-length paradigm simply falls apart in the case of integrated FMNEs. This article's proposal (the Proposal) does not aim to provide a flawless sourcing regime. Taking existing alternatives as its reference point, it aims to provide a more equitable, transparent, administrable, and coherent sourcing solution for FMNEs than the one *currently* in place. Boldly put, given the difficulties of existing alternatives, it is easy for the Proposal to offer improvements.

The analysis in this part assumes the following. First, it is possible to insulate and distinguish FMNEs from other MNEs. Second, FMNEs operate exclusively through branches and fully owned subsidiaries. Third, the article assumes the existence of a comprehensive multilateral agreement that implements the Proposal.

This "ideal" reality allows the article to crystallize the Proposal's principal analytical foundations. However, it is important to stress that this "ideal" reality is not a utopian coast beyond reach in the case of FMNEs. In most Western countries, FMNEs are indeed insulated. They are prevented from operating in other market sectors by the national financial regulatory regimes.<sup>118</sup> Firms operating in the financial sector are subject to distinct ownership rules that prevent them from being substantially engaged in businesses of other sectors. This outcome of prudential financial regulation suggests that although there are always hard cases on the margins, the vast majority of FMNEs could be easily distinguished from other MNEs.

To operate flexibly while complying with financial regulations, which deal with capital adequacy requirements, FMNEs (especially banks) operate mainly through branches.<sup>119</sup> To protect sensitive information and valuable intangibles, many FMNEs own all or almost all of their subsidiaries' stock.

Some type of multilateral agreement in the case of FMNEs is also not impossible. Although a unanimous approval by all countries of a comprehensive income allocation rule does indeed seem unlikely, it is not necessary in the case of FMNEs. To cover most of FMNEs' activities, only a critical mass of countries where FMNEs operate need to approve the Proposal. Most FMNEs' activities take place in jurisdictions that have large-scale financial markets operating within

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<sup>118</sup> IFA, *supra* note 11, at 77, 99.

<sup>119</sup> Branches may go into partnerships with other financial institutions. Determining the income allocation of partners is a separate (and extremely complicated) task, which this article does not address.

them and, therefore, it is only necessary to reach an agreement among those jurisdictions. What comprises this critical mass may vary according to the economic activity performed by the FMNEs. For example, establishing a viable sourcing arrangement in the case of securities dealing probably requires only an agreement among United States, United Kingdom, and Japanese tax authorities. In the case of banking, the addition of Germany and France and other Western European countries may also be required. Given the relatively small number of countries involved, and their similarity of interests,<sup>120</sup> attaining this objective is admittedly difficult but not impossible.

### *C. The Proposal*

In light of the above analysis, it appears that the best factors in an apportionment formula sourcing FMNEs' earnings would be the indicators of tangible property and payroll. The common virtue of both indicators is their relative immobility and ease of assessment. The task of the unitary formula is, therefore, to provide a good proxy for locating the income FMNEs generate. Since FMNEs derive most of their income from intangible and financial assets, the benchmark through which this income should be sourced is payroll.<sup>121</sup> The main underlying normative theme behind this argument is that mobile financial assets are economically owned jointly by all of FMNEs subsidiaries and branches. Since FMNEs' financial assets cannot themselves be geographically located, tax authorities can only allocate FMNE income by tracing the geographic location of the human capital that elicited it. Additionally, while the Proposal relates only to the sourcing of net taxable income, it could easily be extended to include the sourcing of net taxable capital gains and losses arising from the sale of capital assets.

The Proposal involves the following steps. First, one has to determine FMNEs' net taxable income. Due to different tax bases and tax accounting rules, tax authorities' ability to reach one agreed-upon figure of net taxable income is doubtful. This, however, is not a problem in the "ideal" reality addressed by this part, which assumes a comprehensive multilateral agreement. It is nevertheless important to

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<sup>120</sup> All are developed countries and depend, at least to some degree, on corporate income taxes to sustain long term welfare obligations. Part V.B will address this issue in greater detail.

<sup>121</sup> In this respect, the Proposal aligns with the insight of the 2006 OECD report that the main value of FMNEs is generated through their experienced workforce. See OECD, *supra* note 79.

note that this net taxable income figure should include only the profits and losses from business activities (including deductions for employee compensation). As discussed below, it should not include tax expenditures. Furthermore, depreciation expenses of tangible property should be deducted from FMNEs' general pool of income only if all nations employ uniform depreciation rates. I assume that nations do not employ such uniform rates. Therefore, tax depreciation expenses should not be deducted from the general pool of FMNEs' income but from the income allocated to every state.

Second, tax authorities should determine FMNEs' (aggregated) economic, tangible asset, and intangible asset values. The economic value would be determined according to the stock price of FMNEs. The aggregated value of FMNEs' tangible assets (Tangibles' Value) would be determined by their financial accounting "book" value.<sup>122</sup> The aggregated value of FMNEs' financial, intangible, and human capital assets is the difference between the economic value and the Tangibles' Value (Residual Value).<sup>123</sup> It would be calculated by subtracting FMNEs' Tangibles' Values from their economic values. The feasibility of this valuation process depends upon the percentage of FMNEs registered as public companies (which most major FMNEs are). Information about FMNEs' assets could also be obtained from financial regulators, which, especially in the case of banks, closely monitor FMNEs' holdings.

However, with regard to payroll, tax authorities may find that determining the compensation for independent contractors is administratively difficult. For example, an FMNE hires a janitor, a guard, a secretary, and a driver through independent contractors. Besides their labor expenses, independent contractors have depreciation of tangible property as well as operational and managerial expenses, for which they require compensation from the FMNE. More importantly, contractors may assume the liabilities for risks associated with the services they provide and may require the FMNE to further compensate them for that. Some of these indirect

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<sup>122</sup> This would comprise purchase value minus depreciated amounts as determined by GAAP (and not by tax depreciation).

<sup>123</sup> This method is similar to the one of Treas. Reg. § 1.861-9T(h) (2006). Corporations are subject to an interest deduction allocation under Code section 864(e) that requires them to allocate their income deductions according to an asset formula. This regulation allows corporations to elect their deductions using the FMV of their assets rather than by their tax base. Corporations wishing to elect this method must come up with a way to determine the value of their intangibles. They do so by using this notion of residual value.

employees may work for the same independent contractor at a number of locations and receive different salaries for each of these part-time jobs. In this scenario, the FMNE and tax authorities would find it difficult to insulate the compensation for the labor factor of independent contractors.

A number of approaches to this problem may be taken. The formulary payroll factor could include independent contractor compensation. This solution requires taxpayers and tax authorities to bear compliance and administrative costs associated with insulating compensation for labor factor paid to independent contractors. Alternatively, the payroll calculation could exclude independent contractors altogether. This would allow FMNEs to manipulate the payroll factor by sourcing out as many functions as they can (e.g., support staff) to outside contractors in high-tax jurisdictions.

Under the framework developed in Part IV.B, this article suggests a payroll definition that is reasonably accurate and easy to administer and that would limit FMNE planning opportunities. One possible approach is that the payroll factor should only include compensation for professional employees. This would include employees engaged in front and back office activities (e.g., creating and monitoring loans, marketing, and dealing). Admittedly, this requires taxpayers and tax authorities to agree upon a classification of professional employees. However, because the financial sector is heavily regulated, this effort is manageable, and has been addressed by the OECD in its proposed branch allocation rules.<sup>124</sup> The payroll factor should exclude the support staff of FMNEs (e.g., secretaries and administrative assistants), even though the work of skilled support staff is a meaningful contribution to FMNE profitability. The article justifies the exclusion of supporting staff by pointing to FMNEs' ability to contract out their functions to avoid taxes.

This arrangement adheres to the objectives set by the article. The reliance on employees reduces the difficulty of extracting the compensation for labor from services rendered by independent contractors. The work of professional employees could be perceived as providing the core of FMNEs income generating activities — thus, it provides a good indicator to relative volumes of their activities in different jurisdictions. For business reasons, FMNEs are much less

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<sup>124</sup> OECD, *supra* note 77, at 76–77, 127–34 (providing a comprehensive description of the different professional positions and functions undertaken by FMNEs engaged in banking and securities trading).

likely to outsource jobs performed by professional employees.<sup>125</sup> Additionally, their compensation would be easy to observe.

This article may err in two important respects. Tax authorities can significantly reduce the compliance burden of determining compensation for labor paid indirectly by FMNEs to independent contractors by making some simplifying assumptions.<sup>126</sup> Additionally, FMNEs may be able to source out considerably more functions in high-tax jurisdictions than the article assumes they can. This would allow them to manipulate the payroll factor. If either of these possibilities is true, tax authorities may find it better to calculate the payroll factor according to the compensation for labor paid to all employees and independent contractors. Successfully incorporating this broad notion of employees depends on the nature of the simplifying assumptions that this type of system would make.

Leases of tangible property pose a problem similar to the one of independent contractors. To reduce the income allocated to high-tax jurisdictions, FMNEs may lease instead of own tangibles there. Since both the financing and leasing expenses are deductible from FMNEs' general pool of income, leasing may be a profitable strategy for reducing taxes. To deal with this problem, FMNEs should report the economic value of their tangible-property leases as part of their Tangibles' Value. For example, assume an FMNE leases a big complex in London for a period of 20 years. The lease payments, just like the mortgage it would have paid if it purchased the complex, are deductible from its general pool of income. Accordingly, the FMNE would have to add the FMV of the lease — meaning how much a third party would pay right now for the right to lease the building for 20 years.<sup>127</sup> This figure should be added to the Tangibles' Value of the FMNE.

Third, FMNEs' net taxable income should be bifurcated according to the ratio of its Tangibles' Value and Residual Value. Each of the portions would be deemed to reflect the financial income

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<sup>125</sup> Outsourcing these professionals entails bigger business risks (having sensitive information leaked out and high staff turnover), and would prohibit FMNEs from supplying these highly-compensated (and highly-taxed) employees with certain benefits, which are typically tax-subsidized.

<sup>126</sup> Such simplifying assumptions may categorize all payments made to independent contractors as compensation for labor. To avoid inflating the payroll factor, FMNEs should discount a fixed (and arbitrary) percentage of these payments from the payroll factor.

<sup>127</sup> Tax authorities can easily determine the FMV of the lease by determining the net present value of the lease payments.

generated from each type of asset. One would expect that for most FMNEs the income attributed to intangible assets would be considerably greater. This is appropriate because, as explained earlier, the lion's share of FMNEs' value is generated by their ability to provide financial services and to manage financial assets — an ability that is largely invested in their workforces and their adroitness. It is the qualifications of this workforce that allow FMNEs to elicit profits by efficiently internalizing the different risks associated with financial activities. Nevertheless, it is important to have the Tangibles' Value component because the depreciation of tangible assets should be deducted from the income allocated to each country and not from FMNEs' net taxable income. Additionally, as discussed in detail in the subsequent part, the Tangibles' Value is crucial for extending the Proposal to allow formulary allocation of MNEs' financial income.

Fourth, tax authorities would employ two allocation formulas to determine the income attributable to each jurisdiction. The portion of income attributed to Tangibles' Value would be allocated to each jurisdiction according to the relative Tangibles' Value a given FMNE has in that jurisdiction. By the same token, the portion of income attributed to the Residual Value would be allocated to each jurisdiction according to the relative percentage of the overall payroll expenses paid by a given FMNE in it.

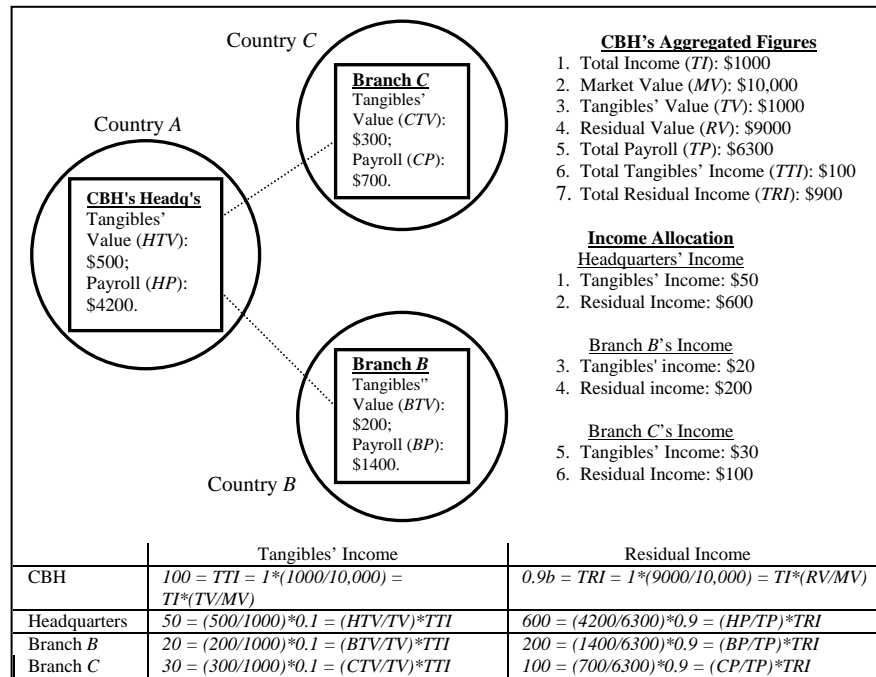
Finally, once FMNEs' income is allocated among jurisdictions, every jurisdiction may allow FMNEs to deduct expenses that were not included in the computation of their net taxable incomes. This would include expenses that are contingent on the specific location: depreciation of tangible assets and tax expenditures.

The following example illustrates how the Proposal works (all figures in this example are in millions of United States dollars). CBH is a profitable FMNE traded on the London Stock Exchange. In a given fiscal year, CBH had a net taxable income of \$1000, which it had to allocate among its headquarters, located in country *A*, and foreign branches located in countries *B* and *C*. CBH's stock was sold under the aggregated market value of \$10,000. Its Tangibles' (book) Value was \$1000 and its Residual Value \$9000 (which is the difference between CBH's market value and its Tangibles' Value). The Tangibles'-Residual Values ratio in that given year was 1:9. Accordingly, 10% of CBH's net taxable income (\$100) would be sourced according to the relative percentage of Tangibles' Value in each jurisdiction, and 90% (\$900) would be sourced according to the relative payroll paid in each jurisdiction. In the present example, a total of \$6300 represented annual payroll payments of CBH, paid in



each of those jurisdictions according to the following distribution: \$4200 at CBH headquarters in country A, \$1400 at the branch in country B, and \$700 at the branch in country C. The numerical example provided in figure #3 can help elucidate this mechanism.

FIGURE 3. CBH'S INCOME ALLOCATION UNDER THE PROPOSAL



The Proposal makes a clear distinction between the fiscal and legal ownerships of financial assets. For tax purposes, an FMNE subsidiary could be allocated more or fewer financial assets than it is perceived to legally own according to other legal doctrines. This tax determination should not affect other legal regimes (e.g., financial regulations, corporate insolvency), in which the geographic allocation of financial assets within FMNEs may bear significance.

The unitary system is a territorial system that taxes FMNEs' income once at the source level. Under the Proposal, no intra-FMNE flows of capital resources are subject to any residence tax cost or to withholding taxes. Taxes on FMNEs' dividend distributions to their shareholders may be subject to tax according to each nation's tax policy.

The Proposal, like any unitary system, raises a number of problems,<sup>128</sup> some of which result from this article's attempt to

<sup>128</sup> See Joann M. Weiner, *Using the Experience in the U.S. States to Evaluate*

introduce a unitary setting in an insufficiently integrated political setting. First, and most notably, the Proposal's emphasis on compensation for labor as a sourcing benchmark neglects the problem of different wage structures in various countries. Thus, the Proposal skews the revenue flow toward the richer countries because of their higher wage scales. This arrangement may seem unfair, and thus significantly reduces the political plausibility of the Proposal. To prevent this, all payroll formulary components would have to include controls for cost of living.<sup>129</sup> Similarly, the assets formula would need controls for the consumption value of money in various jurisdictions. The degree to which these considerations should be taken into account is a complicated topic with profound distributive implications. This issue transcends the scope of this article and is deferred to future papers.

The Proposal's emphasis on payroll requires special treatment for employees working in a number of jurisdictions. This problem is magnified in the case of highly mobile senior managers, whose salaries may significantly skew the sourcing of FMNEs' income. An extreme example of why this may be problematic is an FMNE which in a given (profitable) fiscal year paid 10% of its payroll to its top twenty executives. In that same year, most of these executives spent more time than usual in low-tax jurisdictions. A potential solution to these extreme cases of abuse would be to avoid attributing management salaries to the payroll factor of any specific location, when the total percentage of their salary exceeds a certain relative percentage of the total payroll. This arrangement treats the highly compensated human capital of these managers as owned solely on the level of the FMNEs, thus preventing the relocation of managers from influencing FMNEs' corporate tax liability.

Additionally, while this article firmly maintains that payroll is the most reliable proxy for allocating FMNE income, adopting it poses significant political problems. By tying the sourcing of FMNEs to the payroll as a proxy for their rents from intangibles, the Proposal imposes an implicit tax on labor. Some of the distorting mechanisms of this implicit tax would be reduced by the uniform application of the Proposal and by the inability of FMNEs to substitute insider human capital expertise. FMNEs would not be able to escape these costs

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*Issues in Implementing Formula Apportionment at the International Level*, 13 TAX NOTES INT'L 2113, 2141 (Dec. 23, 1996).

<sup>129</sup> Kathleen Matthews, *U.S. and Canadian Officials Discuss APAs in the Global Trading Context; Advance Pricing Agreements*, 8 TAX NOTES INT'L 1362, 1363 (May 23, 1994).

given their dependency upon skilled workforces operating from high-tax countries. Once most of the key players are subject to similar costs, none is placed in a competitive disadvantage in comparison to the others. Like many other costs,<sup>130</sup> the implicit tax costs on labor would become part of the costs attached to conducting business in the financial sector. Uniform application of the payroll factor would therefore impose a tax on the financial sector as a whole, but would not create huge variations within that sector. Countries can control what they may see as the negative impact of this implicit labor tax by adjusting the corporate income tax rate they impose on FMNEs.<sup>131</sup> Nevertheless, due to the high level of unemployment in some high-tax Western countries, the Proposal's emphasis on payroll as a dominant formulary factor is bound to be extremely controversial. While this concern does not defeat the article's argument, it suggests that promoting the Proposal would be an uphill battle.

Even if the income tax base of FMNEs were to be harmonized via a multilateral agreement, a number of key issues would still have to be left to the discretion of each country. This is true especially with respect to tax expenditures (e.g., charitable donations). Leaving these issues outside the unitary realm is crucial. Otherwise, countries will have incentives to inflate the tax expenditure deductions knowing that they are deducted from FMNEs' aggregated net taxable incomes and not directly from their own revenues. Because only a murky line distinguishes tax expenditures from tax base attributes, policymakers may find it analytically difficult to delineate a guiding principle for what should be left to each country's discretion.

Determining the contours of tax expenditures is particularly complex in those cases where tax expenditures are inherently related to FMNE business conduct, e.g., R&D tax subsidies and accelerated depreciation. While there is no easy-line-drawing solution, it is important to note that the current system is not free from these dilemmas. To the contrary, tax authorities have a difficult time confronting the ability of MNEs to incur tax expenditures in high-tax jurisdictions while reporting income in low-tax jurisdictions. This gave rise to cumbersome and costly mechanisms intended to limit the source deductibility of these expenditures.<sup>132</sup>

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<sup>130</sup> The key issue here is the CAR requirements, which are imposed with some uniformity across the different financial sectors in Western countries.

<sup>131</sup> Under the Proposal, countries would be free to set any corporate tax rate on FMNEs — this would include the right to subject them to lower corporate tax rate with regard to other corporations.

<sup>132</sup> See Treas. Reg. § 1.861-17 (1995).

Although the article refrains from providing a comprehensive answer to this issue, its Proposal is not inferior to the current tax arrangement. The article's principled position is, however, that the concept of tax expenditures should be construed broadly. This is essential to prevent unfair tax base competition in which sovereigns give accelerated deductions, knowing that they would be deducted from FMNEs' net taxable income and not from the income attributed directly to them.

Finally, if strictly applied, cases may arise in which the Proposal's unitary income allocation system may result in compliance and administrative costs that would render its application inefficient. Accordingly, the Proposal should have a *de minimis* rule that exempts small FMNEs and/or FMNEs with only minor foreign operations. While the Proposal should by no means be subject to FMNE election, it should be considered a mandatory default. FMNEs with special business structures would have the opportunity to enter into agreements with tax authorities to select the proper allocation techniques according to which their income should be allocated. This arrangement resembles the current Advanced Pricing Agreement (APA) process,<sup>133</sup> with the exception that it puts tax authorities in a superior bargaining position when entering into such agreements.

#### *D. An Assessment of the Proposal*

There are three benchmarks according to which the Proposal should be assessed. The first refers to the likelihood that its implementation would reduce FMNEs' ability to use their internal financial flows to avoid taxes. The second refers to whether the

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<sup>133</sup> In an APA, taxpayers elect to negotiate in advance the type of transfer-pricing method to which they will be subjected. The APA alternative is primarily election by taxpayers, which, like FMNEs, have integrated cross-border operations, are exposed to uncommon risks or employ unique pricing techniques. Those taxpayers often use the APA method to curtail compliance costs associated with having tax authorities continuously scrutinize and challenge their pricing methods. See Diane M. Ring, *On the Frontier of Procedural Innovation: Advanced Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. 143 (2000). It would likely prove difficult to advocate the use of APAs as a broad solution to the problem of FMNEs because of their voluntariness and particularity. In light of the tax avoidance potential of FMNEs and their prominent role in the global economy, the difficulty of auditing them should not be sporadically resolved on an ad-hoc basis. Kelvin K. Leung, Note, *Taxing Global Trading: An Appropriate Testing Ground for Formula Apportionment?*, 1 MINN. J. GLOBAL TRADE 201, 204-05, 228-30 (1992); see generally Richard McAlonan et al., *Annual Report Provides Transparency Into APA Process*, 115 TAX NOTES 1283 (June 25, 2007).

Proposal reduces the IITR's compliance costs, administrative costs, and inefficiencies. The third is whether the sourcing approximation of the unitary system achieves an overall intuitive sourcing result.

As mentioned in Part II.C, there are three main avenues of abuse — deferral, excessive repatriation of foreign tax credits, and income shifting through related party transactions — all of which would be eliminated under the Proposal. As a territorial system in which all income is taxed only once, at source, the Proposal has no resident taxation and derivatively no tax credit manipulation or problems of deferral. The unitary rules disregard intra-FMNE transactions and thus eliminate FMNEs' ability to engage in income shifting.

Opponents of the Proposal may nevertheless argue that the tradeoff is not that simple. At least in the case of deferral and credit manipulation, the remedy offered by the Proposal throws the baby out with the bathwater because it comes at the price of waiving FMNEs' residence taxation. This could arguably incentivize FMNEs to shift their activities to low-tax jurisdictions.

The answer to this objection is multilayered. As the author wrote in a different paper,<sup>134</sup> to date, residence taxes result in less revenue than a (more territorial) dividend exemption tax system with equivalent tax rate would raise. This is because countries employing residence taxation do not impose residency taxes on foreign subsidiaries; rather they levy their taxes only upon repatriation of those subsidiaries' earnings. In the case of the United States, the use of hybrid entities permitted by the "check the box" regulations allows many MNEs to avoid almost all residency taxes. To date, a growing number of countries have been exploring the possibility of altering tax legislation to establish more territorial tax systems. Given this, the possibility that in the foreseeable future policymakers will introduce a more robust residency taxation to deal with the problems of excessive credit repatriation or with deferral seems unlikely in my opinion. Hence, while strong normative arguments in favor of residency taxation exist,<sup>135</sup> from a practical perspective, there seems little reason to hold fast to residency taxation for FMNEs.

From a normative perspective, this article maintains that tax corporate residency is an analytically flawed concept. The impersonal nature of corporations allows them to manipulate their tax residency. Furthermore, corporate tax residency status bears only negligible

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<sup>134</sup> See Benschalom, *supra* note 82, at 633–34.

<sup>135</sup> See, e.g., Robert J. Peroni, *A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation*, 56 SMU L. REV. 391 (2003); Peroni et al., *supra* note 89.

operational or (pre-tax) economic consequences.<sup>136</sup> As best manifested through the inversion phenomena discussed briefly in Part III.B.1, *supra*, United States MNEs exercised their entrepreneurial rights to expatriate to offshore low-tax jurisdictions simply by reincorporating there. This allowed the MNEs that were formerly tax residents of the United States to avoid completely United States residence taxation while continuing to relish (almost) exactly the same United States market and infrastructure benefits as before they changed residency classification. The following table summarizes a comparative evaluation of various parameters between the Proposal and the current regime.

TABLE 2. A COMPARED ANALYSIS OF THE PROPOSAL AND CURRENT FMNE TAX REGIME

	<b>Current</b>	<b>Article's Proposal</b>
1. Deferral	Very high	N.A.
2. Excessive tax credit repatriation	Very high	N.A.
3. Income shifting by related transactions	Very high	Very low

\*On a scale from "very high" to "very low," the lower ratings in the table are the preferential ones.

The second criterion according to which the Proposal should be evaluated is whether it reduces compliance costs and the economic deadweight of the corporate income tax. As the author has written extensively elsewhere,<sup>137</sup> unitary systems are almost certain to perform better on both accounts. First, the shift to a formulary system reduces compliance associated with FMNEs' need to contractually delineate transactions according to transfer-pricing consideration with the arm's-length standard. By the same token, the shift to a unitary system reduces tax authorities' administrative costs. As a result, the audit process is bound to become less arbitrary because the audit consequences of FMNEs would depend on where productive assets are located and not upon the outcomes of the audit lotteries.<sup>138</sup> Put differently, the unitary system is a legitimate allocation tool even though it does not aim to measure and allocate income with perfect precision. This legitimacy is anchored in the failure of the arm's-length alternative to offer any more precise allocation results.

<sup>136</sup> See Graetz, *supra* note 8, at 320.

<sup>137</sup> Benschalom, *supra* note 82, at 689–94.

<sup>138</sup> The audit lottery refers to the chance that a specific taxpayer will be audited in any given fiscal year.

The shift to a unitary system also reduces the economic deadweight of the income tax in one significant way. By disregarding intra-group financial flows and services, the Proposal removes all tax obstacles on these transactions. It allows management greater resiliency in employing resources without giving heed to tax consequences. Critics of the shift to a unitary system may nevertheless argue that this gain in efficiency comes at the great expense of FMNEs placing more facilities and workforces according to tax considerations. The factual answer to whether the shift to a unitary system results in an efficiency net gain or loss is speculative, factual, and difficult to determine. The article contends, however, that there is a normative difference between the post-investment tax distortions it seeks to alleviate and the pre-investment tax distortions its critics may claim the Proposal enhances.

Unlike the ethos of capital-exporting neutrality, the article does not seek to prevent FMNEs from taking corporate tax considerations into account when deciding where to place workforce and production facilities. Corporate taxes are yet another type of state-imposed costs that should be assessed by entrepreneurs in light of their projected returns. Through the corporate taxes, sovereigns price corporations' use of their infrastructures. Imposing a worldwide corporate tax to attain investment neutrality is equivalent to imposing worldwide labor market regulations to attain such neutrality. Hence, MNEs should legitimately give heed to all tax considerations *prior* to investing in a given location.

The article does however seek to reduce *post*-investment tax distortions. This requires that once an investment has been made — meaning that tangible properties have been purchased and a workforce has been created — the tax price would be fixed to prevent FMNEs from structuring operations solely to manipulate their tax liabilities. The shift to a unitary system allows a substantial efficiency gain because FMNEs would not be able to change the ratio between earned income and tax liability by channeling mobile assets and activities through low-tax jurisdictions. They will therefore have the incentive to increase their pre-tax earnings as much as possible. Moreover, under a unitary system, there are no tax obstacles for doing so: FMNEs could freely arrange their financial assets and corporate structure without incurring tax liability upon intra-group transactions such as earnings repatriation. This would allow them to invest their assets in those places with the highest pre-tax return. Once FMNEs decide to locate some of their workforce and tangible property in a specific jurisdiction, they become indifferent to the tax rates in

jurisdictions where their financial assets are located. Thus, once the investments are made, there are no tax obstacles preventing the efficient investment of FMNE financial resources.

The third criterion is whether allocating FMNEs' net taxable income through a (primarily) payroll-based appropriation formula is intuitively correct. In some cases, the Proposal's allocation seems unintuitive. For example, when a new foreign branch or subsidiary is established, it often takes some time for it to generate profitability. In such instances, the averaging function of the Proposal's allocation formula may seem inadequate. If the FMNE has a positive net taxable income, some of it would be allocated to the new branch or subsidiary. On the other side of the continuum, the Proposal's allocation seems to produce appropriate sourcing results in cases of global dealing, where different branches of a specific FMNE actively trade financial instruments pooled into a single book. The answer to whether the balance struck by the Proposal is appealing depends by and large on what one thinks of the "abusiveness" of income shifting and the use of the arm's-length benchmark. This article's analysis established that FMNE income is generated by financial assets and human capital, that payroll is a good indicator for human capital, and that FMNEs have almost full flexibility in structuring their intra-group financial flows and holdings. If one accepts these conclusions, then the averaging result of the Proposal's formula should seem appropriate.

By way of conclusion, FMNEs are unique in the sense that they are operating in an integrated market and deal primarily with mobile intangible assets. FMNE related transactions often have no market comparables and therefore could not be coherently attributed to any specific jurisdiction. The Proposal's unitary setting is by no means a panacea. However, to evaluate its merits one must consider the alternative it seeks to replace. The article maintains firmly that the key to this evaluation lies in the accelerating level of integration in financial markets. If the Proposal is not adopted, the high levels of cross-border and cross-sector integration would eventually make it completely impossible for tax authorities to break down affiliated transactions according to an arm's-length standard. This inevitably renders the income tax regime more cumbersome, costly, inefficient, and inequitable. Additionally, although the Proposal waives sovereign ability to levy residency tax on FMNEs, it is important to remember that, to date, residence taxation has not been a net revenue gain regime but one which, on top of its complexities, levies fewer revenues than alternative dividend exemption regimes. Bearing this in mind, the Proposal, if adopted, is likely to outperform the current sourcing



techniques, in the case of FMNEs, in almost every respect.

## VI. CONCLUSIONS

This article identifies the core attributes that make financial income so difficult to tax under existing ITR arm's-length conventions: mobility and fungibility. It further points out that in the context of affiliated financial transactions, this combination is horrendous because there is no "correct" market financial structure upon which tax authorities can rely as a benchmark. Related parties can therefore structure financial transactions in many different, economically equivalent, forms to attain tax avoidance preferences by using readily available tax planning expertise. The view that the special attributes of financial income render irrelevant the existing legal structures governing the taxation of affiliated financial transactions is gaining traction among tax policymakers in the United States and other Western countries. Hence, with regard to financial income, legislators, tax authorities, and the OECD have become more willing to deviate from the arm's-length standard in favor of more formulary solutions.

This article advances a unitary solution in the context of FMNEs. It suggests that their income could be adequately sourced through a formula that relies on the value of their tangible assets and intangible human capital assets in each jurisdiction. It offers difficult to manipulate indicators that would help determine the geographic locations of these assets and explains why the adoption of its solution is feasible politically and administratively. Moreover, this article stresses that MNEs' financial income should be sourced, as a matter of principle, in accordance with where their tangible assets and labor is employed and not according to the contractual attributes of the transaction.

In a future paper,<sup>139</sup> I would take this notion a step further and examine how MNEs' financial income should be formulary-sourced. Unlike FMNEs, MNEs have some financial income (gains or losses), but generate mostly non-financial income. This extension of the proposal would therefore require a careful definition of what

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<sup>139</sup> Ilan Benschalom, *Taxing the Financial Income of Multinational Enterprises*, 28 VA. TAX REV. (forthcoming 2009).

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comprises financial income. Additionally, unlike FMNEs, MNEs operate from a wide range of countries and may have a very complicated ownership structure. Accordingly, the proposal for formulary sourcing MNEs' financial income offers a set of ideas about how it could be successfully implemented even in the absence of multilateral consensus and even in complex MNE group ownership structures

