Formulary Taxation Versus the Arm's-Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists

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Jinyan Li has written many books and articles on tax topics, consistently maintaining a high standard for tax scholarship. In recent years, Li's research has focused on the need to reform tax laws to take into account the rise of global electronic commerce. One therefore approaches Li's most recent work, *International Taxation in the Age of Electronic Commerce: A Comparative Study*, with high expectations.[1] Li does not disappoint. This is an excellent book—well written, thoroughly researched, and filled with insightful and original views on many international tax issues.

The purpose of this paper, however, is not to continue to laud the many admirable qualities of Li's book. That would be much too boring! Rather, this paper will challenge one aspect of Li's prescription to cure the problems that plague international

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1 See Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003).

tax: her support for global formulary taxation. The paper begins by outlining Li's recommendations and discusses the quest for conceptual purity by proponents of formulary taxation against the "messiness" of the current transactional arm's-length regime for calculating international transfer prices. I argue that the desire for conceptual purity may inhibit the development of effective policy responses and that more politically feasible reform proposals are better suited to addressing the problems identified by Li. The paper concludes by noting that the ongoing debate surrounding the merits of formulary taxation reflects a broader discourse among tax commentators who can be categorized as "Doubting Thomases," "Purists," and "Pragmatists."

LI'S PROPOSAL: GLOBAL PROFIT SPLITS AND WITHHOLDING TAXES

Near the beginning of her book, Li discusses the various developments that led to the creation of the modern international tax regime in the 1920s.[2] While this regime was developed to deal with growing international trade in tangible products, Li reminds us that nothing is new under the sun: governments and tax authorities continue to struggle with the same old problems, such as determining what is the appropriate nexus that permits the exertion of tax jurisdiction over cross-border sales. Nevertheless, Li maintains that the current international tax regime does not properly address the many vexing challenges faced by tax authorities and multinational firms today. These challenges include increasing regional and global trade and capital market integration, and the movement toward more service-oriented economic activities for many countries.

The main tax problems, discussed throughout the book, result from the rise of information technologies and electronic commerce. This more recent development, according to Li, has exacerbated the old problems. In other words, there has always been some "leakage" in the system, but Li fears that the leaks will eventually become a torrent. In particular, capital-importing countries and net electronic-commerce-importing nations will suffer an erosion of their tax bases, eventually leading to significant revenue losses, in part owing to increasing remote consumer sales via the Internet. Li has much support for her position within the literature that discusses the taxation of international electronic commerce.[3] Gauging the actual dimension of the problem will determine largely whether traditional international tax principles should be tossed aside or not.

2 Ibid., at 37-57.

3 The leading book on the taxation of international electronic commerce, of which Li is a co-author, similarly maintains that electronic commerce requires a re-evaluation of many traditional tax principles. See Richard L. Doernberg, Luc Hinnekens, Walter Hellerstein, and Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation* (The Hague: Kluwer Law International, 2001), 592-95. I have also supported a re-evaluation of certain principles. See, for example, Arthur J. Cockfield, "The Law and Economics of Digital Taxation: Challenges to Traditional Tax Laws and Principles" (2002) vol. 56, no. 12 *Bulletin for International Fiscal Documentation* 606-19.

There is another perspective, however, from those observers who could be called the “Doubting Thomases.” Here are the words of two Doubting Thomases:

> The dire prediction that e-commerce will allow companies to earn significant revenues from states of consumption without having a local physical presence have not come true. Simply put, those advocating change have not offered compelling enough reasons to justify deviating from a conceptual basis of international taxation that has had overwhelming acceptance for over 80 years.[4]

In contrast, Li argues that the problems are sufficiently pressing to advocate replacing the current regime for allocating tax jurisdiction (and hence revenues) by the transactional arm’s-length approach. She proposes that countries adopt a “global profit split” and/or withholding for cross-border electronic commerce transactions. I will not deal with the withholding tax proposal in this paper, other than to say that I have expressed sympathy with this approach in the past.[5] Instead, this paper will focus on the ongoing debate, taken up by Li, on whether the current transactional arm’s-length system should be replaced by formulary taxation. Under the formulary approach, a business with operations in more than one country would be treated as a single taxable entity: factors such as payroll, property, and sales would determine how profits generated would be allocated among the different countries.

First, a note on terminology: Li’s use of the term “global profit split” may strike one as unusual because “profit split” is the term used by tax authorities to describe one of the transactional transfer-pricing rules. Li, however, advocates moving away from calculating transfers on a case-by-case basis to divvying up the tax pie on an annualized basis. A follower of Li’s work might suspect that this seeming anomaly is entirely intentional.[6] Li understands that formulary taxation are “dirty words” in some international tax circles. We will leave it up to future semioticians to deconstruct Li’s usage, but it may be that the term “global profit split” is used as part of her attempt to enlist our support for what she proposes would be a relatively modest development, a point that is addressed subsequently.

FORMULARY TAXATION VERSUS ARM’S LENGTH

The Quest for Conceptual Purity

The main argument in favour of formulary taxation is that the system does a better job of addressing the economic reality of multinational firm behaviour. The main

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4 See Gary D. Sprague and Rachel Hersey, “Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests,” February 27-28, 2003, 1 (available online at http://www.bmck.com/ecommerce/tax-art1.doc, and forthcoming in the *Georgia Law Review*).

5 See Arthur J. Cockfield, “Balancing National Interests in the Taxation of Electronic Commerce Business Profits” (1999) vol. 74, no. 1 *Tulane Law Review* 133-217, at 198-205.

6 In fact, Li recognizes that the term “profit split” is traditionally used for specific transactions. See supra note 1, at 612.

deficiency, in turn, of the transactional arm's-length principle is that the system artificially attempts to draw lines between related aspects of a firm where no line truly exists. In particular, multinational firms are becoming more highly integrated with each other's operations located in different regions: it is often not possible to find comparable transactions with unrelated parties. Formulary taxation, on the other hand, accepts the reality of firm integration and tries to come up with a workable solution that matches each jurisdiction with tax revenues related to the value-adding economic activity that takes place within the jurisdiction. Finally, formulary taxation could be used to address the problem, which the Doubting Thomases deny, of source-state base erosion by employing factors such as sales in the jurisdiction of consumption.

These arguments in favour of formulary taxation are quite powerful, and Li presents them in an accessible and insightful manner. In fact, the shortcomings of the current transfer-pricing regime are becoming more prevalent and prominent as the process of globalization encourages enhanced regional and global economic integration. Perhaps for this reason, Li's views on formulary taxation are often supported by prominent tax economists and others as the way to fix the current system.[7] We can call Li and these supporters "Purists" because they often seek solutions, such as formulary taxation, that are conceptually pure.[8] Formulary taxation does seem more conceptually pure than the current arm's-length system, which is supported by international consensus among national tax authorities. In reality, at least below the surface, there is much disagreement concerning arm's-length principles on issues such as the allocation of profits among the different permanent establishments within a single legal entity.

The Messiness of International Tax Law

Unlike economists, legal scholars are often (with many exceptions) less enthusiastic about reform efforts that move toward a system that exclusively employs formulary taxation. Commentators point out that formulary taxation is not the panacea that some proponents suggest it is (Li herself does not go this far). Consider the problem of intangibles. It is difficult to determine the geographic situs for income produced by intangible assets. Intangibles should hence perhaps not fall within any formula

7 A conspiracy theorist might note that Li's advocacy for formulary taxation is supported by several prominent tax commentators whose last names begin with "Mc." See Charles E. McLure Jr., "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment" (2002) vol. 56, no. 12 *Bulletin for International Fiscal Documentation* 586-99; Robert S. McIntyre and Michael J. McIntyre, "Using NAFTA To Introduce Formulary Apportionment" (1993) vol. 6, no. 14 *Tax Notes International* 851-56; and Paul R. McDaniel, "Formulary Taxation in the North American Free Trade Zone" (1994) vol. 49, no. 4 *Tax Law Review* 691-744. Of these authors, only McLure is a tax economist.

8 In Canada, there exists a subset of this category who might be called Carterian Purists because they believe that any departure from the "buck is a buck is a buck" doctrine set out in the Carter report (Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966)) is tantamount to heresy, punishable by burning at the nearest stake.

to determine which jurisdiction should enjoy the right to tax. This problem alone might deal a death blow to formulary taxation for electronic commerce purposes because so many of these transactions involve intangible digital goods and services.

Other critics point out that formulary taxation may in fact lead to more abusive tax planning as firms devise strategies, for instance, to hire independent contractors in a jurisdiction so that a formula that included salaried employees would not count the independent contractor salaries.[9] Detractors also maintain that formulary taxation could increase compliance and enforcement burdens and present insurmountable hurdles in determining what is a "unitary enterprise."[10] Notably, a Canadian government report rejects formulary taxation for electronic commerce purposes because, among other things, "it would not eliminate the risk of double taxation and it is doubtful whether it would be easier to administer than the current . . . arm's-length principle."[11]

Li deals with all of these criticisms, but maintains that formulary taxation is still the way to go. Moreover, Li recognizes that the distinction between formulary taxation and the arm's-length principle is not "pure black or white" and that the better way to view transfer-pricing methodologies is that they are all part of the same continuum.[12]

HOW TO GET THERE FROM HERE

The task undertaken in this paper is not to end the debate surrounding the merits of formulary taxation or the transactional arm's-length principle. Instead, this section will try to demonstrate that quests for conceptual purity, including Li's global profit split proposal, may reach too far, given the traditional drivers behind international tax reform efforts.

Returning to a point raised earlier, any reform efforts should take into account the estimated magnitude of the problem under scrutiny. For example, empirical studies estimate that US state and local governments are currently losing billions of dollars in tax revenues owing to their inability to enforce state and local sales and use tax laws on remote consumer transactions.[13] In addition, the traditional sales tax rules

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9 See, for example, Joann M. Weiner, *Using the Experience in U.S. States To Evaluate Issues in Implementing Formula Apportionment at the International Level*, OTA Paper 83 (Washington, DC: US Department of the Treasury, Office of Tax Analysis, April 1999) (available online at http://www.treas.gov/ota/) (arguing that the economic conditions that support US state formulary taxation do not exist at the international level).

10 See John S. Brown, "Formulary Taxation and NAFTA" (1994) vol. 49, no. 4 *Tax Law Review* 759-68.

11 See Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998), paragraph 4.1.3.2.

12 Supra note 1, at 548.

13 See Arthur J. Cockfield, "Walmart.com: A Case Study in Entity Isolation" (2002) vol. 25 *State Tax Notes* 633-40 (arguing that state tax authorities can attack entity isolation strategies through attributional nexus theories).

have led to abusive tax planning, including "entity isolation" strategies where companies form separate subsidiaries to shelter remote sales from collection obligations. These two developments likely justify the proposed radical harmonization of the tax bases of the 45 US states and over 7,000 local governments with sales tax regimes, as proposed by the state-tax-authorities-sponsored Streamlined Sales Tax Project.

Unfortunately, there are no similar studies at the international level that have gauged revenue losses or other welfare losses associated with maintaining the current regime. Nevertheless, there are a number of worrisome signs that this regime has led to tax distortions and harmful tax competition in many circumstances. Assuming, therefore, that Li is fundamentally correct in suggesting that reform efforts are needed to address current or anticipated problems, the question is: what is the most effective way to move the process forward so as to deal with these issues?

Sovereignty Hurdles

The most obvious barrier to wholesale adoption of formulary taxation is that it would require a degree of cooperation among tax authorities that may not be possible in the current political environment. The Organisation for Economic Co-operation and Development (OECD) rejects formulary taxation in part because it "would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation."[14] Moreover, the system would intrude to an unacceptable extent on a nation's tax sovereignty: countries would need to reach agreement on a set of common rules at the supranational level that would determine how much revenue each state would collect from cross-border transactions. By doing so, each state would have to cede fiscal sovereignty with respect to aspects of its international income tax laws.

Finally, even proponents of formulary taxation suspect that effective formulary taxation will require an even greater sovereignty sacrifice because it will require the harmonization of corporate tax bases and possibly even tax rates.[15] A group of EU tax experts—the so-called Ruding committee—rejected formulary taxation on a number of grounds, including the argument that "[f]irstly, and foremost, allocation is suitable only if States have reached an advanced degree of integration, such as common currency, common company law, common accounting standards and common expertise in the tax administrations."[16] More recent reform efforts by the

14 See Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf), paragraph 3.66.

15 See McDaniel, supra note 7, at 734-37.

16 See Commission of the European Communities, *Report of the Committee of Independent Experts of Company Taxation* (Luxembourg: Office for Official Publications of the European Communities, 1992), 130. It is noteworthy that the Ruding committee was in favour of "radical" change for business taxation within the European Union and recommended the harmonization of corporate income tax rates—but still rejected formulary taxation. The harmonization recommendations have never been implemented.

European Commission have moved away from proposals for harmonization of corporate income tax rates toward corporate tax base consolidation, which, as Li discusses, does offer the tantalizing prospect of movement in the direction of formulary taxation.

To raise one last point with respect to tax sovereignty, Li mentions that equity considerations or "inter-nation fairness" should be paramount when different policy proposals are scrutinized.[17] While this suggestion is laudable because it would better address the interests of the less economically powerful states, it may not be realistic to expect nation states to abandon their selfish interests to accommodate the interests of others. For example, each participant in a formulary apportionment regime would likely argue for allocation factors that favoured its interests: importing states would want factors such as destination sales to support more taxation while exporting states would argue for apportionment based primarily on residence.

In short, fiscal sovereignty concerns continue to play a critical part in a nation's decision to reform its international tax system.[18] For the foreseeable future, countries will likely struggle to protect their national interests and, until the case is made out that the current regime is in danger of imminent collapse, will remain reluctant to offer concessions in areas that are contrary to these interests.

Need for an Incremental Approach

Li takes pains to state in a number of places in her book that her advocated approach should be seen as evolutionary.[19] For example, she mentions the growing use of advance pricing agreements and profit splits for global trading to support her view that there "has been a steady drift toward formulary allocation."[20] Methinks Li doth protest too much. Her proposals would likely be perceived to be radical indeed. In particular, her view that the transactional approach to calculating an arm's-length price should be jettisoned will not likely attract support in the foreseeable future, as Li acknowledges.[21] Nevertheless, it should be reiterated that her proposals are both sound and theoretically attractive.

The reality is that the OECD and its member states seem wedded, at least for the foreseeable future, to the maintenance of the transactional arm's-length standard, despite its many deficiencies. Li's own comparative review of the responses by national tax authorities suggests that these authorities have for the most part approached taxation of electronic commerce issues in a tepid and conservative manner, relying on traditional principles. Moreover, in two documents signed at the OECD

17 Supra note 1, at 586.

18 See generally Arthur J. Cockfield, "Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Concerns" (1998) vol. 34, no. 1 *Stanford Journal of International Law* 39-73.

19 See especially supra note 1, at 591 and 604-12.

20 Ibid., at 607.

21 Ibid., at 619.

conference on global electronic commerce held in Ottawa in October 1998, the OECD and the business community set out the view that traditional tax laws and principles should guide the formulation of reform efforts directed at international electronic commerce.[22]

This slavish following of traditional principles has led to some misguided reform efforts, such as the enshrining of a new server/permanent establishment rule in the commentary on the OECD model convention.[23] Still, the nations that, for good or ill, design the international tax rules have signalled that great leaps forward will not be tolerated. For the time being, we may need to be satisfied with the current "messy" system.

Apart from taking into account sovereignty concerns, how does international tax law move forward? Richard Bird points out, "Changes in tax policy and tax structure reflect changes in administrative realities as much [as] or more than they do changes in policy objectives."[24] It may be preferable to adopt a reform approach that protects tax sovereignty, relies on the current transactional arm's-length regime, and is technically feasible.

Toward a Quantitative Economic Presence Threshold

All of this, of course, gives me a chance to tout my own prescription. The OECD and its member states should consider adopting a new permanent establishment fiction—a quantitative economic presence test—that permits source countries to tax cross-border profits associated with above-threshold sales (for example, gross revenues in excess of $1 million) even if the taxpayer has no physical presence in the source country.[25] This approach would arguably address many of the concerns discussed by Li—including source-country base erosion—without overturning traditional international tax principles.

22 See Organisation for Economic Co-operation and Development, *Electronic Commerce: Taxation Framework Conditions* (Paris: OECD, 1998); and "Joint Declaration of Business and Government Representatives: Government/Business Dialogue on Taxation and Electronic Commerce," Hull, Quebec, October 7, 1998.

23 The 2003 OECD model convention amends the commentary on article 5 to make it clear that a computer server (that is, a computer that has been networked to the Internet) can constitute a permanent establishment in some circumstances. See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, 2003), 102-5. Millions of computer servers around the world will now constitute permanent establishments if the software within the servers performs integral functions of a cross-border transaction. For discussion, see Arthur J. Cockfield, "Should We Really Tax Profits from Computer Servers? A Case Study in E-Commerce Taxation" (2000) vol. 21, no. 21 *Tax Notes International* 2407-15; and Arthur Cockfield, "Through the Looking Glass: Computer Servers and E-Commerce Profit Attribution" (2002) vol. 25, no. 3 *Tax Notes International* 269-75.

24 See Richard Bird, *Taxing Electronic Commerce: A Revolution in the Making*, C.D. Howe Institute Commentary no. 187 (Toronto: C.D. Howe Institute, September 2003), 15.

25 See Arthur J. Cockfield, "Reforming the Permanent Establishment Principle Through a Quantitative Economic Presence Test" (2003) vol. 38, no. 3 *Canadian Business Law Journal* 400-24.

A quantitative economic presence test admittedly suffers from its own set of problems and lacks the conceptual purity of Li's prescription: a Purist might therefore turn up her nose at the thought of introducing yet another rule into the already overloaded international tax regime. In addition, one suspects that the Doubting Thomases would portray this approach as being overly ambitious by granting taxing jurisdiction to a country on the basis of sales, in contrast to the historic need for a real physical presence.

Nevertheless, movement toward a quantitative economic presence test or some other incremental reform effort might be supported by those we can call "Pragmatists."[26] These Pragmatists acknowledge the attraction of grand schemes like formulary taxation, but consider that more moderate reform efforts are more feasible and hence may be more effective in confronting challenges presented by changing commercial practices.

CONCLUSION

Jinyan Li's book provides insightful analysis of many international tax law issues. It makes a significant contribution by promoting a better understanding of the tax challenges raised by global electronic commerce. I also suggest that the book can serve as a helpful source for international tax matters other than the taxation of electronic commerce. Li's text occupies a prominent place on the shelf in my office, within easy reach, where I have relied on it in the past to assist me with my own research.

This paper queried whether Li's prescription to move toward a global profit split will help to move forward reform attempts to address many of the vexing problems facing the international tax community today. While prognostication is always a risky activity, it does not seem likely, as Li recognizes, that the world will move toward global formulary apportionment at any time in the near future. The desire to pursue conceptual purity for international tax proposals may inhibit the development of effective policy solutions to address current problems. The path of international law is directed by three main drivers: tax sovereignty concerns, practical administrative concerns, and guiding international tax principles. Formulary taxation arguably meets the latter two concerns, but it is unacceptable on tax sovereignty grounds principally because it would bind participants to formulas and tax

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26 For a good example of the Pragmatist approach, see Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1079-1158 (arguing that limited international coordination—not harmonization—is the most effective way to counter abusive arbitrage activities); Richard L. Doernberg, "Electronic Commerce and International Tax Sharing" (1998) vol. 16, no. 13 *Tax Notes International* 1013-22 (asserting that searches for conceptual certainty should not act as a barrier to effective reform efforts); and Richard M. Bird, "A View from the North" (1994) vol. 49, no. 4 *Tax Law Review* 745-57 (arguing that an incremental approach to international tax law reform is the most effective approach with respect to transfer-pricing allocation methodologies).

rules set at the supranational level. It may be more feasible to address increasingly pressing concerns through an incremental approach that does not seek to overthrow traditional principles. Adding a quantitative economic presence test to the current permanent establishment/transactional arm's-length scheme is one possible approach along these lines.

This discussion reflects a broader discourse that takes place in tax law among Doubting Thomases, Purists, and Pragmatists. In the context of the debate surrounding formulary taxation versus the arm's-length principle, the Doubting Thomases ask for too little, the Purists ask for too much, and the Pragmatists simply want to see that the job gets done.