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Solution to BEPS May Be 'Menu of Options' With Formulary Alternative, Practitioner Says

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BNA Snapshot

Key Development: Panel discussion points to parallels between U.S. state tax regimes and proposals for international tax reform.

Takeaway: Global formulary apportionment might be unlikely, but a formulary alternative in certain circumstances could make sense, one practitioner says.

By Dolores W. Gregory

June 18 — Countries participating in an international initiative to fight base erosion are mistaken to think they must choose between upholding the arm's-length standard on one hand and adopting global formulary apportionment on the other, a practitioner said.

Instead, the ultimate solution may be to retain separate entity accounting while allowing for some kind of formulary option as an alternative transfer pricing method, said Peter Barnes of Caplin & Drysdale in Washington.

"Separate entity reporting is the only way to go," Barnes said June 18, "but within transfer pricing methods there are a variety of accepted approaches."

In some cases, he said, "profit split is a reasonable way to allocate income."

Rather than choose between two extreme options, he said, nations ultimately may end up with "a menu" of approaches to address base erosion and profit shifting. One of them may be to apply some kind of formulary approach within a separate entity context, he said. Another option may be to rely more heavily on transaction taxes, he said.

However, it is clear that if some nations retain separate entity accounting and other countries adopt a form of combined reporting, compliance will become far more complicated and costly for multinationals, Barnes said.

Barnes was one of several panelists speaking at a Tax Analysts forum on U.S. state tax considerations for international tax reform.

Parallels Between States, OECD

The forum focused on the parallels between state corporate income tax regimes and proposals being

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considered by the Organization for Economic Cooperation and Development to combat BEPS.

Barnes said he is skeptical that a global formulary approach can work because of the wide variation in profit levels among countries. India, for example, has documentation to show that a number of multinationals enjoy profits within its borders that are two to three times higher than the corporation's global average, he said.

A formulary approach effectively throws all the multinational's revenue into a pot and divides it among the countries where it is doing business. Under that approach, he said, India wouldn't likely accept a global profit level of 10 percent when it knows that the multinational is clearing profits of between 20 percent and 30 percent within its borders.

Diann Smith of McDermott Will & Emery LLP in Washington observed that states routinely use a transfer pricing approach to determine the tax base of particular companies. They look at whether cross-border transactions are at arm's length, she said, to determine if they need to make an adjustment to income.

Reliance on Federal Determination

Joe Huddleston, executive director of the Multistate Tax Commission, countered that while state tax commissioners have the authority to make income adjustments, many states are nevertheless “heavily reliant” on the federal determination of taxable income.

Most states, he said, don't have the resources to “go above the line” and make an independent determination. “They start with federal taxable income and that is where they stay,” he said.

Huddleston also cautioned that U.S. states have failed to achieve uniformity within a formulary approach. He noted that states started out using the same equally weighted three-factor formula of property, payroll and sales to determine what portion of a multistate corporation's income was subject to tax in that jurisdiction. Over time, however, states drifted away from that formula. Now a number of states, including California, have adopted a single sales factor approach, he said.

The reasons, he said, are largely political. A single sales factor approach tends to reduce the tax burden for companies that are headquartered in a state or that have a significant manufacturing operation there. Thus, it can serve as an inducement to investment.

“States are prepared to slice and dice their own tax bases for the benefits perceived,” he said.

One alternative to the formulary approach, he said, is combined reporting. Under that method, multistate corporations are required to calculate the tax based on the activities of the entire group, not just the entity operating within the state. As a result, multistate taxpayers can't use transfer pricing to shift income to related parties in low- or no-tax states.

Economic Nexus

Smith and Huddleston noted differences between permanent establishment rules of the OECD and standards for establishing income tax nexus in the states. The threshold is higher for establishing a PE, Huddleston noted.

“There are all kinds of activities that create physical presence in the United States that might not in the European Union,” he said.

Smith observed that because states aren't subject to the U.S. tax treaties, they can impose requirements on multinationals that conflict with the treaties. Further, in contrast to the federal government, many U.S. states also apply an economic nexus standard for determining jurisdiction to tax. Thus, multinationals

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may find that, even though they have no PE in the U.S., they nevertheless are subject to state corporate income taxes.

Huddleston took issue with the paradigm that a tax should relate to the benefits received by the taxpayer within the jurisdiction. In an era when taxpayers can do business across borders without ever entering a jurisdiction, he said, the notion of what constitutes a “benefit” is much broader.

Access to the market is clearly one benefit, he said; the ability to enforce contracts under the judicial system of the market state is another.

“Physical presence can no longer be a reasonable standard in the world we live in,” Huddleston said.

But Barnes noted that multinationals are largely undaunted by the threat of nexus for state tax purposes.

“The fact that you might be taxable is not that big a deal. The issue is how much income is attributable” to the jurisdiction, he said

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