The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?
Acknowledgments

A project of this scope requires considerable support for its completion. Therefore, I would like to thank the numerous people who have in one way or another helped me to write this thesis.

I confidently engaged in this endeavour as a result of the encouragement of my mentor, my colleague, and my friend, Ken Aird. Ken is invariably generous with his help and kind with his comments. He has been an inspiration to me, and, for all this, I am grateful.

I have also most particularly noted, with great appreciation, the enthusiasm with which Winston Berry, Di Burney, Euan Campbell, Jim Killaly, Vera Markovski, Jenny Montagna, Kate Roff and Dédé Tadebois have greeted me every time I sought their help and advice. Phyliss Bultitude graciously spent much time expressing the proposed formula in mathematical form.

Lee Burns and Professor Richard Vann were liberal with their advice and encouragement. They have shown their commitment to the project, and their insights, meaningful comments, and suggestions were eagerly sought and unreservedly given. I am deeply indebted to them, and especially to Professor Vann whose objectivity in testing my ideas has been much appreciated.

I have severely tested the patience and ability of the staff of the University of Sydney Law School Library and that of the Australian Taxation Office Library, Sydney. It is therefore with deep gratitude that I wish to thank them for their cooperation, resourcefulness and competence, and especially Ms Anne-Marie van Wierst of the Australian Taxation Office Library, Sydney, for her invaluable help.

I would like also to express my appreciation to the Australian Taxation Office whose Commissioner’s Postgraduate Scholarship provided me with the resources to finish this project. Such substantial help has no doubt enabled me to complete this work within a reasonable time frame.

My wife Sylvia, Jean-Christophe, and Marie-Paule have all obviously sustained my efforts with their patience and sacrifice. When all seemed lost, their support renewed my determination not to give up. My gratitude to them is boundless.

Lindsay Célestin
A Sylvia, Jean-Christophe, Marie-Paule et toute ma famille, avec mon affection, mes remerciements et ma gratitude.
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<td>Advisory Commission on Intergovernmental Relations (California)</td>
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<td>APA</td>
<td>Advance Pricing Arrangements/Agreements</td>
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<tr>
<td>APEC</td>
<td>Asia-Pacific Economic Cooperation</td>
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<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
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<tr>
<td>AASB</td>
<td>Australian Accounting Standards Board</td>
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<tr>
<td>ATO</td>
<td>Australian Taxation Office</td>
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<tr>
<td>AUD</td>
<td>Australian dollar</td>
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<tr>
<td>BALRM</td>
<td>Basic arm’s length return method</td>
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<td>BIAC</td>
<td>Business and Industry Advisory Committee</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BOO</td>
<td>Build-own-operate</td>
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<tr>
<td>BOT</td>
<td>Built-operate-transfer</td>
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<tr>
<td>BTO</td>
<td>Built-transfer-operate</td>
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<tr>
<td>CA</td>
<td>Competent authority</td>
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<tr>
<td>CARICOM</td>
<td>Caribbean Community</td>
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<tr>
<td>CATA</td>
<td>Commonwealth Association of Tax Administrators</td>
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<td>CEN</td>
<td>Capital Export Neutrality</td>
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<tr>
<td>CFC</td>
<td>Controlled Foreign Corporations</td>
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<tr>
<td>CIAT</td>
<td>Inter-American Centre of Tax Administrators</td>
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<tr>
<td>CIN</td>
<td>Capital Import Neutrality</td>
</tr>
<tr>
<td>CMEA</td>
<td>Council for Mutual Economic Assistance also referred to as COMECON</td>
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<tr>
<td>CPA</td>
<td>Certified Public Accountants</td>
</tr>
<tr>
<td>CPM</td>
<td>Comparable Profit Method</td>
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<tr>
<td>CREDAF</td>
<td>Centre de rencontres et d’études des dirigeants des administrations fiscales</td>
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<tr>
<td>CUFT</td>
<td>comparable uncontrolled financial transaction method</td>
</tr>
<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price</td>
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<tr>
<td>DFI</td>
<td>Derivative financial instruments</td>
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<tr>
<td>DISC</td>
<td>Domestic International Sales Corporations</td>
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<tr>
<td>DTA</td>
<td>Double Tax Agreement</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<td>ECJ</td>
<td>European Court of Justice</td>
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<td>ECOFIN</td>
<td>European Council of Economic Finance Ministers</td>
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<td>EEC</td>
<td>European Economic Community</td>
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<tr>
<td>EMU</td>
<td>Treaty on Economic and Monetary Union</td>
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<td>EU</td>
<td>European Union</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board (U.S.)</td>
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<td>FCN</td>
<td>Treaties of Friendship, Commerce and Navigation</td>
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<td>FDI</td>
<td>Foreign direct investments</td>
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<td>FRC</td>
<td>Financial Reporting Council (Australia)</td>
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<td>FOIA</td>
<td>U.S. Freedom of Information Act</td>
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<td>FSC</td>
<td>Foreign Sales Corporations</td>
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<td>FTB</td>
<td>Franchise Tax Board (California)</td>
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<td>FTCS</td>
<td>Foreign Tax Credit System</td>
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<td>FTUE</td>
<td>Formulary Taxation of the Unitary Enterprise</td>
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<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>GAO</td>
<td>General Accounting Office</td>
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<tr>
<td>GATS</td>
<td>General Agreement on Tariff and Services</td>
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<td>GATT</td>
<td>General Agreement on Tariff and Trade</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GMM</td>
<td>Gross margin method</td>
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<td>GMUM</td>
<td>Gross mark-up method</td>
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<tr>
<td>GNP</td>
<td>Gross National Product</td>
</tr>
<tr>
<td>IAFFEI</td>
<td>International Association of Financial Executives Institutes</td>
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<tr>
<td>IASs</td>
<td>International accounting standards</td>
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<tr>
<td>IASC</td>
<td>International Accounting Standards Committee</td>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>ICSID</td>
<td>International Centre for the Settlement of Investment Disputes</td>
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<td>IFA</td>
<td>International Fiscal Association</td>
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<tr>
<td>IFS</td>
<td>Institute for Fiscal Studies, London</td>
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<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
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<tr>
<td>IIB</td>
<td>Institute of International Bankers</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
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Abbreviations

IOTA Intra-European Organisation of Tax Administrators
IPA Interest Paid Adjustment
IPS International profit shifting
IRC Internal Revenue Code (U.S.)
IRS Internal Revenue Service (U.S.)
ITAA Income Tax Assessment Act (Australia)
JVA Joint Africa Institute
JVI Joint Vienna Institute
LDC Less developed countries
MAATM  *Convention on Mutual Administrative Assistance in Tax Matters*
MAI Mutual Agreement on Investments
MAP Mutual Agreement Procedure
MFN Most Favoured Nation
MNC Multinational Corporations/Companies
MNE Multinational Enterprises
MTC Multistate Tax Compact
NAFTA North American Free Trade Association
NTA National Tax Association (U.S.)
NTA National Tax Administration (Japan)
OAS Organisation of American States
OCAM Organisation Commune Africaine Malgache et Mauricienne
OECD Organisation for Economic Co-operation and Development
OEEC Organisation for European Economic Co-operation
OPEC Organisation of Petroleum Export Countries
OTC Over-the-counter (derivative products)
PATA Pacific Association of Tax Administrators
PCM Profit Comparison Method (Australia, Draft Ruling TR95/D22).
PCS Pre-Confirmation System
PE Permanent Establishments
PR U.S. Proposed Regulation in Global Dealings
QBU qualified business units
QMV Qualified majority voting
R & D Research and Development
<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>RAROC</td>
<td>Risk adjusted return on capital</td>
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<td>RORAC</td>
<td>Return on risk-adjusted capital</td>
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<tr>
<td>SA/AL</td>
<td>Separate Accounting/Arm’s Length Method</td>
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<tr>
<td>SE</td>
<td>Société Européenne</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SIC</td>
<td>Standing Interpretations Committee</td>
</tr>
<tr>
<td>SGATAR</td>
<td>Study Group on Asian Tax Administrators and Research</td>
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<td>SDC</td>
<td>Standards Development Committee (IASC)</td>
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<tr>
<td>TAAS</td>
<td>Tax Administration Advisory Services</td>
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<tr>
<td>TEP</td>
<td>Transatlantic Economic Partnership</td>
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<td>TIEA</td>
<td>Tax Information Exchange Agreements</td>
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<tr>
<td>TIN</td>
<td>Tax Identification Number</td>
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<tr>
<td>TNC</td>
<td>Transnational Corporation</td>
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<td>TNE</td>
<td>Transnational Enterprise</td>
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<td>TNMM</td>
<td>Transactional Net Margin Method</td>
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<td>TPM</td>
<td>transfer pricing methodologies</td>
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<tr>
<td>UDITPA</td>
<td>Uniform Division of Income for Tax Purposes Act</td>
</tr>
<tr>
<td>U.K.</td>
<td>The United Kingdom</td>
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<tr>
<td>U.N.</td>
<td>The United Nations</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>U.N. Conference on Trade and Development</td>
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<tr>
<td>U.S.</td>
<td>The United States of America</td>
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<tr>
<td>USD</td>
<td>U.S. dollar</td>
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<tr>
<td>VAT</td>
<td>Value-added tax</td>
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<tr>
<td>WAIFC</td>
<td>World Association of International Financial Centres</td>
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<td>WTO</td>
<td>World Trade Organisation</td>
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<tr>
<td>WUT</td>
<td>Worldwide Unitary Theory</td>
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<td>WWCR</td>
<td>Worldwide Combined Reporting</td>
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The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?
The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?

Synopsis

The central hypotheses of this thesis are:

- that global formulary apportionment is the most appropriate method for the taxation of transnational corporations (TNCs) in lieu of the present system commonly referred to as the separate accounting/arm’s length method; and

- that it is essential, in order to implement the proposed global formulary model, to create an international organisation which would fulfil, in the taxation field, a role equivalent to that of the World Trade Organisation (WTO) in international trade.

The world economy is fast integrating and is increasingly dominated by the activities of transnational enterprises. These activities create a dual tax problem for various revenue authorities seeking to tax gains derived thereon:

- Firstly, when two or more countries entertain conflicting tax claims on the same base, there arises what is commonly referred to as a double taxation problem.

- Secondly, an allocation problem arises when different jurisdictions seek to determine the quantum of the gains to be allocated to each jurisdiction for taxation purposes.

The traditional regime for solving both the double taxation and the allocation problem is enshrined in a series of bilateral treaties signed between various nations. These are, in general, based on the Organisation for Economic Co-operation and Development (OECD) Model Treaty. It is submitted, in this thesis, that while highly successful in an environment characterised by the coexistence of various national taxation systems, the traditional regime lacks the essential attributes suitable to the emerging ‘borderless world’.

The central theme of this thesis is the allocation problem. The OECD Model attempts to deal with this issue on a bilateral basis. Currently, the allocation problem is resolved through the application of Articles 7 and 9 of the OECD Model. In both instances the solution is based on the ‘separate enterprise’ standard, also known as the separate entity theory.

This separate accounts/arm’s length system was articulated in the 1930s when international trade consisted of flows of raw materials and other natural products as well as flows of finished manufactured goods. Such trade is highly visible and may be adequately valued both at the port of departure or at the port of entry in a country. It follows that within this particular system of international trade the application of the arm’s length principle was relatively easy and proved to be extremely important in resolving both the double taxation and apportionment problems.

Today, however, the conditions under which international trade is conducted are substantially different from those that prevailed until the 1960s.

- Firstly, apart from the significant increase in the volume of traditionally traded goods, trade in services now forms the bulk of international exchanges. In addition, the advent of the information age has dramatically increased the importance of specialised information whose value is notoriously difficult to ascertain for taxation purposes.

- Secondly, the globalisation phenomenon which gathered momentum over the last two decades has enabled existing TNCs to extend their global operations and has favoured the emergence of new transnational firms. Thus, intra-firm trade conducted outside market conditions accounts for a substantial part of international trade.

- Thirdly, further economic integration has been achieved following the end of the Cold War and the acceleration of the globalisation phenomenon. In this new world economic order only TNCs have the necessary resources to take advantage of emerging opportunities.

The very essence of a TNC is ‘its ability to achieve higher revenues (or lower costs) from its different subsidiaries as a whole compared to the results that would be achieved under separate management on an arm’s length basis.’ Yet, the prevailing system for the taxation of TNCs overlooks this critical characteristic and is therefore incapable of fully capturing, for taxation purposes, the aggregate gains of TNCs. The potential revenue loss arising from the inability of the present system to account for and to allocate synergy gains is substantial.

It follows that the perennial questions of international taxation can no longer be addressed within the constraints of the separate entity theory and a narrow definition of national sovereignty. Indeed, in order to mirror the developments occurring in the economic field, taxation needs to move from a national to an international level.

Moreover, a profound reform of the system is imperative in order to avoid harmful tax competition between nations and enhance compliance from TNCs. Such a new international

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Synopsis
tax system needs to satisfy the test of simplicity, equity, efficiency, and administrative ease. To achieve these objectives international cooperation is essential. The hallmark of international cooperation has been the emergence, after World War II, of a range of international organisations designed to facilitate the achievement of certain goals deemed essential by various nations. The need for an organisation to deal specifically with taxation matters is now overwhelming.

Consequently, this thesis recommends the creation of an international organisation to administer the proposed system. The main objective of this international organisation would be to initiate and coordinate the multilateral application of a formulary apportionment system which, it is suggested, would deal in a more realistic way with ‘the difficult problems of determining the tax base and allocating it appropriately between jurisdictions’.3

The global formulary apportionment methodology is derived from the unitary entity theory. The unitary theory considers a TNC as a single business which, for convenience, is divided into ‘purely formal, separately-incorporated subsidiaries’.4 Under the unitary theory the global income of TNCs needs to be computed, then such income is apportioned between the various component parts of the enterprise by way of a formula which reflects the economic contribution of each part to the derivation of profits.

The question that arises is whether the world of international taxation is ready for such a paradigm shift. It is arguable that this shift has already occurred albeit cautiously and in very subtle ways. Thus, the latest of the OECD Guidelines on the transfer pricing question provides that ‘MNE [Multinational Enterprise] groups retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm’s length principle in accordance with these Guidelines.’5 Arguably, the globalisation process has created ‘the specific situation’ allowed for by the OECD. This thesis, therefore, explores the relative obsolescence of the bilateral approach to the taxation of TNCs and then suggests that a multilateral system is better adapted to the emerging globalised economy.

The fundamental building blocks of the model proposed in this thesis are the following:

- First, the administration and coordination of the proposed system is to be achieved by the creation of a specialised tax organisation, called Intertax, to which member countries would devolve a limited part of their fiscal sovereignty.

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3 Id., at 333.
Second, in order to enable the centralised calculation of TNC’s profits, the proposed system requires the formulation of harmonised methods for the measurement of the global profits of TNCs. Therefore, the efforts of the International Accounting Standards Committee (IASC) to produce international accounting standards and harmonised consolidation rules must be recognised and, if needs be, refined and ultimately implemented.

Third, the major function of Intertax would be to determine the commercial profits of TNCs on a standardised basis and to apportion the latter to relevant countries by way of an appropriate formula/formulas.

Once this is achieved, each country would be free, starting from its share of commercial profits, to determine the taxable income in accordance with the particular tax base that it adopts and, ultimately, the tax payable within its jurisdiction. In the proposed system, therefore, a particular country would be able to independently set whatever depreciation schedules or investment tax credits it chooses, and adopt whatever tax accounting rules it deems fit relative to its policy objectives.

Moreover, this thesis argues that the global formulary apportionment model it proposes is not dramatically opposed to the arm’s length principle. Indeed, it suggests that the constant assumption to the contrary, even with regard to the usual formulary apportionment methodology, is extravagant because both methodologies are based on a common endeavour, that is, to give a substantially correct reflex of a TNC’s true profits.

It has often been objected that global formulary apportionment is arbitrary and ignores market conditions. This thesis addresses such concerns by rejecting the application of a single all-purpose formula. Rather, it recognises that TNCs operating in different industries require different treatment and, therefore, suggests the adoption of different formulas to satisfy specific industry requirements. For example, the formula applicable to a financial institution would be different to that applicable to the pharmaceutical industry. Each formula needs to be based on the fundamental necessity to capture the functions, taking into consideration assets used, and risks assumed within that industry. In addition, if the need arises, each formula should be able to be fine-tuned to fit specific situations. Moreover, it is also pertinent to note that the OECD already accepts ‘the selected application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE group...such as it might be used in a mutual agreement procedure, advance transfer pricing agreement, or other bilateral or multilateral determination.’\(^6\) The system proposed in this thesis can thus be easily reconciled with the separate accounting/arm’s length which the OECD so vehemently advocates. Both models

\(^6\) *Id.*, at III-20 para. 3.60.
have the same preoccupations so that what is herein proposed may simply be characterised as an institutionalised version of the system advocated by the OECD.

Multilateral formulary apportionment addresses both the double taxation and the allocation problems in international taxation. It resolves the apportionment question ‘without depending on an extraordinary degree of goodwill or compliance from taxpayers.’ It is therefore submitted that, if applied on a multilateral basis with a minimum of central coordination, it also seriously addresses the double taxation problem. Indeed, it is a flexible method given that different formulas may be devised to suit the needs of TNCs operating in different sectors. Consequently, formulary apportionment understood in this sense, is a realistic alternative to the limitations of the present system.

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7 Bird, supra note 2, at 333.
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## PART II  THE SEARCH FOR A NEW INTERNATIONAL TAX ORDER

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