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## Formulary Apportionment vs. Arm's Length Principle

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*“From insight  
to impact”* 

## Overview

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- **Introduction and Terminology**
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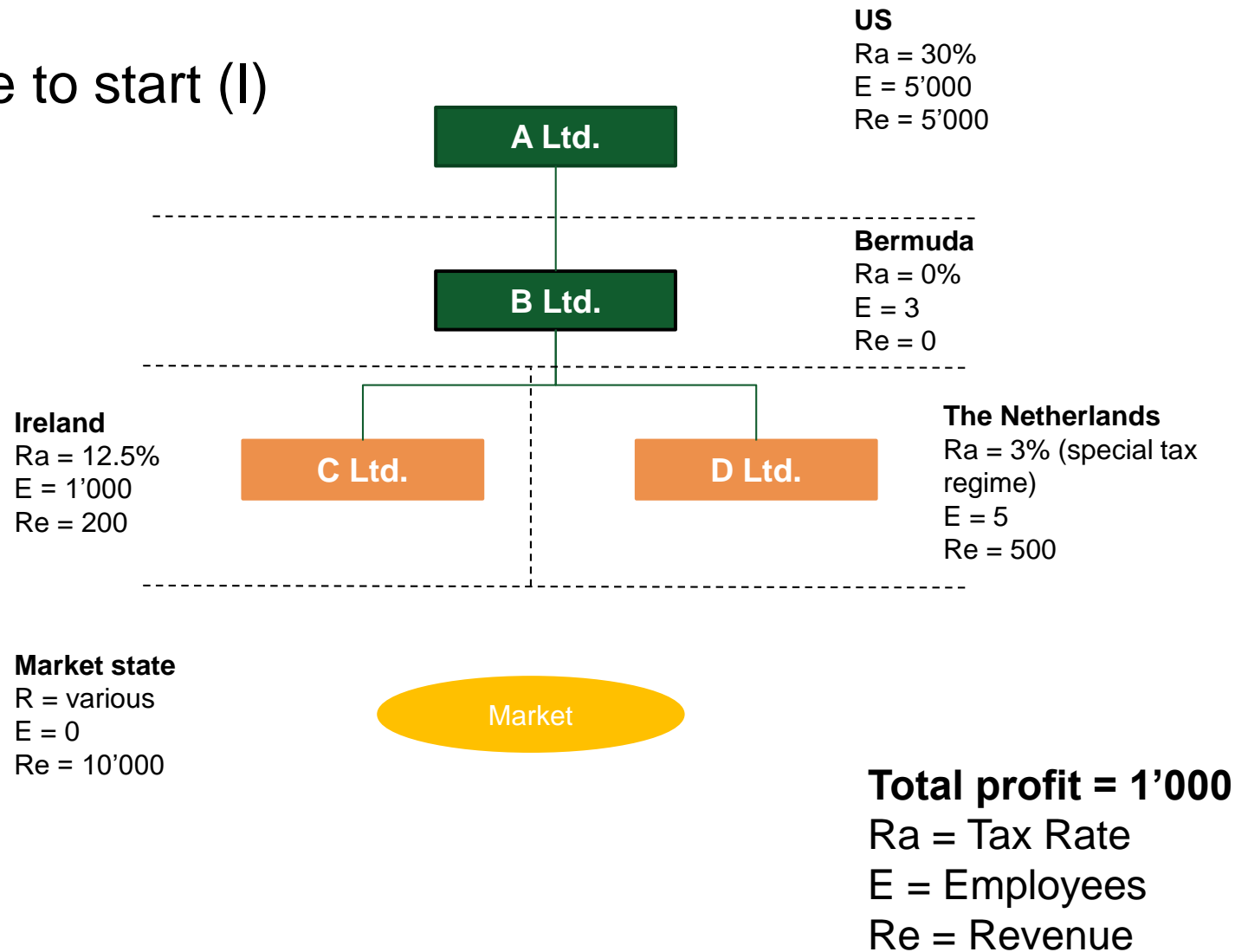


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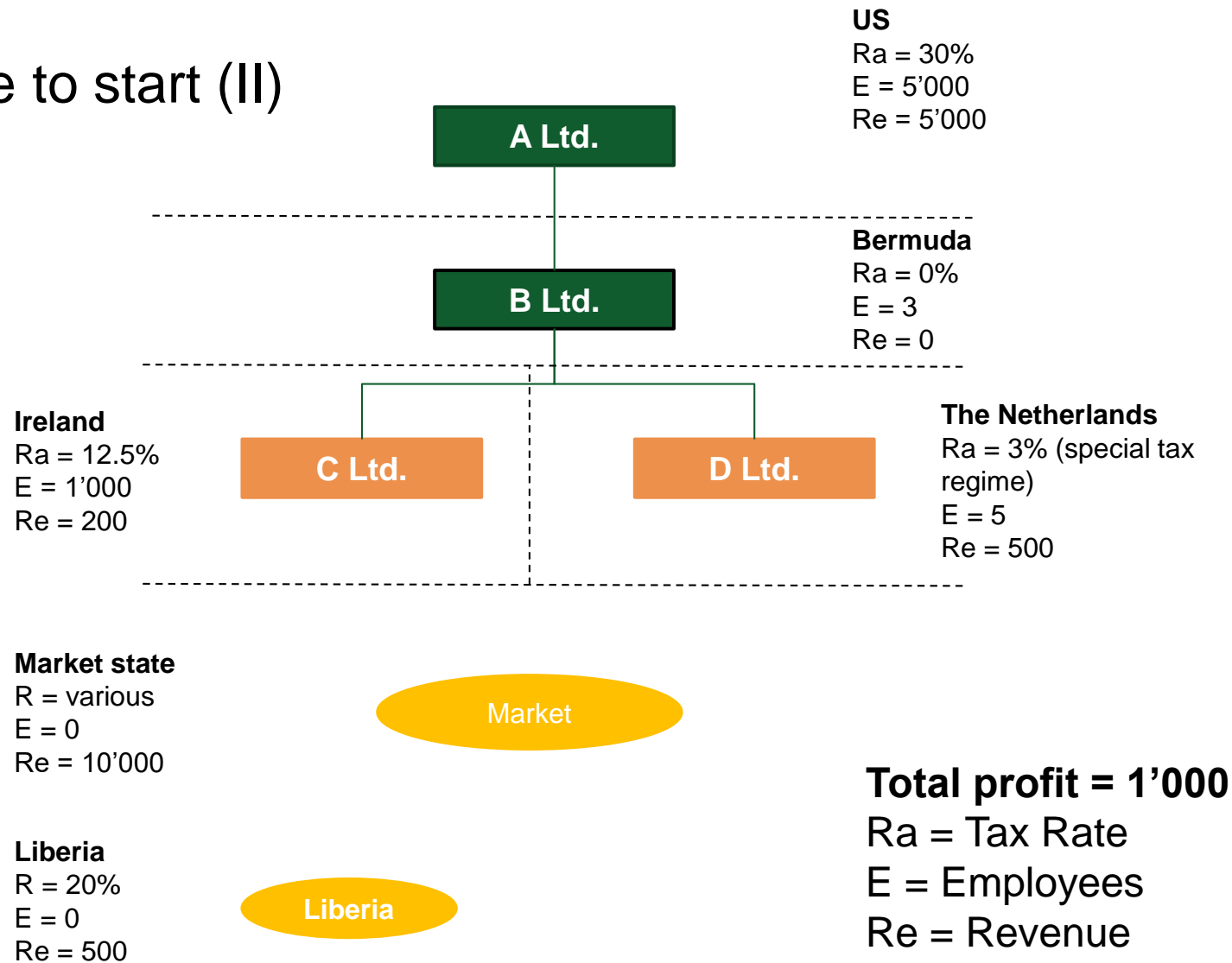


An example to start

## An example to start (I)



## An example to start (II)





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## Introduction and Terminology

## Introduction and Terminology

Formulary apportionment – some preliminary remarks

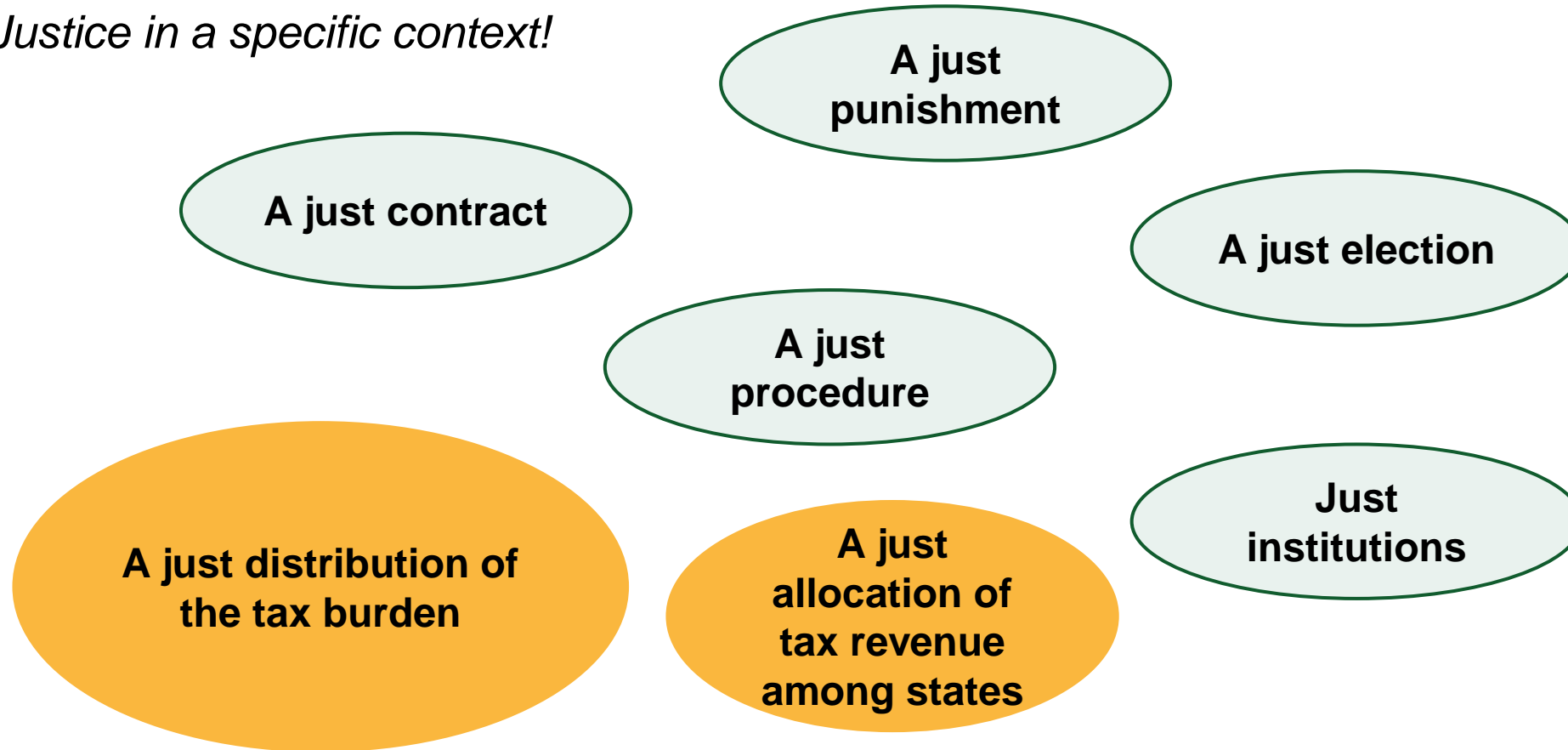
- *Allocation of profits among several entities (companies and PEs)*
- *Applied in domestic situations (e.g. in the US and Switzerland)*
- *Discussed as an allocation key in the EU (e.g. CC[C]TB)*
- *Partly relevant for some TP methods (e.g. profits split)*
- *Partly relevant for the determination of the GloBE minimum tax (see allocation of UTPR revenue)*

*Potential factors:*

- *Revenue*
- *Assets*
- *People / Labour*

## Introduction and Terminology

*Justice in a specific context!*







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Justice in an Institutional Context

## Justice in an Institutional Context

1. Governmental institutions trigger specific justice considerations
2. A societal basic structure triggers specific justice considerations

*«A conception of justice for the basic structure of society is a conception of social justice. Social justice concerns justice in the production and distribution of the goods for the sake of which a people cooperates within and through the basic structure of its society. Rawls distinguishes social justice from local or transactional justice (a conception of justice for a particular kind of institution or transaction within a society), on the one hand, and international justice (a conception of justice for the relations between societies), on the other. He begins, but does not end, his inquiry into justice with an inquiry into social justice. Rawls's two principles specify a conception of social justice, "justice as fairness."»*

*(The Cambridge Rawls Lexicon, Mandle & Reidy [eds])*

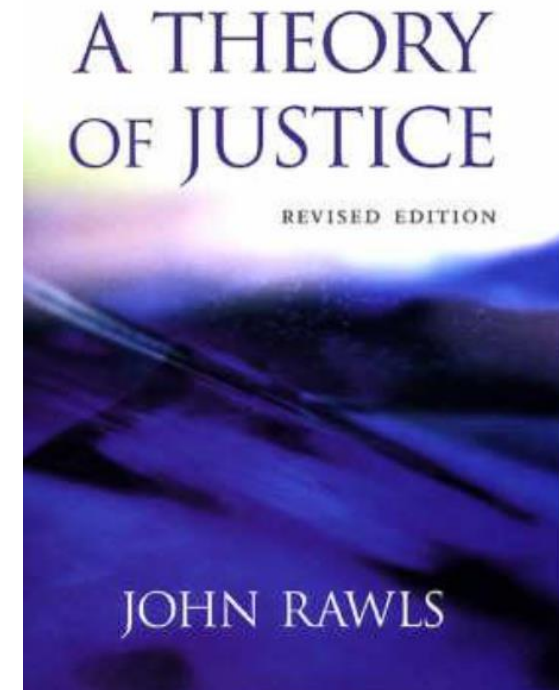
## Justice in an Institutional Context

Rawls' «Two Principles of Justice as Fairness»

**First Principle:** *Each person has the same inalienable claim to a fully adequate scheme of equal basic liberties, which scheme is compatible with the same scheme of liberties for all;*

**Second Principle:** *Social and **economic inequalities** are to satisfy two conditions:*

- a. They are to be attached to offices and positions open to all under conditions of fair equality of opportunity;*
- b. They are to be to the greatest benefit of the least-advantaged members of society (the difference principle)*





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Justice in a Global Context

## Justice in a Global Context

Some questions we will deal with:

- Do states indeed need to share „the pie“, i.e. is single taxation indeed the ideal solution?
- If yes, how should we avoid double taxation?
- If yes, what does single taxation mean?
- Is there a normative claim for cross-border distributive duties?
- Is tax law an efficient instrument to achieve distributive duties? Or are other legal measure more efficient?
- Should international tax policy aim at strengthening the sovereignty of states or not?

## Justice in a Global Context

### Some preliminary philosophical remarks

- There is an intense discussion about global justice among philosophers since the 1970s
- Still a young discipline but (of course) some important reference points in the past, inter alia:
  - Aristotle (distributive justice – commutative justice)
  - Kant (The Perpetual Peace)
- Two important contemporary ideas
  - Monism / Cosmopolitanism
  - Dualism / Statism

## Justice in a Global Context

### Some preliminary philosophical remarks

- Monism vs. Dualism
- Statism vs. Cosmopolitanism

## Justice in a Global Context

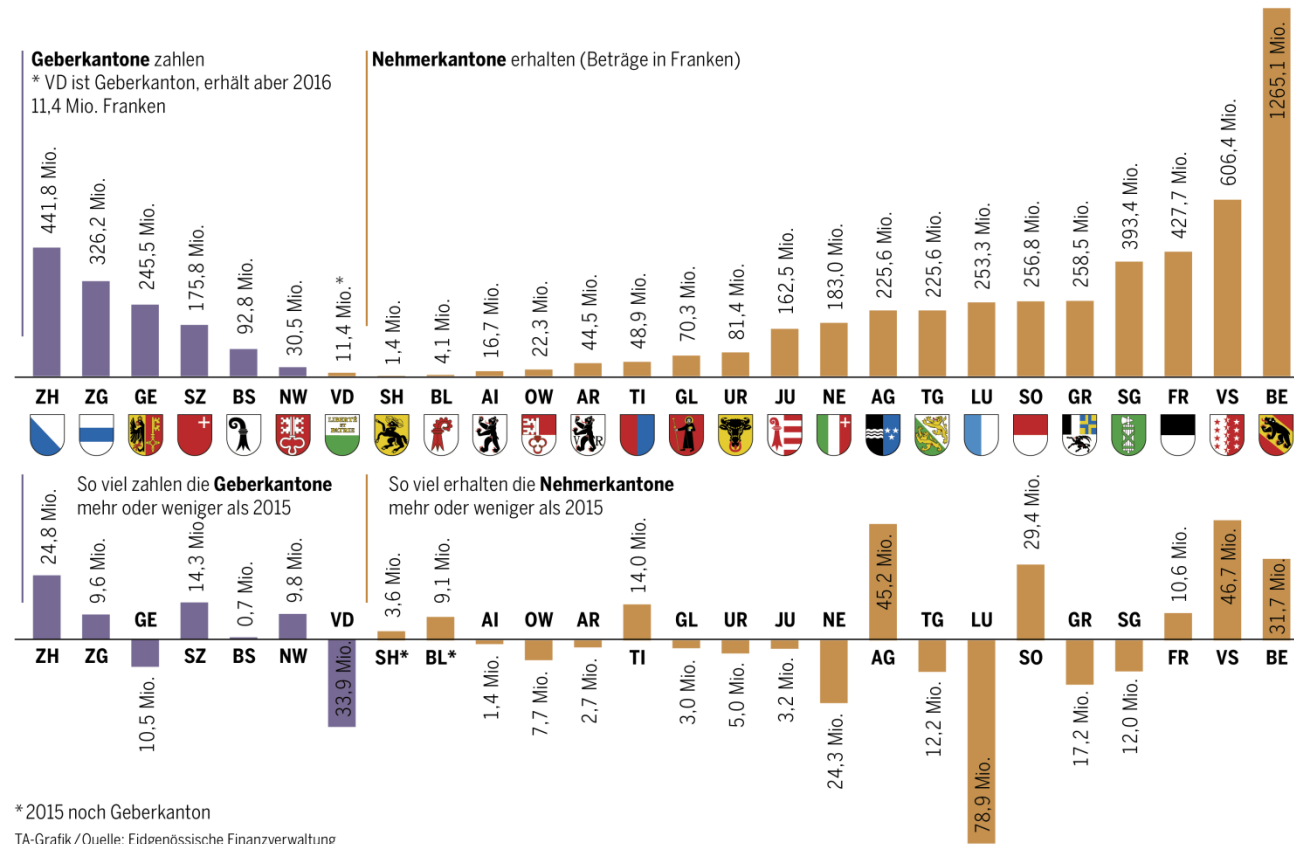
### Monism / Cosmopolitanism

- Egalitarian approach
- Same duties against everyone in the world?
- Distributive payments from the rich to the poor countries
- Practical constraints?
- Thomas Pogge & Charles Beitz



# Normative Review of the Most Essential Design Principles

## Der Finanzausgleich 2016



## Normative Review of the Most Essential Design Principles

### Überblick Ausgaben DEZA 2013 - 2017 (Mio. CHF)

	2013	2014	2015	2016	2017 <sup>a</sup>
Humanitäre Hilfe	387.2	463.0	539.9	481.1	447.3
Entwicklungszusammenarbeit	1'419.5	1'496.8	1'562.9	1'523.3	1'321.4
Ostzusammenarbeit	129.1	148.5	164.2	155.6	134.1
EU-Erweiterungsbeitrag	109.3	119.9	90.3	62.1	76.0
Eigenaufwand	-	-	-	-	104.8
<b>Gesamtausgaben DEZA</b>	<b>2'045.1</b>	<b>2'228.2</b>	<b>2'357.3</b>	<b>2'222.2</b>	<b>2'083.6</b>

<sup>a</sup> Exkl. Anteil der Ausgaben von Schweizer Vertretungen im Ausland für die internationale Zusammenarbeit



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Normative Review of the Most Essential Design Principles

# Normative Review of the Most Essential Design Principles

## **In general**

- No constitution
- How do you justify tax policy decisions?
- Design principles are key

# Normative Review of the Most Essential Design Principles

## Source principle

- The source principle as a sovereignty concern
  - Source principle als justification-to-tax but also as a limitation-to-tax principles
  - States should not tax income that has ben generated abroad with no link to a territory
- The source principle as an allocation key?
  - Depending on the understanding this leads to a higher allocation to very productive countries
  - Libertarianism?

# Normative Review of the Most Essential Design Principles

## Benefit principle

- The benefit principle as a sovereignty concern
  - Benefit principle als justification-to-tax but also as a limitation-to-tax principle
- The source principle as an allocation key?
  - Could lead to obviously unjust results

### Example

A Haitian professional boxer earned USD 10,000 in 2012 as a salary, which he receives from the national boxing federation. He earns very little income from sponsors. In 2012, he attended the Olympic Games and stayed in London for 3 weeks. The tax rate in London is presumably 30%, but only 10% in Haiti. Let's assume that the received benefits in the year 2012 are equal between Haiti and the United Kingdom, as the security and building of the specific Olympic premises were very expensive and, therefore, even though he stayed only a few weeks in London, the UK benefits have the same value as the Haitian benefits for the rest of the year.<sup>2229</sup> This would mean, following the benefit principle as an allocation principle, that London could tax USD 5,000 at 30%, i.e. USD 1,500 and Haiti could tax USD 5,000 at a rate of 10%, i.e. USD 500. This would be a strange outcome and clearly opposing cosmopolitan theories of justice, such as those developed by Pogge and Beitz.<sup>2230</sup>

Peter Hongler, Justice in International Tax Law, IBFD 2019, p. 450

## Normative Review of the Most Essential Design Principles

### **Efficiency/neutrality**

- Capital export neutrality
- Capital import neutrality
- Capital ownership neutrality
  
- Why should the international tax system be neutral/efficient?
- Utilitarian position – growing the cake is good per se!
- But: we cannot distribute income at an international level.



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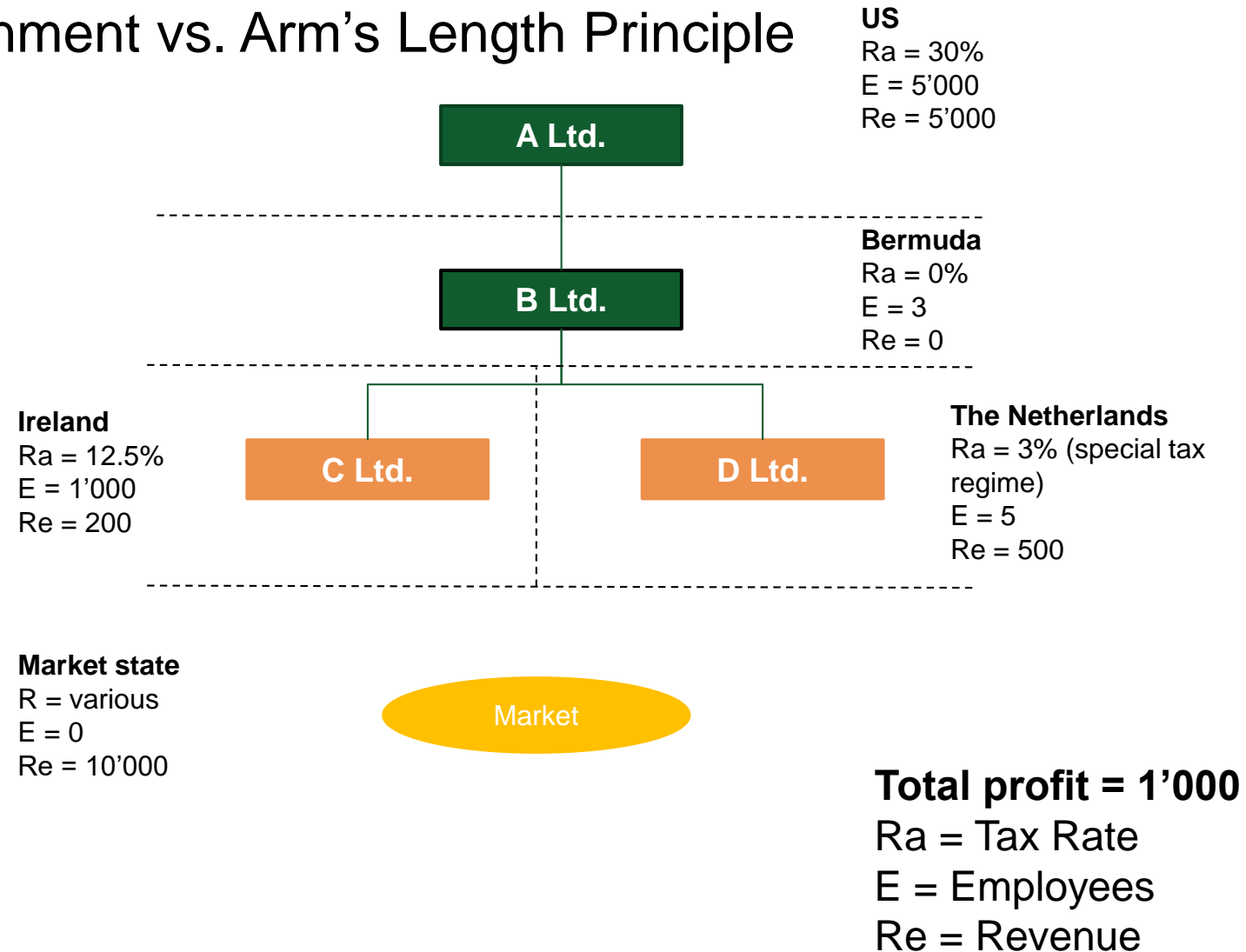


Formulary Apportionment vs. Arm's Length Principle



## Formulary Apportionment vs. Arm's Length Principle

1. Source principle
2. Benefit principle
3. Efficiency?



## Formulary Apportionment vs. Arm's Length Principle (Disadvantages!)

Formulary apportionment	Arm's length principle
Arbitrary results - not reflecting the business reality	No comparable
Would require intense cooperation	Transfer mispricing / aggressive tax planning
Would lead to distortions	Excessively complex
No underlying theoretical concept	Favors capital exporting countries due to the allocation of the residual profits
Depending on the formula, detrimental for developing states	Does not reflect value creation
Unfair / unjust	Unfair / unjust

## Formulary Apportionment vs. Arm's Length Principle

### Formulary Apportionment vs. Arm's Length Principle (Disadvantages!)

- ALP only applies to active income!
- Both systems have losers and winners
- However, ALP does not require full harmonization
- Why should I agree to full harmonization if I loose? (due to other benefits – fiscal transfers, union advantages, etc.)
- Tax harmonization in federal states such as Switzerland has only been succesful as there is a comprehensive transfer system in place

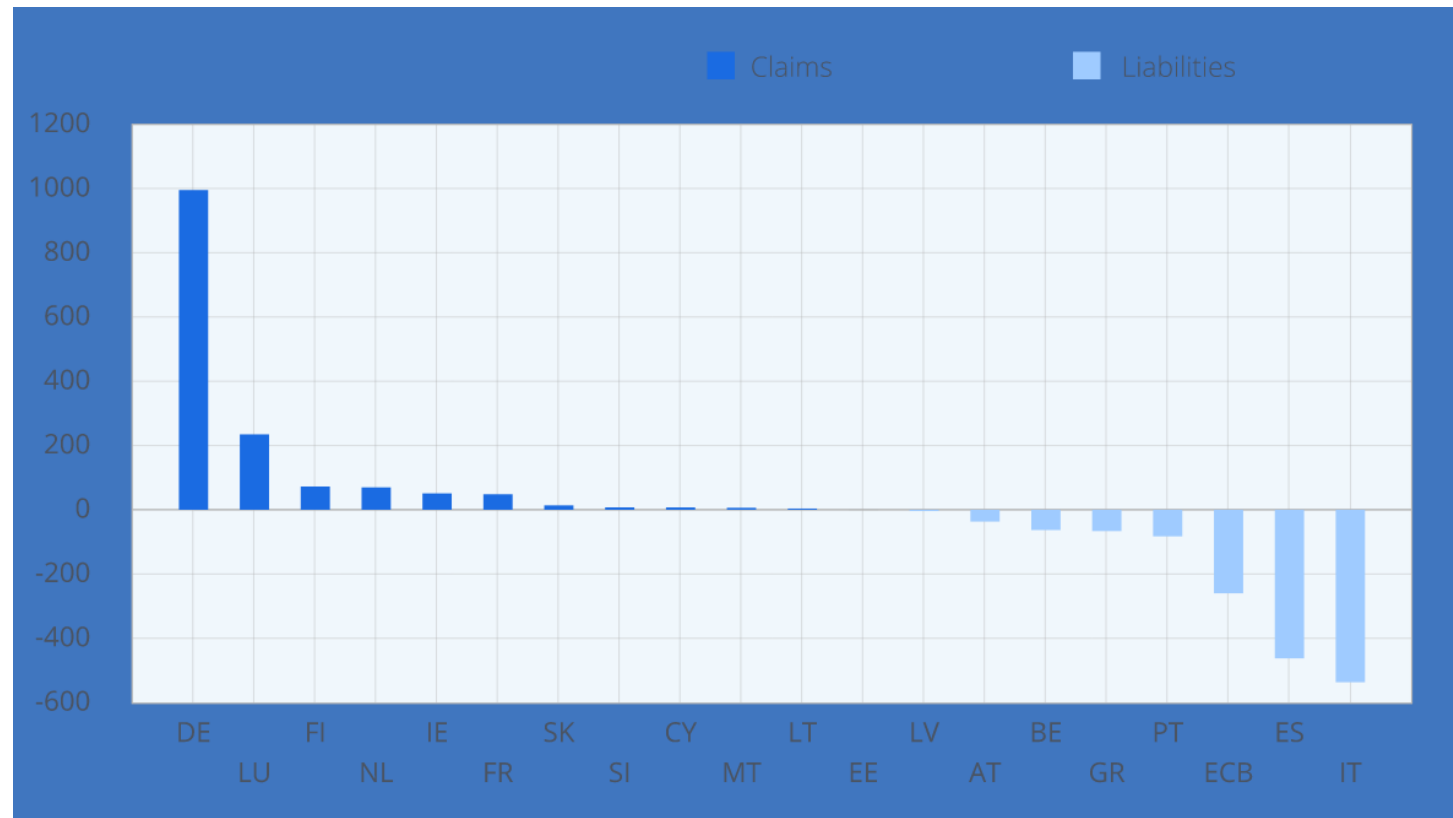
## Formulary Apportionment vs. Arm's Length Principle

- Will tax harmonization (incl. formulary apportionment) in the EU be successful?
- Tax harmonization has winners and losers – losers will and should only agree if the system is well-balanced e.g. through a fiscal transfer system
- Key is question: Are the Target 2 claims and liabilities considered to be fiscal transfers between states?
- If yes, there are good reasons in order to argue in favor of harmonizing corporate income taxes within the EU
- (I am not in a position to argue whether there should or should not be a fiscal transfer system in the EU)

## Formulary Apportionment vs. Arm's Length Principle (Disadvantages!)

**Will tax harmonization in the EU be succesful?**

**Target 2 – Claims and liabilities – a fiscal transfer system**



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