Unitary Taxation of the Finance Sector

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Summary

Multinational financial institutions (MNFIs) play a significant role in financing the activities of their clients in developing nations. Consistent with the ‘follow-the-customer’ phenomenon which explains financial institution expansion, these entities are increasingly profiting from activities associated with this growing market. However, not only are MNFIs persistent users of tax havens, but also, more than other industries, have the opportunity to reduce tax through transfer pricing measures. This paper establishes a case for an industry-specific adoption of unitary taxation with formulary apportionment as a viable alternative to the current regime. In doing so, it considers the practicalities of implementing this by examining both definitional issues and possible formulas for MNFIs. This paper argues that, while there would be implementation difficulties to overcome, the current domestic models of formulary apportionment provide important guidance as to how the unitary business and business activities of MNFIs should be defined, as well as the factors that should be included in an allocation formula, and the appropriate weighting. This paper concludes that unitary taxation with formulary apportionment is a viable industry-specific alternative for MNFIs.

Keywords: international tax; unitary taxation; formulary apportionment; multinational banks; developing nations.

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Acronyms

| Acronym | Description                                      |
|---------|--------------------------------------------------|
| APA     | Advance Pricing Agreement                        |
| ATTA    | Australasian Tax Teachers Association            |
| CCCTB   | Common Consolidated Corporate Tax Base           |
| CSFT    | Complex Structured Finance Transactions          |
| EU      | European Union                                   |
| ICTD    | International Centre for Tax and Development     |
| IMF     | International Monetary Fund                      |
| IRS     | Inland Revenue Service                           |
| MNFI    | Multinational Financial Institution              |
| OECD    | Organisation for Economic Co-operation and Development |
| US      | United States                                    |
Introduction

The international tax system, designed a century ago, has not kept pace with the modern multinational entity, rendering it ineffective in taxing many modern businesses according to economic activity. There are difficulties associated with the application of the traditional international tax regime to traditional multinational entities, and these are exacerbated when the same regime is applied to sectors of multinational entities which are considered non-traditional businesses. One of the modern multinational entities where this is most evident is the multinational financial institution (MNFI). The recent global financial crisis provides a particularly relevant and significant example of the failure of the current financial system on a global scale. However, because MNFIs are intermediaries that facilitate foreign investment, the activities of these multinational entities continue to impact the economies of developing nations, and this is particularly evident in the context of taxation. Unlike mining, tourism and manufacturing, the finance and banking industry is not generally considered to be a primary participant in the economic growth of developing nations. However, its influence on that growth cannot be underestimated.

MNFIs are generally thought of as potential promoters of aggressive tax planning strategies, with the focus of reports and exposés calling for tax reform generally aimed at the industries these institutions assist. However, MNFIs themselves are also taxpayers, which enter the markets of developing nations and profit from their strong growth rates. As such, while this paper does not dismiss the role that MNFIs play in aggressive tax planning by their clients, it focuses on the MNFI as a taxpayer rather than the facilitator of such practices.

Section 1 of this paper explains the significance of MNFIs for developing nations, and establishes the rationale for industry-specific international tax reform through unitary taxation based on formulary apportionment. Longitudinal studies conducted by International Monetary Fund (IMF) researchers provide evidence of the rate of growth of MNFI presence in developing nations. The IMF recently reported that from 1995 to 2009, foreign bank presence in developing countries grew by 122 per cent (Claessen and Van Horen 2012). The same study indicates that foreign banks have a 20 per cent market share in Organisation for Economic Co-operation and Development (OECD) countries, and 50 per cent in emerging markets and developing countries. Hence, MNFIs are increasingly undertaking an intermediary role in developing economies, where they are financing core business activities such as manufacturing, mining and tourism. IMF analysis also suggests that in future foreign bank expansion will be greatest in emerging economies. This part of the paper also explains the unique nature of MNFIs, and the difficulties developing nations face in applying the current international tax rules. Difficulties associated with the application of the current source rules, along with the traditional transfer pricing regime and its arm’s length requirement, are particularly acute in relation to MNFIs, which are the biggest users of tax havens and offshore finance. It then states the theoretical case for the adoption of unitary taxation with formulary apportionment for MNFIs.

Sections 2 and 3 investigate whether a unitary taxation approach, which reflects economic reality and is theoretically superior, would from a practical perspective more easily and effectively ensure that the profits of MNFIs are taxed in the jurisdictions which give rise to them. Specifically, this paper analyses the effect of a unitary taxation approach on the allocation of profits of MNFIs to the developing nations in which the profits are earned. In doing so, the paper examines the practicality of the implementation of unitary taxation for MNFIs in terms of the key components of such a regime, and their implications for developing countries. The paper adopts a two-step approach to considering the implications of unitary taxation as a means of improved corporate tax coordination, which requires
international acceptance and agreement. Section 2 considers the definitional issues of the unitary MNFI, while Section 3 investigates an appropriate allocation formula for the sector.

Specifically, Section 2 asks how the financial sector should be defined for the purposes of unitary taxation, and what should constitute a unitary business for that sector. It argues that it is appropriate to adopt a modern concept of nexus for the purposes of jurisdiction to tax, as well as a broad definition of financial institution for the purposes of determining the application of the regime to a particular sector. It also argues that a wide definition of the unitary business should be adopted where a sector-specific approach to unitary taxation is implemented. It outlines the previous practice of applying a unitary taxation approach to the financial sector which has focused on a narrowly-defined segment of the business of MNFIs and the integrated nature of 24-hour global trading. This leads to the conclusion that particular aspects of the sector cannot and/or should not be separated from the more traditional aspects of financial sector activities. This is of particular importance for developing countries, in which MNFIs typically would locate only retail and some aspects of wholesale financial services but not their trading activities. Adoption of a narrow definition of a unitary business for MNFIs would be likely to limit the potential advantages of unitary taxation generally, and for developing countries specifically.

Section 3 considers what would be the 'best practice' model for an allocation formula for the purpose of apportionment of the profits of the unitary business of a financial institution. Recommendations are based on available data from existing domestic unitary tax regimes, proposed regimes and current practice in relation to advance pricing agreements (APAs) for global trading. A theoretical analysis of a formula for this particular sector of multinational entities is considered in order to investigate the effect of the different variations of the predominant three-factor formula of assets-labour-sales. This part of the paper specifically considers the effect of adopting such a formula on the allocation of profits, both in terms of differences between the current and recommended model and the effect on developing countries.

The paper concludes that MNFIs, through their intermediary role of facilitating finance to core industries, play a significant role in the economic advancement of developing nations. As such, it needs to be ensured that the banks themselves as taxpayers are being taxed fairly and equitably in accordance with the location of the economic substance of the activities that give rise to their profits. The economic substance of the activities of MNFIs operating in developing nations is located in those jurisdictions – that is, the MNFIs are earning profits based on their transactions with clients operating in developing nations. As such, unitary taxation with formulary apportionment provides a viable industry-specific solution to a fair and equitable allocation of those profits, and this paper suggests that a two-factor equally-weighted formula of sales and compensation is likely to be the most appropriate formula to apply. This paper also suggests that agreement on the definitional and practical implementation issues is possible. There is already evidence that the current jurisdiction and allocation rules do not work for MNFIs, and that there are existing practices that can provide guidance for an acceptable formulary apportionment model for MNFIs. As such, acceptance of this model as superior for the specific industry of MNFIs may not be as onerous as its acceptance for multinational entities generally.

1 The significance of MNFIs

Section 1 of this paper is divided into four sections. Section 1.1 provides a general background to the emergence of MNFIs, along with a brief discussion of MNFIs in the international tax context. Section 1.2 describes the significant role that MNFIs play in the global economy, and in particular in developing nations. Section 1.3 explains why MNFIs are
unique and why it is difficult, if not impossible, to apply the traditional source and transfer pricing rules to obtain a result that reflects the allocation of taxing rights to the place of the economic substance of the profits. Section 1.4 argues that unitary taxation based on formulary apportionment is a theoretically superior industry-specific model for MNFIs. However, it concludes that the practical implementation issues discussed in Sections 2 and 3 would need to be overcome for such an industry-specific model to be viable.

1.1 Background

The modern MNFI is increasingly undertaking more globalised and complex trading operations, and is one of the most highly-integrated classes of multinational entity. A primary reason for the globalisation of financial institutions is that they typically follow the customer into jurisdictions where international capital and international investors are required. Currently global growth is being experienced in developing nations, hence MNFIs are following their customers into those countries. Additionally, the attractiveness of profit opportunities in the host nation, no or low barriers to entry, and the presence of mechanisms to mitigate information costs of doing business in a foreign market, have also been suggested as reasons for bank expansion into developing nations (Cull and Martinez Peria 2010). The global expansion of domestic banks has resulted in jurisdictions addressing the increase in MNFIs by amending regulatory control measures, despite the financial sector being at ‘the cutting edge of globalisation with very significant growth in cross border financial positions in recent decades’ (Carter 2013: 103), very little has been done in the tax context. Historically, there were relatively few MNFIs in existence and, as such, international tax issues associated with the industry were not considered significant.

However, since 1984, the year that OECD specifically addressed some of the substantive transfer pricing issues relating to multinational banks, there has been continued and increasing concern about equitable distribution of the taxing rights to the profits earned. It has previously been argued that the uniqueness of MNFIs results in a failure of the current system to accurately allocate profits, and that unitary tax with formulary apportionment as an alternative could provide a sounder allocation model for international tax purposes. Rather than providing traditional goods and services, these financial institutions are continually innovating and developing new ways to provide services to clients. The traditional business of banking – the borrowing and on-lending of money – creates a set of problems which are exacerbated when financial institutions carry out global trading roles. Faults where they already exist are made worse in the context of MNFIs, while other faults are unique to the industry itself. The recent shift by MNFIs towards developing nations as host countries means that it is timely to consider the role these institutions play in contributing their fair share of tax revenue to the nations where the activities of financial institutions are giving rise to their profits. As Carter states, ‘Clearly, there is much at stake – for developing, emerging and developed countries alike – in seeking to get the taxation of the financial sector right’ (Carter 2013: 101).

1 For a discussion on the unique nature of MNFIs and the difficulties associated with taxing this sector under the traditional international tax regime, see Benahalom (2008).
2 The increase in global trading is driven by the global demand created by the clients of banks, both borrowers and investors. In particular, the global market established by traditional multinational entities created a demand for the innovative financial instruments subsequently developed by multinational banks (Neighbour 1997). An explosive growth of these innovative financial instruments has occurred over the last four decades – see, for example, Colon (1999).
3 This is most notable in the various OECD reports. See, for example, OECD (1984), OECD (1998), and OECD (2010).
4 See in particular Sadiq (2011) and Sadiq (2012).
1.2 The role of MNFIs in developing nations

The role that MNFIs play in the global economy and national tax systems by facilitating foreign investment is widely recognised, as is their role in facilitating and/or promoting aggressive tax planning techniques (OECD 2009). It is also recognised that MNFIs not only have clients which use complex structured finance transactions to benefit from tax arrangements, but may also receive tax benefits themselves from such transactions and structures. As Carter states: ‘[t]he development of the financial sector is a crucial part of the growth process in developing countries since it has major implications for the effectiveness of capital allocation across the rest of the economy and the ease with which the government or central bank can implement monetary policy operations. The centrality of these functions has long lent the sector special importance’ (Carter 2013: 99).

Previous industry-specific studies into the effects of aggressive tax planning on developing nations, along with recommendations for reform, have focused on traditional multinational activities such as manufacturing, with other traditional industries such as mining and tourism also considered worthy of focus. However, to fund these traditional ventures financial institutions are often brought into play, and to that extent we have seen an unprecedented degree of globalisation in the finance sector with a dramatic increase in cross-border capital flows (Claessen and Van Horen 2012). The increased participation by foreign banks into developing nations is very much a phenomenon of the 1990s (Cull and Martinez Peria 2010). The significance of the expansion of MNFIs has been recognised by IMF researchers. Building on its existing research into foreign bank trends, in a January 2012 report the IMF found that globalisation of the finance industry not only involves banks from developing countries expanding into developing nations, but also banks from developing nations establishing a presence in other jurisdictions (Claessen and Van Horen 2012). The findings of Claessen and Van Horen (2012) which are particularly relevant to this paper are:

- between 1995 and 2009, foreign bank presence in OECD and high-income countries grew by approximately 40 per cent; in emerging markets the number of foreign banks grew by 72 per cent and in developing countries the number grew by 122 per cent;
- during the same period foreign bank presence shifted away from OECD countries towards developing counties, explained by more open financial markets and improved prospects in developing nations;
- in terms of loans, deposits and profits, foreign banks have an average 20 per cent market share in OECD countries, close to 45 per cent in emerging markets and close to 50 per cent in emerging markets and developing countries;
- in countries with over 50 per cent foreign bank presence, foreign banks play an important part in financial intermediation and engage less in traditional lending; and
- banks are responding to the economic slowdown in advanced countries and the increased economic importance of emerging markets, with growth opportunities and profit margins likely to be higher in those markets.

Studies into MNFI entry into developing nations as host nations are increasing in line with the recognition of their significance. To date, studies have focused on both the effect of foreign bank entry into developing nations and their broader role in economic development. Recent studies conclude that foreign banks entering developing nations have a positive effect on bank performance (Čihák and Podpiera 2005), by increasing efficiency and competition (Cull and Martinez Peria 2010). These institutions arguably provide much needed capital, introduce innovative financial products and contribute technical skills to developing nations.

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5 The acronym CSFT is used by OECD in its report on such transactions OECD (2009).

6 OECD states: ‘The majority of banks who provide standard banking services will include CSFTs as part of their suite of products. However the degree of involvement can vary, from only providing payment processing for the transaction, to executing a part of the transaction, through to structuring and marketing the transaction as well as being a party to the CSFT and enjoying any tax benefits themselves’ (OECD 2009: 22).
However, more broadly, questions remain around the contribution made by MNFIs to sustainable economic development, with studies finding that they tend to be much more passive than local banks and, at least in nations such as Zimbabwe, fail to make any significant contribution to economic development (Mabvure et al. 2012). While these studies do not extend to the tax arrangements entered into by MNFIs themselves, ActionAid recently released a report entitled *Time to Clean Up: How Barclays Promotes the Use of Tax Havens in Africa*, calling for Barclays Bank to ‘ensure it makes the maximum contribution towards sustainable and equitable growth’ (ActionAid 2013: 4). The focus of the ActionAid report is the role that Barclays plays in facilitating aggressive tax planning and promoting the use of tax havens by businesses investing in Africa,7 pointing out that this is a failure by Barclays to support responsible investment and sustainable development for all (ActionAid 2013). The ActionAid report also gleans insights into the activities of Barclays as a taxpayer, revealing the following which are particularly relevant for this paper:

- UK banks are the most prolific users of tax havens amongst listed UK companies, with five banks in the FTSE 100 having 1,780 subsidiaries in tax havens;8
- Barclays, reported to be the largest retail bank in Africa and the largest UK bank operating on the continent, is one of the most persistent users of tax havens with 471 subsidiaries listed in tax havens in 2012; and
- Barclays has a significant presence in Mauritius.

Not only are MNFIs persistent users of tax havens, but previous studies have also demonstrated that MNFIs are shifting profits through transfer pricing. It is believed that multinational banks have, even more than other multinational entities, opportunities for reducing their tax burden in high-tax countries by way of intra-firm transfer pricing (Demirguc-Kunt and Huizinga 2001). In their study of multinational banks, Demirguc-Kunt and Huizinga find that taxes paid by foreign banks are relatively low in many of the major industrialised nations. By examining the relationship between the taxes paid and the statutory tax rate, they obtain further support for their profit shifting hypothesis. Their study shows a negative relationship between taxes paid and the statutory tax rate, suggesting the presence of profit shifting (Demirguc-Kunt and Huizinga 2001).9 As additional support for the profit shifting premise Demirguc-Kunt and Huizinga, controlling for bank characteristics, find that foreign banks pay lower taxes in several developed countries. Further, on a cross-country basis, as additional evidence of profit shifting by foreign banks, they find a negative relationship between taxes paid and the statutory rate. While this study focuses on developed nations, it is reasonable to expect that the same techniques are being used to shift profits from developing nations.

### 1.3 The unique nature of MNFIs

The role of the MNFI is vastly different to the traditional multinational entity, as it acts as an intermediary between capital users and capital suppliers, with profits earned on the marginal difference between the supply and the use. In this context, the product supplied is simply ancillary to the true nature of the business, being the supply of a service which is designed to meet client global demand. By acting as an intermediary, it is also simple for MNFIs to separate their services role from the legal contracts that give rise to their profits. This means that the functions performed by MNFIs may be conducted across a number of jurisdictions, none of which may relate to the jurisdiction where the economic activity which gives rise to the income is occurring. Further, the application of traditional transfer pricing regulations to

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7 ActionAid cites the example of Barclays Offshore Corporate division as well as its operations in Mauritius.
8 ActionAid cites its research at <http://www.actionaid.org.uk/tax-justice/ftse-100-tax-haven-tracker-the-new-data> to support these figures.
9 Demirguc-Kunt and Huizinga’s estimates suggest that the relationship between the taxes paid and the statutory tax rate is positive for domestic banks, but negative for foreign banks. This is interpreted as profit shifting by foreign banks.
global trading of commodities and financial instruments presents unique difficulties (King 2009). However, the unique difficulties extend beyond global trading to all activities of MNFIs. Put simply, while the traditional activities of multinational corporations may have obvious physical ties to a geographic location, the activities of MNFIs are under no such constraints.

It has previously been argued that there are fundamental differences between multinational entities generally and MNFIs specifically which make it particularly difficult to apply traditional source and transfer pricing rules to arrive at a fair allocation of profits to the relevant jurisdictions for the purposes of taxation. The unique nature and distinguishing features of MNFIs can be divided into two core categories: the unique nature of the services and consequent products supplied, and the non-traditional organisational structure adopted. Specifically, MNFIs are unique in the provision of services because they undertake an intermediary role in the marketplace, obtain synergistic gains because of international expansion to meet the needs of existing clients, and also have monopolistic advantages and network linkages. MNFIs also often adopt a non-traditional organisational structure with integrated and centralised trading models, along with the aim of servicing time zones rather than geographic locations.

1.4 Unitary taxation as a viable alternative

The unique nature of MNFIs means that they are an ideal industry-specific candidate for the introduction of unitary taxation based on formulary apportionment. It is because of the unique nature of MNFIs that the theoretical benefits associated with the application of formulary apportionment align with the practical reality of this industry. One of the biggest differences between traditional multinational entities and MNFIs is the economic interdependence of the parts of the entity, which means that MNFIs are so highly integrated that the entity cannot be divided into any smaller component parts with any degree of accuracy, especially when economies of scope and scale are taken into account. Unitary taxation ignores the legal structure of an MNFI, and recognises that branches and subsidiaries are integrated and part of one unitary business. Further, as Benshalom explains, ‘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’ (Benshalom 2008: 205). This is fundamentally different to traditional multinational entities.

Internalisation means that there are factors which contribute to the overall profitability of the multinational entity that are not taken into account when allocating income under the arm’s length model. For example, ‘functional integration, centralization of management and economies of scale are simply not reflected in any “transactions” between entities in a corporate group, but arguably do impact on the profitability of the various aspects of a multinational’s business’ (Sandler 1994: 574). Savings in transaction costs and economies of scale, both of which are experienced by MNFIs and are part of the motivation for becoming multinational, are also important features of a vertically-integrated multinational entity and contribute to the efficiency of the entity as a whole.

The aim of any MNFI is profit maximisation, and it is the responsibility of management to ensure that this occurs. As such, resources will be allocated according to the location that ensures profit maximisation. Unitary taxation conforms to the aim of efficient operations within MNFIs by providing the advantage of consistency between management policy and tax policy. A formulary apportionment model allocates income to the place of economic activity by recognising the factors that contribute to the overall profits of the entity, consistent

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10 See, for example, Sadiq (2012; 2011; 2008; 2007). The summary contained in Section 1.4 is based on this prior work of the author.
with management policy. The business decisions within the multinational bank are reflected in the formulary apportionment model, as well as the decision to become multinational.

A criticism of unitary taxation and formulary apportionment is that it operates in a vacuum by only considering firm-specific information.\textsuperscript{11} The fact that unitary taxation operates in a vacuum is arguably accurate, however this is an advantage as the economic reality is that MNFIs also operate in a vacuum. This was evident during the recent financial crisis where some banks failed, while others did not. It is only the income or loss of the individual MNFI that is relevant for determining the income or loss to be attributed to each jurisdiction in which that entity operates, not the entire industry. The formulary apportionment model accepts that the market does not dictate the profits of individual MNFIs, and seeks ‘a “fair” or “proper” division of the overall profits regardless of how the marketplace would operate’ (Surrey 1978: 415).

A successful formulary apportionment model makes the use of havens to gain tax advantages pointless, as there is no longer an opportunity to have income sourced within that jurisdiction unless the factors in the formula are present. The use of tax havens by MNFIs is one of the reasons why there is such a distortion in the allocation of profits as compared to economic activity. This distortion would be limited under a formulary apportionment regime to the genuine business that MNFIs undertake in those tax haven countries. There is no doubt that there is genuine activity undertaken in tax haven jurisdictions, but it is demonstrated below that this would be taken into account in a formulary apportionment model which has a compensation factor.

While it can be demonstrated that unitary taxation with formulary apportionment is a theoretically superior model for taxing MNFIs, the practical difficulties associated with its implementation are not insignificant. In particular, consensus as to the tax base, the composition of the formula and definition of the factors, and the scope of the unitary business would be needed. Such agreement would not be reached without conflict, and, as such, the remainder of the paper considers two key components of the regime which would need to be determined were an industry-specific approach adopted: the unitary business of an MNFI and a suitable formula for MNFIs. The issues relating to these components are raised with a view to disclosing pertinent questions that need to be dealt with at a practical level before implementation of unitary taxation based on formulary apportionment would be possible for MNFIs. Debate continues as to whether formula apportionment is better than the current system, with studies suggesting that both models distort behaviour (Altshuler and Grubert 2010). Sections 2 and 3, however, adopt the approach that unitary taxation based on formulary apportionment has been demonstrated to be a superior model to the current allocation rules for MNFIs, and, as such, does not continue to draw a distinction between the current source and residency rules of the existing international tax model and a proposed unitary taxation with formulary apportionment model, but rather focuses on the tensions within a unitary tax model.

2 Defining the unitary business of an MNFI

This section explores the definition of a unitary business and unitary business activities for MNFIs and, within the context of current structures adopted in the financial sector, recommends an appropriate approach for defining a unitary business for MNFIs. It does so

\textsuperscript{11} There are numerous other criticisms levelled at formulary apportionment, with the OECD maintaining that it should not be considered as an alternative. See, for example, OECD (2013) where the OECD specifically states that it will not be considering replacing the current transfer pricing system. For a comprehensive discussion on the myths surrounding formulary apportionment and the debunking of those myths see Avi-Yonah and Benshalom (2010).
before considering the apportionment formula, as it is necessary to determine what constitutes the unitary business group and the income to which the formula will be applied as a precursor to any apportionment. Broadly, a unitary business should include the operations and activities of the commonly-controlled entities, no matter what the structure, that contribute to an overall business enterprise. However, it is necessary to consider both (1) the definition of an MNFI – that is, which multinational entities would fall within the scope of such an industry-specific application both in terms of being multinational and a financial institution, and (2) the scope of what would be considered the unitary business of an MNFI. As such, this section is divided into three parts. Section 2.1 considers what is meant by a financial institution which is multinational, and discusses the issue of nexus in the context of jurisdiction to tax. Section 2.2 describes what is generally considered to fall within the scope of an MNFI and discusses the various components of the market sector. Section 2.3 then goes on to look at the unitary business of an MNFI by considering which activities of an MNFI should be included, both in the context of the different parts of the entity and the different activities undertaken.

In this section, the practical implementation issues evidenced from this research are contextualised for the financial sector and analysed within a theoretical framework which supports a wide definition of the unitary business. Specifically, this part of the paper argues that it is appropriate to adopt a wide definition of unitary business where a sector-specific approach to unitary taxation is implemented. For example, previous practice applying a unitary taxation approach to the financial sector has focused on the integrated nature of 24-hour global trading. This leads to the need to address such issues as whether this particular aspect of the sector could or should be separated from the more traditional aspects of the financial sector. This is of particular importance for developing countries in which MNFIs typically would locate only retail and some aspects of wholesale financial services, but not their trading activities. It is argued that the adoption of a narrow definition of a unitary business for MNFIs would be likely to limit the potential advantages of unitary taxation for developing countries.

2.1 The taxable connection to an MNFI

An industry-specific adoption of unitary taxation inherently requires that the target industry is defined. So far, this paper has discussed the multinational entity sector of financial institutions as an obvious candidate for an industry-specific approach, but has yet to define what is meant by an MNFI and the scope of that sector. Further, it must also be remembered that the purpose of taxing multinational entities, and particularly MNFIs, under a unitary taxation model with formulary apportionment is to ensure that jurisdictions receive their fair share of tax revenue according to the economic activity undertaken. In order for jurisdictions to have the right to tax, a necessary nexus must be established. The current international tax regime generally adopts the ‘permanent establishment’ concept to establish a taxable connection. Such an approach is consistent with traditional multinational entities, but may need to be reconsidered for MNFIs, as its usefulness as a criterion for being subject to tax under a formulary apportionment regime is questionable (Martens-Weiner 2007). The discussion below demonstrates why.

As a starting point, we can define the multinational entity generally.12 Prior to the study of the multinational entity per se, an entity involved in such activities was examined in the context of foreign direct investment or the business corporation (Fieldhouse 1986). It was not until nearly two centuries after the beginnings of the multinational entity that the term first used to describe the phenomenon, the multinational corporation, was coined (Fieldhouse 1986: 9). In 1960 David E. Lilienthal described multinational corporations as ‘corporations which have their home in one country but operate and live under the laws and customs of other countries

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12 The author has previously discussed the concept of an MNFI in the work cited earlier in this paper.
as well’ (Aharoni 1971). Despite the steady rise of a geographically-diversified banking services market, as recently as four decades ago banks were excluded from discussions of multinational entities. For example, Aharoni (1971) suggests that the definition of a multinational entity can be subdivided by three criteria: the type of operations in which they are involved, the size of their operations, and the areas in which they operate. Corporations, according to the type of operations in which they are involved, are then divided into exporters, importers, transporters, manufacturers, traders, and petroleum producers. The obvious omission from this list is the category of the service provider, into which the multinational bank would fall. Multinational entities were thought to be providers of goods rather than services, an assumption it could be argued that legislators have also made, but this is incorrect.

More recently, as noted by Williams, a multinational entity has been more widely defined as ‘an enterprise that owns and controls activities in different countries’. This definition is broader because it extends beyond physical ownership in another country to control over activities, and may be much closer to what we consider to be a multinational entity today. However, in the context of an MNFI there is lack of agreement as to when we have international banking as contrasted with multinational banking because, if we consider what is meant by a multinational bank, ‘developments in the institutional and technological features of multinational banking have resulted in banks owning and controlling banking activities in one country from geographical locations removed from the assumed location of that activity’ (Williams 1997: 72). A narrow definition of the multinational entity, and one that requires physical presence, could be restrictive in terms of the institutions which are caught within the scope of an MNFI. That is because physical presence is not required for there to be multinational activity, as activities may result in transactions involving foreign jurisdictions without the bank leaving its home country. A narrow definition which requires physical presence does not capture such activities, and would therefore also fail to satisfy a taxable connection. As such, from an MNFI perspective, it may be necessary to ensure that a broader definition of a multinational enterprise is accepted to include not only a physical presence but also extend to include control of activities in different jurisdictions, to ensure that economic presence is captured. This approach is consistent with the discussion below, which argues that jurisdiction to tax should be based on a broad business presence test, rather than a physical presence.

An analysis of current formulary apportionment models suggests that physical presence through a permanent establishment is the most common way to confirm a taxable connection. Certainly, this is the criteria adopted in many of the existing domestic formulary apportionment regimes, although in the US there have been cases where the courts have found that ‘significant economic presence’ is a better indicator of nexus. Depending on the factors contained in the formula, an approach which relies on the traditional concept of permanent establishment to establish nexus can lead to income being allocated to a jurisdiction with insufficient taxable connection. It is demonstrated below that this is certainly possible where a sales factor based on destination is included in the formula. As such, a different taxing nexus or taxable connection such as sales into a jurisdiction, rather than residence or its proxy of a permanent establishment, would better align with economic substance, and provide a taxing nexus where MNFIs are conducting business consistent with a formulary apportionment approach.

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13 Williams (1997: 11) citing Buckley and Casson (1991: 33) The Future of the Multinational Enterprise, 2nd Edition, MacMillan.
14 For a comprehensive discussion on the nexus requirement in relation in financial institutions in the US, see Berger (2008). See also Grob and Roberts (2007).
15 For further support of this proposal see, for example, Morse (2010).
2.2 The scope of an MNFI

Where a separate regime for taxing a specific industry is proposed, it is clearly necessary to define the scope of that industry or market sector. In this particular case, it would be necessary to define what is meant by an MNFI. The most obvious MNFI is the multinational bank, with multinational banking alone encompassing a wide variety of activities such as currency trading, participation in the Euromarket, borrowing and lending, and the financing of international trade. The MNFI sector also includes other obvious examples such as insurance companies, mortgage companies, investment and pension funds, stock brokerages and investment advisory services (Carter 2013), but that list is not complete. There is no doubt that international financing is undergoing continual growth and change (Williams 2002), which means that it is impossible to predict the type of financial activities that will be undertaken and entities that will undertake them in the future, and, as such, a broad principles-based approach may be more appropriate than a prescriptive approach. Williams attributes these continual changes to factors such as deregulation of domestic financial systems, product innovation and increased participation by non-traditional providers of financial services (Williams 2002). While multinational banks, with the provision of banking services, are still major participants in the MNFI sector, financial services are increasingly being supplied by a broader category of financial institutions as well as non-traditional providers. As such, to ensure that all providers whose business is that of predominantly providing financial services are subject to the same international tax regime, it would be necessary to define an MNFI more widely than the multinational bank. Not to do so would undoubtedly fail to capture some of the riskier and more innovative financial providers and arrangements. To this extent, various existing legislative definitions may assist, and by way of example various legislative definitions and their source are listed in the Appendix.

2.3 The unitary business of an MNFI

Once it is determined that a multinational entity falls within the particular market sector of the financial institution, it becomes necessary to define the unitary business. That is, which parts of the business of the financial institution are considered part of the MNFI for unitary taxation purposes? This requires consideration not only of determination of the scope of the corporate group, in other words which parts of the MNFI are to be included in the unitary business (the scope of the group), but also which activities of the MNFI are to be subject to unitary taxation with formulary apportionment (the scope of the business activities). At the outset, it should be recognised that the adoption of a narrow definition of a unitary business for MNFIs would be likely to limit the potential advantages of unitary taxation for developing countries. As such, this paper argues for a wide definition of both the scope of the unitary business and the unitary business activities, while at the same time recognising that from a practical perspective this is a more difficult approach to adopt.

2.3.1 The scope of the unitary MNFI group

An important element of a unitary tax model is the taxable unit – what is included in the unitary group – and this can be a single entity, a consolidated corporate group or a unitary combined group (Martens-Weiner 2006). Normally a unitary business is understood to be ‘a business that has common control, common management, integrated operations, and, in general, a flow of value among the related entities’ (Martens-Weiner 2006: 71). While the various approaches adopted in domestic regimes are briefly discussed below in the context of apportionment formulas, this part of the paper deals specifically with the structure of an MNFI. Where a financial institution is multinational, its organisational structure may take on several different forms. Organisational structure relates to both legal structure as well as allocational structure. Allocational structure relates to the way in which the organisation allocates the duties and responsibilities as well as lines of authority, and this may be done
based on geographic, functional or divisional lines. Allocational structure issues will arise in relation to the application of a formula for allocation purposes, while the legal structure will relate to the unitary group. Where an MNFI establishes a presence in a host nation, it has several options in terms of legal organisational structure, with host nation regulations often contributing to the decision as to the optimal structure.

Williams (2002) provides a list of eight legal organisational structures, described in Table 1.

**Table 1 Legal organisational structures**

| Legal organisational structures |
|--------------------------------|
| **Correspondent banking**      |
| Correspondent banks act to clear transactions between banks. The domestic bank appoints a foreign bank to act as its agent for transactions in that foreign country. |
| **Representative offices**     |
| A representative office is a small office in the host nation that coordinates a bank’s correspondent banking relationships and renders assistance to the bank’s existing customers. The office often has a secondary role of disseminating information about the parent bank and collecting information about the host country. |
| **Agencies**                   |
| Agencies conduct transactions. The activities permitted to agencies vary according to host country laws, with some nations prohibiting agency activity by multinational banks. These agencies cannot normally raise or solicit deposits. |
| **Consortium banks**           |
| A consortium bank can be considered as a joint venture bank separately incorporated and owned by two or more shareholders who are themselves banks, usually of different nationalities. Some consortium banks are formed to service a particular market segment or to access a particular geographic market. |
| **Merchant bank subsidiaries** |
| A merchant bank subsidiary is a merchant (investment) bank that is wholly owned by a bank located in another country. It is a subsidiary that offers the full range of wholesale services without the constraints that may be imposed on a full banking entry. |
| **Edge Act corporations**      |
| Edge Act Corporations are an organisational structure unique to the United States (US). Edge Act corporations can conduct a wide range of banking activities including financing international trade. |
| **Bank branches**              |
| A foreign bank branch is a branch located in a different country from the country of incorporation of the parent bank, without the branch itself having separate incorporation. It carries on banking business, subject to the laws of the host nation. |
| **Bank subsidiaries**          |
| A bank subsidiary is a separately incorporated bank that is controlled by a parent located in another country. Multinational banks generally prefer the branch structure to the subsidiary structure, however in some cases the host nation regulator will not permit foreign bank branches to be established. |

Source: Descriptions are adapted from Williams (2002)

An examination of the legal organisational structures reveals three broad categories: branch, subsidiary and agent. The US approach to what constitutes a unitary business may provide some guidance as to how the unitary business of an MNFI should be defined, as could the proposed EU Common Consolidated Corporate Tax Base (CCCTB) model, although case law demonstrates that this is by no means a settled matter and the question may be one of fact and circumstance. Arguably, there will be no one correct definition of what falls within the scope of the unitary business of an MNFI, and ultimately what will be important is political agreement. It will usually be obvious that a branch is part of the unitary business of finance, as it will fall within the current concept of permanent establishment, both in terms of the traditional international tax regime and also any of the domestic formulary apportionment.
regimes. However, what may not be so obvious is when the other legal structures fall within the scope of the unitary business of an MNFI.

Two approaches have developed to determine whether separately-incorporated affiliates are part of a unitary group: legal unity and economic unity. The first defines the unitary business by reference to legal control, whereas the second defines the unitary group by reference to common economic activities. Both approaches are not without problems, the most obvious being that the legal approach is open to manipulation, while the economic integration approach leads to uncertainty and practical difficulties in its application.

The proposed EU CCCTB model suggests the following test:

Eligibility for consolidation (group membership) should be determined in accordance with a two-part test based on (i) control (more than 50 per cent of voting rights) and (ii) ownership (more than 75 per cent of equity) or rights to profits (more than 75 per cent of rights giving entitlement to profit). Such a test ensures a high level of economic integration between group members, as indicated by a relation of control and a high level of participation. The two thresholds should be met throughout the tax year; otherwise, the company should leave the group immediately. There should also be a nine-month minimum requirement for group membership.

(European Commission 2011, para 21; see Articles 54 and 55 of the proposed model for the actual wording)

Such an approach for MNFIs may mean that much of the activity described in Table 1 may fall outside the scope of the unitary MNFI business. A dependent agent provision, in line with the traditional permanent establishment definition, would certainly widen much of what is caught, however it may still not incorporate all activities.

Even where the unitary group is determined, there is a second question that needs to be addressed, and that relates to the activities which fall within the scope of the unitary business for the purposes of applying the formula.

2.3.2 The scope of the unitary business activities

On the one hand, it is argued that ‘apportionment formulas used should, to the extent practically possible, be applied to all of the taxpayer’s consolidated income, from all sources, without attempting to distinguish between business and non-business income, and without seeking to divide taxpayers’ incomes among different unitary activities’ (Durst 2013a: 22). On the other hand, it is generally accepted that it is neither necessary nor desirable to include all of the activities of the multinational entity within the scope of the unitary business if they do not engage in related activities (Picciotto 2012, 2013). As Picciotto points out, such an approach might in fact enable tax avoidance through the acquisition of an unrelated business which facilitates profit shifting and/or profit dilution (Picciotto 2012). These points should be considered as two separate issues: first, whether the income should include both business and non-business income; and, second, whether the income should be subject to the formulary apportionment regime on an activity-by-activity basis.

Business and non-business income

The approach in the US has been to distinguish between business and non-business income. However, as Durst points out, this is far from ideal (Durst 2013b). For the purposes of this paper, the problems would be especially obvious where the multinational in question is an MNFI. It has historically been difficult to distinguish between business and non-business income, with different jurisdictions having different rules for doing so, and quite often a
continued degree of uncertainty as to the distinction. This would be exacerbated in the finance industry given the highly complex structures and transactions entered into. As such, allowing MNFIs to distinguish between business and non-business income would most likely lead to aggressive tax planning practices. The ability to reclassify business income into passive income would likely be easily achieved by MNFIs.

**Combined income versus activity-by-activity approach**

The application of formulary apportionment to MNFIs would require a decision on whether the formula is to be applied to the global income of an MNFI (with the obvious difficulties of adjusting that income to reflect taxable income), or the combined income of certain activities of the MNFI, known as the activity-by-activity approach. Currently, we have the example of a type of formulary apportionment applying to global trading in Notice 94-40 discussed below, which is an illustration of the latter. MNFIs are an example of an industry where the activity-by-activity approach would be relatively easy to implement compared to the combined income approach. Most MNFIs have relatively delineated retail, commercial and investment banking activities, along with separate global trading activities. However, if we take global trading as an example, it can be demonstrated that the activities caught are very limited. Global dealing or global trading operations are generally narrowly defined only to include ‘the execution of customer transactions (including marketing, sales, pricing and risk management activities) in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants’ (Department of the Treasury 1998: 63). This means that activities such as lending are not included within the definition of a global dealing operation. As such, a combined income approach is one that more accurately captures all the activities of an MNFI globally. In the context of developing nations, an activity-by-activity approach may do little in the way of allocating income according to the location of the economic activity, if formulary apportionment was only applied to those parts of an MNFI where the arm’s length approach is difficult to apply.

**3 The apportionment formula**

The apportionment formula is perhaps the most important, but also the most difficult and therefore most controversial, element of a unitary tax model. Its two elements are, first, the factors of the formula, and, second, the weighting of those factors. From a pragmatic perspective, under a proposed unitary tax model for MNFIs, it is via the formula that the international income of those entities is ultimately divided. As such, Section 3 investigates an appropriate formula for MNFIs. Section 3.1 examines current formulary apportionment models based on available data from existing domestic unitary tax regimes and international tax authority negotiations (for example, APAs). Section 3.2 looks at the broad definitions and problems associated with the three factors that are common to the models examined. Section 3.3 then considers a theoretical analysis of an industry-specific formula for MNFIs. Section 3.3 investigates the effect of the different variations of the predominant three-factor formula of assets-labour-sales, and, in doing so, will specifically consider the effect of adopting such a formula on the allocation of profits, both in terms of the differences between the current and recommended models and the effect on developing countries. Prior to embarking on a discussion of alternative approaches to the formula, it should be noted that formulary apportionment does not necessarily require unitary taxation. A formula can simply be applied to the income of the legal entity over which a jurisdiction has the right to tax. However, this paper adopts the view that the discussion on formulary apportionment is based on a unitary tax system being a superior model.

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For a comprehensive discussion on the different approaches, see Durst (2013c).
3.1 Current formulary apportionment models

Formulary apportionment regimes are not new; several working examples have been around for more than half a century, which can be considered to evaluate the various factors to be incorporated into a formula, along with appropriate weightings. Currently, the US, Canada and Switzerland all have effective formulary apportionment regimes in place at a national level. Germany also uses a form of formulary apportionment in relation to its trade tax. Further, the European Union (EU) has a proposed model, and, more specifically, in relation to MNFIs, there is industry-specific guidance for the adoption of a formulary apportionment model when entering into a global trading APA. While the US model is the most discussed and analysed system, to avoid any bias this paper considers the existing systems in alphabetical order, followed by the proposed EU system and the industry-specific APA guidance.

3.1.1 The Canadian system

Canada has a system of provincial and territorial corporation tax which, except for Quebec and Alberta, is administered by the Canada Revenue Agency at federal level. Under the Canadian system a taxpayer who carries on business in more than one province or territory uses a formula to determine the provincial income allocation.\(^{17}\) This system is known as formulary allocation, and applies where a taxpayer has a permanent establishment\(^{18}\) in more than one province or territory. Jurisdiction to tax is based on the permanent establishment nexus. Legislative details of the regime are contained in Part IV of the Canadian Income Tax Regulations.\(^{19}\) Under the regulations a common formula is applied by the federal government to a common tax base, and then a provincial specific tax rate is applied. The taxable unit is the single entity and not a consolidated corporate group or unitary combined group (Martens-Weiner 2006).

As a general rule, Canada applies a two-factor formula of sales and payroll with each weighted equally.\(^{20}\) Canada rejected the one-factor sales formula on the basis that it gave too much weight to the location of the head office, while the three-factor formula of the US was rejected on the basis that it favoured exporting provinces and the property factor was difficult to administer (Mayer 2006).

The Canadian Regulations also provide for nine industry-specific formulas, all of which maintain two factors. These industries are: insurance corporations, banks, trust and loan corporations, railway corporations, airline corporations, grain elevator operations, bus and truck operators, ship operators, and pipeline operators.\(^{21}\) Of particular relevance for this paper are the variations to the banking industry, as well as the trust and loan corporations. The formula for banks is different to the general formula, and while a two-factor formula is retained the split is varied to one-third payroll and two-thirds loans and deposits. For trust and loan corporations, the special provisions relate to the definition of gross revenue of the permanent establishment, that is, the amount of the sales component. It includes loans secured by lands situated in the province; loans, not secured by land, to persons residing in the province; loans to persons residing in a province or country other than Canada in which the corporation has no permanent establishment and administered by a permanent establishment in the province except loans secured by land situated in a province or country other than Canada in which the corporation has a permanent establishment;

\(^{17}\) Canada Revenue Authority, Provincial Income Allocation Newsletters, available at <http://www.cra-arc.gc.ca/txtchncl/pia-iapr/menu-eng.html>.

\(^{18}\) A permanent establishment is defined in sec 400(2) of the Income Tax Regulations.

\(^{19}\) Income Tax Regulations CRC, c. 945.

\(^{20}\) Section 402, Income Tax Regulations CRC, c. 945.

\(^{21}\) The formulas for these industries are found in sections 403-411 of the Income Tax Regulations CRC, c. 945.
and business conducted at the permanent establishment in the province, other than revenue in respect of loans.

| Canadian formulas |
|-------------------|
| **General formula** |
| Provincial profits = \(\frac{1}{2} \left(\frac{\text{provincial payroll}}{\text{total payroll}}\right) + \frac{1}{2} \left(\frac{\text{provincial sales}}{\text{total sales}}\right)\) \times \text{total profits} |
| **Bank formula** |
| Provincial profits = \(\frac{1}{4} \left(\frac{\text{provincial payroll}}{\text{total payroll}}\right) + \frac{3}{4} \left(\frac{\text{provincial loans & deposits}}{\text{total loans & deposits}}\right)\) \times \text{total profits} |

A summary by Mayer of the advantages and the disadvantages of the Canadian system suggests that it represents a balanced compromise between uniformity and coordination, and provincial flexibility; meets the criteria of fairness; and has relatively low compliance costs (Mayer 2006). On the other hand, it is also noted that the regime may increase tax competition and lead to profit shifting (Mayer 2006).

### 3.1.2 The German system

Very seldom does a comparative analysis of formulary apportionment mention the German model for allocating trade tax. Perhaps the reason is that the formula does not apportion the income amongst the taxing authorities, but rather apportions the tax. That being said, the German model does offer insight into possible formulas, and for that reason it is briefly discussed in this paper. Trade tax has been imposed in Germany since 1936, with the tax base consisting of trade proceeds so defined. The basic tax amount is then determined and apportioned amongst those municipalities in which a permanent establishment is maintained. The taxable entity extends to affiliated companies with subsidiaries treated as permanent establishments where certain conditions (such as residency) are met. However, it should be noted that the German system varies significantly from a unitary tax model in that intragroup transactions are not ignored. Rather, the aggregate tax base includes profits that arise from intragroup transactions – that is, the legal structure of the entity is recognised and maintained.

The formula which is applied to the basic tax amount is a single factor of salaries and wages, on the basis that this represents the costs that are caused by trade activities. However, there are various rules as to what is included and, for example, salaries over a certain cap are excluded to prevent a bias in favour of the place of central management. While there is now only a single formula applied across all industries, historically there have been two instances of industry-specific formulas. The first is retail, which is not relevant to this paper, but the second is the banking, insurance and loan industry. Until 1974, where an entity was considered to fall within this special category a single factor formula of gross receipts was used, with receipts attributed to the permanent establishment where the main business activities were located.

It has been suggested that the German system operates satisfactorily and that ‘the system effectively prevents double taxation and the results are generally acceptable both for the taxpayers and the affected municipalities. However, the conditions for applying group taxation are very strict, and the only flexibility the municipalities enjoy is that of determining the rate of assessment’ (Mayer 2006: 3.4.2).

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22 It should be noted that much of the literature on the German system is in German. As such, this part of the paper places a heavy reliance on Mayer (2006).

23 This summary is based on Part 3.5 of Mayer (2006).
3.1.3 The Swiss system

The origins of the Swiss tax system can be contrasted with that of Canada and the US, as it was formed in a way that allowed the Swiss Cantons to still enjoy substantial independence from the federal state. Switzerland has a complicated tax system, a comprehensive discussion of which is outside the scope of this paper. As with Canada, the taxable unit in Switzerland is the single entity and, with the exception of an entity that is set up for tax avoidance purposes, not a consolidated corporate group or unitary combined group (Mayer 2006: 3.4.2). Jurisdiction to tax is based on the concept of residence, with a main tax residence and secondary tax residences. For companies, the main tax residence will normally be the place of the registered office, and secondary tax residences will be the location of permanent establishments defined by the courts as ‘a lasting physical installation or facility in which a quantitatively and qualitatively material part of the technical or commercial activities of an enterprise is exercised’ (Mayer 2006: 3.4.3). Tax bases vary across the cantons, as does the object of apportionment; however, the sum of the apportionment fractions cannot exceed 100 per cent. As Mayer points out, ‘this leads to the interesting result that, although the sum of apportionment percentages equals 100%, the sum of all attributed portions of tax base does not equal the total tax base of any one canton’ (Mayer 2006: 3.4.4.1). With twenty-six cantons applying different formulas, and different formulas applying to different industries, the Swiss system is a complex one.

Three different methods are used for apportioning the income of a company: direct, indirect and mixed. Mayer describes the three methods as follows:

- ‘If the “direct” method of apportionment is used, the aggregate apportionable income of the company is distributed among profitable subunits of the company in proportion of their separate accounting profits. If the company is profitable in all cantons and potential effects of a Präzipuum are ignored, this method leads to the same results as would separate accounting.’
- ‘The “indirect” method of apportionment is similar to the practice of the US states and Canadian provinces: a company’s profits are apportioned according to the fraction of auxiliary factors such as turnover, payroll and sales that are located within a canton. Applying this method is only admissible when the “direct” method cannot be used.’
- ‘The “mixed” method combines the “direct” and the “indirect” method in a two-step procedure. First, the total apportionable income is apportioned on the basis of separate accounting results (“direct method”) to separate divisions of the company, which may be engaged in different lines of business. Subsequently, those part profits are distributed within the divisions to the different cantons using the “indirect” method. This approach permits a more realistic allocation if a company incorporates separate trades of different profitability and it also allows the application of different apportionment formulae to the different lines of business within one company.’

(Mayer 2006: 3.4.5.1)

While the indirect method of apportionment relies on a formula, as stated above, there is no one standard applied as different formulas have been developed for different businesses. Interestingly, in the case of banks the direct method of apportionment is generally applied, thereby reverting back to a separate accounting approach. The direct method is also used where there are losses to be allocated.

The outcome of such a complex and canton-specific approach is that a body of case law has been developed to deal with the constitutional requirement that prohibits double taxation and determine appropriate allocation principles. That being said, Mayer suggests that the Swiss

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24 It should be noted that much of the literature on the Swiss system is in German. As such, this part of the paper also places a heavy reliance on Mayer (2006).

25 For a summary of the Swiss tax system, see Mayer (2006).
system works relatively well, and there are no signs of strong tax competition between the cantons (Mayer 2006).

### 3.1.4 The US system

As stated earlier, the US system is the most widely cited and best understood formulary apportionment regime. It also generally forms the basis for much of the analysis in proposals which argue for (or against) the adoption of unitary taxation with formulary apportionment at an international level. As such, its analytical significance should not be underestimated. Interestingly, however, despite being in existence for more than half a century, the US system continues to be an evolving one. There are countless prior studies of the US formulary apportionment system, and, as such, this paper does not attempt to undertake another but rather outlines some of the key components. Examples of factors which have been used at some time in US state formulas include the share of physical assets or intangible assets, the share of employment, the share of sales, manufacturing costs, purchases, expenditure for labour, accounts receivable, net cost of sales, capital assets, and stock of other companies (Weiner 1996). While all of these factors have, at some time, been used for the purposes of the US state tax regime, property, payroll and sales are now seen as the acceptable factors. Each of the states applies their own formula, however commonalities exist. As a starting point, the well-known Massachusetts formula should be noted. This is a three-factor, equally-weighted formula consisting of tangible property, payroll expense and sales revenue. However, many states no longer use this traditional formula instead placing greater emphasis on sales, either by double-weighting the sales factor or adopting a single-sales factor formula.

| US formulas                      |
|---------------------------------|
| **Massachusetts formula**       |
| State profits = \( \frac{1}{3} \) (state property/total property) + \( \frac{1}{3} \) (state payroll/total payroll) + \( \frac{1}{3} \) (state sales/total sales)) x total profits |
| **Double-weighted sales formula** |
| State profits = \( \frac{1}{4} \) (state property/total property) + \( \frac{1}{4} \) (state payroll/total payroll) + \( \frac{1}{2} \) (state sales/total sales)) x total profits |
| **Single-sales factor formula** |
| State profits = state sales/total sales x total profits |

### 3.1.5 The proposed EU system

The long-awaited proposal for a Common Consolidated Corporate Tax Base (CCCTB) was published by the European Commission in March 2011 (European Commission 2011). The proposal is described as ‘a complete set of rules for company taxation. It details who can opt in, how to calculate the taxable base and what is the perimeter and functioning of the consolidation. It also provides for anti-abuse rules, defines how the consolidated base is shared and how the CCCTB should be administered by Member States under a “one-stop shop” approach’ (European Commission 2011: 6). The discussion below only focuses on that part of the report that is relevant to the proposed formula; the unitary business aspect of the proposal was discussed above.

The EU CCCTB proposal adopts a three-factor equally-weighted formula comprising labour, assets and sales. However, in contrast to previous examples, the labour factor is computed

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26 See, for example, Hellerstein and McLure (n.d.).
27 For a summary of the state apportionment formulas adopted, see Durst (2013b).
on the basis of payroll and the number of employees, with each item counting for half. As an exception to the general principle, where the outcome of the apportionment does not fairly represent the extent of business activity a safeguard clause provides for an alternative method. The CCCTB proposal also includes special apportionment rules for four industries: financial institutions; insurance; oil and gas and shipping; and inland waterway transport and air transport.

The proposed EU model

\[
\text{Member Profits} = \left( \frac{1}{3} \left( \frac{\text{member sales}}{\text{total sales}} \right) + \frac{1}{3} \left( \frac{\text{member payroll}}{\text{total payroll}} + \frac{1}{2} \frac{\text{no. of member employees}}{\text{total number of employees}} \right) + \frac{1}{3} \left( \frac{\text{member assets}}{\text{total assets}} \right) \right) \times \text{consolidated tax base}
\]

The asset factor is defined to consist of all fixed tangible assets. Intangibles and financial assets are excluded from the formula due to their mobile nature and the risk of circumventing the system. However, where the entity is a financial institution this is varied to include 10 per cent of the value of financial assets, except for participating interests and own shares.

Financial assets are included in the asset factor of the group member in the books of which they were recorded when it became a member of the group (European Commission 2011: Article 98). Such a modification is arguably seen as necessary because of the significance of these assets to MNFIs. The sales factor, normally defined to mean the proceeds of all sales of goods and supplies of services after discounts and returns, excluding value added tax, other taxes and duties and excluding exempt revenue, interest, dividends, royalties and proceeds from the disposal of fixed assets, is also varied for financial institutions. The sales factor is varied from the general definition to include 10 per cent of revenue in the form of interest, fees, commissions and revenue from securities. Financial services are deemed to be carried out, in the case of a secured loan, in the member state in which the security is situated or, if this member state cannot be identified, the member state in which the security is registered. Other financial services are deemed to be carried out in the member state of the borrower or of the person who pays fees, commissions or other revenue. If the borrower or the person who pays fees, commissions or other revenue cannot be identified or if the member state in which the security is situated or registered cannot be identified, the sales shall be attributed to all group members in proportion to their labour and asset factors (European Commission 2011: Article 98).

3.1.6 The APA/global trading system

There is very little in the way of publicly-available data on the use of formulary apportionment in the MNFI sector. Clearly regulations require the use of the arm’s length pricing methodologies and, as such, limited use of methods that resemble formulary appointment are found in APAs. The only example of formulary apportionment being used for global trading is found in the APAs entered into in the US. These formulas are not true instances of global formulary apportionment as they have regard to the particular facts of individual cases. Further, APAs are confidential and little, if any, is revealed about the final agreement between the taxpayer and revenue authorities.\(^{28}\) In 1994, the Inland Revenue Service (IRS) released Notice 94-40, Global Trading Advance Pricing Agreements (IRS 1994), containing its experience and generic information relating to APAs entered into with taxpayers that have functionally fully-integrated operations in the global trading of financial products. Notice 94-40 specifically deals with the IRS experience of entering into APAs with taxpayers who engage in operations which involve the transfer of the authority to trade in a ‘book’ of positions from trading location to trading location, and outlines the method and factors that were used to allocate income derived from functionally fully-integrated operations.

\(^{28}\) Although, interestingly, it is generally understood that Barclays Bank was the recipient of the global trading ruling addressed in Notice 94-40 and discussed in this paper. See, for example, McIntyre (2000).
The application of Notice 94-40 is very limited as ‘global trading operations of companies that are functionally fully integrated are characterized by the centralized management of risk and personnel. The business is managed as one global position for purposes of risk management rather than several discrete businesses’ (IRS 1994: 3). Where taxpayers genuinely operated a functionally fully-integrated trading model, the IRS used a profit split method of allocating income between the taxing jurisdictions, stating that this method ‘reflects the contribution of each trading location to the profitability of the global book’ (IRS 1994: 5).

### Notice 94-40: Factors used in global trading APAs

1. The relative value of the trading location (the ‘value factor’): a direct measure of the contribution of a trading location to the worldwide profits of that business. Traders were viewed as the most significant resource in generating trading profit or loss for the company because they typically had customer lists and knowledge of the market. Compensation is generally based upon a salary and a discretionary incentive bonus that depends upon contribution to the profitability of the book. APA participants viewed compensation of the traders at a trading location as the best measure of the value of a trading location. Accordingly, this factor was weighted more heavily than others.

2. The risk associated with a trading location (the ‘risk factor’): a measure of the potential risk to which a particular trading location exposes the worldwide capital of the organisation. It is stated that this factor provides an important indication of the contribution of that trading location to the production of gross profits of the business. Based on the unique characteristics of each taxpayer, the risk factor is measured in several different ways but generally focuses on value and volume of trades.

3. The extent of the activity of each trading location (the ‘activity factor’): measured by reference to the compensation of key support people at a trading location (for example, back office support) or the net present value of transactions executed at a trading location (determined by aggregating the present values of the cash flows computed at the inception of each transaction for each trading location).

(IRS 1994: 8-11)

The factors used in global trading APAs are heavily weighted towards payroll with very little emphasis on sales. While it has not been possible to determine the weighting placed on the three factors used, it is unlikely that the risk factor is significant. Subsequent to Notice 94-40, the US Treasury Department issued proposed regulations dealing with the allocation and sourcing of income and deductions among taxpayers engaged in global dealing operations (Department of the Treasury 1998). These proposed regulations, which have not been finalised, make it clear that determination of the allocation of income among participants engaged in a global dealing operation is to be done on an arm’s length basis using the best method rule, with the four methods available being the comparable uncontrolled financial transaction (CUFT) method, the gross margin method, the gross mark-up method or the profit split method.

### 3.2 The factors defined

In addition to identifying the relevant factors, each factor needs to be defined. In this part of the paper the three most common factors of payroll, property and sales are revisited with the aim of defining each, as well as outlining the likely issues that would arise if they were used in an industry-specific formula for MNFIs.

#### 3.2.1 The payroll factor

The payroll factor, generally defined as total employee compensation including salaries, commissions and bonuses, is included to reflect the contribution of labour to the generation of the income of the entity. There are two significant issues in relation to the payroll factor which would impact on developing nations. First, compensation is generally much lower in developing countries than it is in developed countries. As such, there is an argument that the factor should take into account the number of employees rather than remuneration. The proposed EU model combines both payroll and number of employees by equally weighting the two within the labour factor. This leads to a second problem of outsourcing labour functions as the payroll factor does not generally include independent contractors.
Developed nations may also view the payroll factor as discouraging jobs in a particular jurisdiction.

In the context of MNFIs payroll will be an important factor, especially given it is the most difficult to manipulate. However, to ensure an accurate reflection of the cost of labour to MNFIs, there should be no distinction between employees and independent contractors (Benshalom 2008). The proposed CCCTB model, which places equal weight on remuneration and number of staff, is also likely to be more suited to MNFIs given the high salary and bonuses paid to some staff as compared to others who undertake simple retail activities.

3.2.2 The property factor

The property factor, sometimes known as the asset factor, is included in some formulas on the basis that capital is an important income-producing factor. However, property is also the most complex factor to define and value. Apart from the obvious valuation problems, that is, whether historical cost or market value should be used,29 the single biggest problem with the payroll factor is the issue of intangibles and allocation to the relevant jurisdictions. The US solution to this problem is to simply remove intangibles from inclusion in the property factor where such a factor is still used, although, as previously indicated, many states are moving away from the traditional Massachusetts formula and either applying less weight to property or removing it altogether. Canada, on the other hand, has avoided the use of a property factor altogether.

Where a property factor is used in the US, a different definition is generally applied for financial institutions. As Martens-Weiner explains, ‘the property factor may also include intangible property, such as coin and currency, loans related to in-state property and credit card receivables if the fees and charges are billed to the state’ (Martens-Weiner 2006: 56). This is also consistent with the approach of the proposed EU CCCTB, as discussed above. While the formula itself doesn’t vary, the definition of property does vary to include an amount of 10 per cent of the value of financial assets.

While many of the formulas use property as a factor, this paper suggests that it should not be included in an industry-specific formula for MNFIs. To the reader, the obvious response may be that given capital is such a significant part of an MNFI’s operations, it should be included and have significant weighting. Further, given various international and domestic standards required of financial institutions, it may arguably be easy to measure. However, several issues may arise. First, not all financial institutions may be caught by such requirements. Second, domestic capital requirements will vary across jurisdictions, and their compliance is a matter of form rather than an indication of substantive use of the funds. Third, the ultimate purpose of an allocation formula is to allocate profits in a manner which accurately reflects the location of activities which give rise to the profits of an MNFI. By using labour and sales factors in the formula this is achieved, with capital (the property factor) arguably contributing nothing additional to the allocation model.

Due to the difficulties associated with the property factor, along with a move away from its use in domestic jurisdictions, it seems that the most appropriate approach would be to avoid the use of this factor in an industry-specific formula for MNFIs. This is especially in light of the significant intangible assets held by MNFIs and the ability to manipulate this factor easily. It is also arguable that property is already indirectly represented in the formula as property will be associated with the place of labour and potentially sales. As such, a property factor is likely to add little to the ability of a formula to allocate profits fairly.

29 The standard US formula uses historical cost, and the proposed EU model also suggests original cost for land and non-depreciable assets.
3.2.3 The sales factor

The sales factor (by destination) is generally viewed as a relatively easy factor to measure. However, the most obvious difficulty with the sales factor is the ability to identify the location of sales. One of the biggest challenges in designing a formula for MNFIs is ensuring that sales revenue is allocated to the appropriate geographic location. While tangible goods may not pose such problems, the sale of intangible goods and services, especially intermediary services such as those performed by MNFIs, poses the biggest problem. In the case of MNFIs, there is also the incentive to finalise contracts in low tax jurisdictions (and, more likely, tax havens). The solution to this problem is to adopt an ‘ultimate destination’ test to determine where the services are ultimately used, thereby applying a tracing rule. Retail services to individuals would readily lend themselves to such an approach, however corporate clients would pose significant problems given their ability to establish subsidiaries anywhere (Benshalom 2008). In these cases ultimate destination tracing would be problematic and, from a practical perspective, the compliance costs and complexities associated with such an approach would mean that a great deal of resistance could be experienced.\footnote{Durst suggests that a tracing rule might be too burdensome to be widely required (Durst 2014).}

As noted above, the use of a destination-based sales factor also needs to align with a jurisdiction’s taxing connections in order to avoid income being allocated to a jurisdiction which has no taxing rights over that income. While this problem has been overcome in the US with either a ‘throw-back\footnote{Sales are returned to the state of origin.}’ or ‘throw-out\footnote{Sales which do not have an identifiable location are removed.}’ mechanism, neither is ideal.

In his series on formulary apportionment Durst specifically deals with an analysis of the sales factor, highlighting the rationale for maintaining a factor which recognises the market for goods and services within a country, along with the fact that the ‘exploitation of that resource should be apportioned at least in part to the country’s tax base’ (Durst 2014: 1). However, he raises many of the technical issues associated with this factor, and recognises that financial services are one industry where difficulties would arise (Durst 2014).

The earlier discussion in this paper centred on the role that MNFIs play in developing nations, as well as their incentive to become multinational and the follow-the-customer motivation for doing so. As such, a heavily-weighted destination-based sales factor is consistent with the economic substance of MNFI transactions. MNFIs are operating on business incentives (in the current case, to follow clients into developing nations), and, as such, there is inelasticity in ultimate destination-based sales (Morse 2010). Such an approach also reduces the impact of any property and payroll factors, thereby allowing nations to encourage investment and employment in their jurisdiction.\footnote{As Clausing and Avi-Yonah explain, ‘the key advantage of a sales-based formula is that sales are far less responsive to tax differences across markets, because the customers themselves are far less mobile than are firm assets or employment. Even in a high-tax country, firms still have an incentive to sell as much as possible’ (Clausing and Avi-Yonah 2007: 12). In the case of MNFIs, these entities are following clients into developing nations which are involved in traditional businesses such as the extractives industry and tourism.} As Clausing and Avi-Yonah explain, ‘the key advantage of a sales-based formula is that sales are far less responsive to tax differences across markets, because the customers themselves are far less mobile than are firm assets or employment. Even in a high-tax country, firms still have an incentive to sell as much as possible’ (Clausing and Avi-Yonah 2007: 12). In the case of MNFIs, these entities are following clients into developing nations which are involved in traditional businesses such as the extractives industry and tourism.

Because of the difficulties associated with a destination-based sales factor for services, domestic regimes often locate the income to where the services are performed or alternatively the location of the customer. However, to adopt such an approach means there is a reversion to an origin-based approach which would influence the location of the activities of MNFIs, particularly where customers are also encouraged to operate in low tax jurisdictions. The location of consumption overcomes this problem but poses significant

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\footnote{\textsuperscript{30} Durst suggests that a tracing rule might be too burdensome to be widely required (Durst 2014).} \footnote{\textsuperscript{31} Sales are returned to the state of origin.} \footnote{\textsuperscript{32} Sales which do not have an identifiable location are removed.} \footnote{\textsuperscript{33} Described by Morse as a ‘productive capacity shift’ (Morse 2010: 616).}
problems (Morse 2010). In a similar manner to some US states in relation to intangible property, where the location of the income-producing activity can be identified, receipts can be assigned to that location. However, situations may arise where it is not possible to identify a specific location, and in that case it may be necessary to remove those receipts from the sales factor (Martens-Weiner 2006).

The proposed EU CCCTB model adopts a sales-by-destination approach, and provides that sales of goods shall be included in the sales factor of the group member located in the member state where dispatch or transport of the goods to the person acquiring them ends. If this place is not identifiable, the sales of goods shall be attributed to the group member located in the member state of the last identifiable location of the goods, while supply of services shall be included in the sales factor of the group member located in the member state where the services are physically carried out (European Commission 2011: Article 96).

It should also be noted that, under the US model, the financial institutions industry is subject to special rules in defining sales. This is because the financial sector generates receipts which are not easily analogous to sales income (Roin 2008). In particular, the ‘sales’ factor is replaced with a ‘receipts’ factor, and ‘may include income from securities and money market instruments, interest income from loans secured by personal property in the state, and receipts from credit cards if regularly billed in the state’ (Martens-Weiner 2006: 56).

### 3.3 A proposed formula for MNFIs

Prior to proposing a possible industry-specific formula for MNFIs, it is worth noting the theoretical and practical issues which need to be considered in the design of a formula. The choice of factors, as well as the relative weighting, is influenced by competing forces. First and foremost, a formula needs to be equitable and efficient. A system of dividing international income must be considered fair by taxpayers and voters and practically administrable by taxpayers and governments, as well as being cost-effective in terms of costs relative to taxes collected (Durst 2013d). At the outset, any formula, whether general or industry-specific, would need to be politically acceptable to both developed and developing nations. This means that the formula would need to be fair, taking into account factors and applying a balanced weighting which results in a distribution of income according to what is viewed as sensible and a reflection of where a multinational entity actually earns its income (Martens-Weiner 2006). Generally, this is interpreted to mean that factors such as the location of offices, people and sales should be used in the formula with a weighting that minimises distortions. However, there is an inherent incentive for individual jurisdictions to achieve a formula that places emphasis on factors which have a significant presence within their jurisdiction (Green 1993). There is also the problem that developing countries may be disadvantaged where emphasis is placed on such factors as labour and capital that have lower costs in developing counties (Casanegra de Jantscher 2000). As such, they are unlikely to agree to a formula which weighs these factors heavily.

Any proposal for a formulary apportionment model for MNFIs must have the ultimate goal of allocating income on an economically-sound basis, rather than having aggressive tax planning as its primary motivation. A clear observation from the discussion above is that there are significant differences in how a formulary apportionment regime is implemented, with varying degrees of agreement. The contrast between Canada and the US is an obvious example of this. In Canada there are uniform rules on the factors, weighting and the tax base, while in the US states can apply their own factors and weightings as well as adjust the

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34 Ilan Benshalom labels any move towards a different allocation model as the ‘Allocation Phase’ with the hope ‘that it represented the beginning of an emerging new sourcing paradigm in the international income tax regime. The features of this phase reflect policymakers’ recognition that the main challenge and duty of the international income tax regime is not to eliminate abusive transactions but to develop economically sound, administrable, and fair sourcing allocation methods for financial income’ (Benshalom 2009: 666).
categorisation of income. At an international level, to avoid distortions, minimise complexity and lessen opportunities for aggressive tax planning, a significant amount of agreement is required. McLure argues that at an international level all key elements of the system, apart from tax rates, should be consistent across countries (McLure 2002). However, it cannot be assumed that the same formula should be applied to all industries, and, as we have seen with domestic regimes, financial institutions are one industry where there has either been a variation on the standard formula or a special industry-specific formula.

Unitary taxation with formulary apportionment only works to the extent that the factors of the formula allocate income on an economically-sound basis. It can be seen from the above discussion that there are numerous combinations of both factors and weightings that can be adopted. Each nation has the incentive to place greater emphasis on the factors which maximise taxable income in its jurisdiction. However, this will be weighed against broader economic policy, such as attracting foreign investment. Generally, the tendency has been for fewer factors to be used, with a resulting combination of factor/s at origin (assets and payroll) and factor/s at destination (sales) making up the adopted formulas. However, in terms of both the factors and the weighting, the outcome of any analysis suggests that there is no one ‘correct’ formula. As such, much of the argument will centre on country bias, dependent on whether consumption factors or destination factors produce the best result, and ultimately depend on what the majority can agree on. Developing nations will generally argue for greater emphasis on a destination-based sales factor, on the basis that it is those nations where the market is located.

As a basic premise, the factors contained in the formula ‘should be connected to immobile indicators of economic activity’ (Benshalom 2008: 200). Benshalom states that ‘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’ (Benshalom 2008: 200). However, consistent with this paper, he goes on to argue that the unitary system would be most effective in such a situation – that is, when applied to hard-to-locate financial activities.

The discussion above supports the view that an equally-weighted two-factor formula of labour and sales for MNFIs is the most likely to be broadly accepted, as well as meet the criteria of fairness and equity. An origin-based labour factor and a destination-based sales factor is the most appropriate for MNFIs. The biggest difficulty will be the sales factor and, as Avi-Yonah, Clausing and Durst explain, determining the location for sale of certain services such as financial services ‘will require toleration of some degree of reasonable estimation and generally will require some restraint in enforcement. In addition, owing to the wide range of situations in which sales can arise, regulations will need to be detailed, and a rulings process will be needed to provide flexibility for particularly difficult situations’ (Avi-Yonah et al. 2009: 518). The same authors also propose statutory language to account for this scenario and state that ‘it is anticipated that regulations will provide that revenues for the provision of banking, insurance, brokerage, or other financial services will be treated as earned by the related party that is resident for income tax purposes in the country in which such revenues can be identified, with reasonable certainty in view of the records and other information available to the taxpayer, with services provided to individuals resident, property located, or active business activities conducted within that country’ (Avi-Yonah et al. 2009: 543).
4 Conclusion

MNFIs, through their intermediary role of facilitating finance to core industries, play a significant role in the economic advancement of developing nations. However, their role is much more significant than simply facilitating finance, and extends to helping create an environment where all multinationals pay their fair share of tax in the jurisdiction where their profits are earned. The obvious way to achieve this is to encourage MNFIs to act responsibly in their promotion of financial products and arrangements. However, this does not address the behaviour of the banks themselves as taxpayers. The economic substance of the activities of MNFIs operating in developing nations is located in those jurisdictions; that is, MNFIs are earning profits based on their transactions and clients in developing nations. As such, unitary taxation with formulary apportionment provides a viable industry-specific solution to a fair and equitable allocation of those profits. Consequently, this paper proposes that unitary taxation based on formulary apportionment be implemented on an industry-specific basis with the obvious industry being MNFIs. There is already evidence that the current jurisdiction and allocation rules do not work for MNFIs. As such, acceptance of this model as superior for the specific industry of MNFIs may not be as onerous as its acceptance for multinational entities generally.

The model proposed in this paper, based on both theoretical and pragmatic considerations, is an equally-weighted two-factor formula of labour and sales, where labour reflects both remuneration and numbers of staff. Ideally, this formula should be applied to all the income of an MNFI on a combined income basis. However, this paper also recognises the difficulties associated with such an approach.
# Appendix  Legislative definitions of a financial institution

| Country | Source | Definition |
|---------|--------|------------|
| **EU**  | Article 98 of the Proposed CCCTB Model | The following entities shall be regarded as financial institutions:  
(a) credit institutions authorised to operate in the Union in accordance with Directive 2006/48/EC of the European Parliament and of the Council;  
(b) entities, except for insurance undertakings as defined in Article 99, which hold financial assets amounting to 80% or more of all their fixed assets, as valued in accordance with the rules of this Directive. |
| **Australia** | Income Tax Assessment Act 1936 | An AFI or **Australian financial institution** means any of the following Australian entities:  
(a) a body corporate that is an ADI (authorised deposit-taking institution) for the purposes of the **Banking Act 1959**;  
(b) a person who carries on State banking within the meaning of paragraph 51(xii) of the Constitution;  
(c) a registered entity under the **Financial Sector (Collection of Data) Act 2001**. |
| **India** | Reserve Bank of India Act 1934 | i. Asset Finance Company: An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets;  
ii. Investment Company: IC means any company which is a financial institution carrying on as its principal business the acquisition of securities;  
iii. Loan Company: LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company;  
iv. Infrastructure Finance Company: IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs. 300 crore, c) has a minimum credit rating of ‘A’ or equivalent, d) and a CRAR of 15%;  
v. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities which satisfies certain conditions;  
vi. Infrastructure Debt Fund: Non-Banking Financial Company (IDF-NBFC): IDF-NBFC is a company registered as NBFC to facilitate the flow of long-term debt into infrastructure projects;  
vii. Non-Banking Financial Company - Micro Finance Institution: NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy certain criteria;  
viii. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit-taking NBFC engaged in the principal business of factoring. |
| **United States** | Bank Secrecy Act 31 USC 5312 (a)(2) | (A) an insured bank (as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)));  
(B) a commercial bank or trust company;  
(C) a private banker;  
(D) an agency or branch of a foreign bank in the United States;  
(E) any credit union;  
(F) a thrift institution;  
(G) a broker or dealer registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 USC 78a et seq);  
(H) a broker or dealer in securities or commodities; |
(I) an investment banker or investment company;
(J) a currency exchange;
(K) an issuer, redeemer, or cashier of travelers’ checks, checks, money orders, or similar instruments;
(L) an operator of a credit card system;
(M) an insurance company;
(N) a dealer in precious metals, stones, or jewels;
(O) a pawnbroker;
(P) a loan or finance company;
(Q) a travel agency;
(R) a licensed sender of money or any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system;
(S) a telegraph company;
(T) a business engaged in vehicle sales, including automobile, airplane, and boat sales;
(U) persons involved in real estate closings and settlements;
(V) the United States Postal Service;
(W) an agency of the United States Government or of a State or local government carrying out a duty or power of a business described in this paragraph;
(X) a casino, gambling casino, or gaming establishment with an annual gaming revenue of more than $1,000,000 which
(i) is licensed as a casino, gambling casino, or gaming establishment under the laws of any State or any political subdivision of any State; or
(ii) is an Indian gaming operation conducted under or pursuant to the Indian Gaming Regulatory Act other than an operation which is limited to class I gaming (as defined in section 4(6) of such Act);
(Y) any business or agency which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity which is similar to, related to, or a substitute for any activity in which any business described in this paragraph is authorized to engage; or
(Z) any other business designated by the Secretary whose cash transactions have a high degree of usefulness in criminal, tax, or regulatory matters.

| United States | FATCA |
|---------------|-------|
| The term “Financial Institution” means a Custodial Institution, a Depository Institution, an Investment Entity, or a Specified Insurance Company. |
| The term “Custodial Institution” means any Entity that holds, as a substantial portion of its business, financial assets for the account of others. |
| An entity holds financial assets for the account of others as a substantial portion of its business if the entity’s gross income attributable to the holding of financial assets and related financial services equals or exceeds 20 per cent of the entity’s gross income during the shorter of: (i) the three-year period that ends on December 31 (or the final day of a non-calendar year accounting period) prior to the year in which the determination is being made; or (ii) the period during which the entity has been in existence. |
| i) The term “Depository Institution” means any Entity that accepts deposits in the ordinary course of a banking or similar business. |
| j) The term “Investment Entity” means any Entity that conducts as a business (or is managed by an entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer: |
(1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
(2) individual and collective portfolio management; or
(3) otherwise investing, administering, or managing funds or money on behalf of other persons.

k) The term “Specified Insurance Company” means any Entity that is an insurance company (or the holding company of an insurance company) that issues, or is obligated to make payments with respect to, a Cash Value Insurance Contract or an Annuity Contract.

| United Kingdom | The Financial Services and Markets Act 2000 (Prescribed Financial Institutions) Order 2013 | Prescribed financial institutions |
|----------------|----------------------------------------------------------------------------------------|----------------------------------|
|                | (1) All financial institutions are prescribed for the purposes of section 192B(4) of the Act, in so far as it applies—                                   |
|                | (a) to parent undertakings of a recognised UK investment exchange (within the meaning of section 192B(5) of the Act), and                          |
|                | (b) for the purposes of Part 12A of the Act as that Part is applied in relation to the Bank of England by paragraph 17 of Schedule 17A to the Act (further provision in relation to exercise of Part 18 functions by Bank of England). |
|                | (2) Financial institutions of the following kinds are prescribed for the purposes of section 192B(4) of the Act in so far as it applies to parent undertakings of a qualifying authorised person— |
|                | (a) an insurance holding company;                                                      |
|                | (b) a financial holding company;                                                       |
|                | (c) a mixed financial holding company.                                                 |

Note: The Explanatory Memorandum to the Financial Services and Markets Act 2000 (Prescribed Financial Institutions) Order 2013 states the following:
The definition of ‘financial holding company’ derives from European law which contains a definition of ‘financial institution’. Hence it is appropriate to define financial institution when used in that context. However the definition of financial institution will not apply to the references to financial institution in article 2 of the Order. This reflects the fact that financial institution is used in FSMA (see for example section 192B(4), as inserted by section 27 of the Financial Services Act 2012) without a definition. Financial institution is a generally understood term which is used, again without definition, in other legislation (including the Banking Act 2009). The term includes an entity which itself provides financial services or which operates financial market infrastructure or whose business involves the ownership of, or management of, such entities. It would therefore be inappropriate for the definition of financial institution in the Order to apply to the references to financial institution in article 2 which are closely related to the operation of section 192B of FSMA.

| Canada | Canada Revenue Agency: GST/HST memorandum 17.6 September 1999 |
|--------|---------------------------------------------------------------|
|        | 1. Bank                                                      |
|        | 2. Corporation that is licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada the business of offering to the public its services as a trustee |
|        | 3. Person whose principal business is as a trader or dealer in, or as a broker or salesperson of, financial instruments or money |
|        | 4. Credit union                                             |
|        | 5. Insurer or any other person whose principal business is providing insurance under insurance policies |
|        | 6. Segregated fund of an insurer                             |
|        | 7. Canada Deposit Insurance Corporation                      |
|        | 8. Person whose principal business is the lending of money or the purchasing of debt securities or a combination thereof |
|        | 9. Investment plan                                           |
|        | 10. Person providing tax discounting services referred to in section 158 of the Act |
|        | 11. Corporation deemed under section 151 of the Act to be a financial institution |
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