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The Global Taxation of Corporations

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The Global Taxation of Corporations

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Abstract

This paper suggests that there needs to be a global approach to the taxation of corporate profits.

National taxing authorities apply transfer pricing rules to Multinational Enterprises in an attempt to apportion corporate profits based on a notion of 'arm's length' dealings. As multinational enterprises grow larger and control ever greater levels of world trade finding 'arm's length' values for trade becomes more difficult. Multinational Enterprises are taking advantage of their corporate personhood and the free global movement of capital to take advantage of the transfer pricing rules and so, avoid tax.

There needs to be an alignment of corporate profits and taxation to the jurisdictions in which corporations actually earn the profits. There also needs to be recognition of the fact that MNEs are using the current transfer pricing rule to legally avoid their tax obligations in the taxing jurisdictions where their business is conducted. The US formula apportionment method of allocating profits between jurisdictions is based on sales made, property owned and people employed in a particular jurisdiction. This apportionment recognizes the physical impact of corporations in a jurisdiction and attempts to apportion profits recognizing this impact. The apportionment is not perfect but at least it takes into account some of the realities of the operation of a corporation.

Apportioning corporate profits grounded in a physical reality, even if not perfect, attempts to acknowledge the impact corporations, artificial people, have on real people where they physically live and work.

Keywords:

Introduction

This paper suggests that there needs to be a global approach to the taxation of corporate profits. This is because although multinational enterprises (MNEs) operate globally, their profits are taxed within the confines of a nation state.

The nation state, through its national taxing authorities, attempt to fairly tax MNE corporate profits by applying transfer pricing rules to apportion corporate profits based on a notion of ‘arm’s length’ dealings. The transfer pricing rules used by the 34 countries in the Organization for Economic Cooperation and Development (‘OECD’) are guided by the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which guidelines were updated in 2010. As MNEs grow larger and control ever greater levels of world trade finding ‘arm’s length’ values for trade becomes more difficult. Despite this difficulty, the OECD Guidelines still prefer the use of transfer pricing methodologies in determining the taxable profits of MNEs.

There needs to be an alignment of corporate profits and taxation to the jurisdictions in which corporations actually earn the profits. There also needs to be recognition of the fact that MNEs are using the current transfer pricing rule to legally avoid their tax obligations in the taxing jurisdictions where their business is conducted. The US formula apportionment method of allocating profits between jurisdictions is based on sales made, property owned and people employed in a particular jurisdiction. This apportionment recognises the physical impact of corporations in a jurisdiction and attempts to apportion profits recognizing this impact. The apportionment is not perfect but at least it takes into account some of the realities of the operation of a corporation. The formula could be improved by recognizing the impact that corporations in jurisdictions have on the external environment, for example, the carbon emissions made by a corporation in each location.

Apportioning corporate profits grounded in a physical reality, even if not perfect, attempts to acknowledge the impact corporations, artificial people, have on real people where they physically live and work. ‘The main policy challenge is to develop effective international tax rules and processes in what is essentially a non-cooperative government setting’ (Cockfield, 9)

The Problem

‘Corporations dominate the contemporary economic, political and social landscape of most nations, (Sikka and Willmott, 2010, 344). The main obligation of a corporation is to maximize profits and increase shareholder wealth. As a logical consequence, corporations seek to minimize their expenses, including the ‘expense’ of taxation. Taxation, instead of being viewed as a ‘return to society on the investment of social capital’ (Sikka and Willmott, 2010, 344) is viewed as an expense to be managed. By minimizing their tax corporations are in fact not paying for the privileges enjoyed by the gift of incorporation; limited liability, capital aggregation, perpetual existence,

access to a healthy educated workforce and, infrastructure that enables them to conduct their businesses.

The problem of a few individuals avoiding their obligations to pay tax will probably not lead to a ‘massive budget crisis that could lead to another Great Depression’ (Gamage and Shanske, 2011-2012, 20). However, the problem of effectively taxing the profits of MNEs means that nation states are suffering declining tax revenues from MNEs to such an extent that the nation state is in danger of becoming unable to function. Vito Tanzi, then with the International Monetary Fund, coined the term ‘fiscal termites’ to describe those taxpayers who ‘gnaw away at the foundations of their taxation systems’ (Tanzi, 2001, 1).

Since the 1970’s when the economist Galbraith wrote about the dangers of the market concentration of major corporations, the economic concentration of the major corporations has become even more pronounced.

Progressively large-scale transnational mergers in the 1990’s, combined with strategies of manufacture-market integration, have established interlocking oligopolist structures in the production and sales of, *inter alia*, consumer durables, mass media products, cars and trucks, food processing, computers, electronic components, airlines and aerospace products, oil, steel, chemicals, and pharmaceutical and biotech products (McMurtry, 2002, 245).

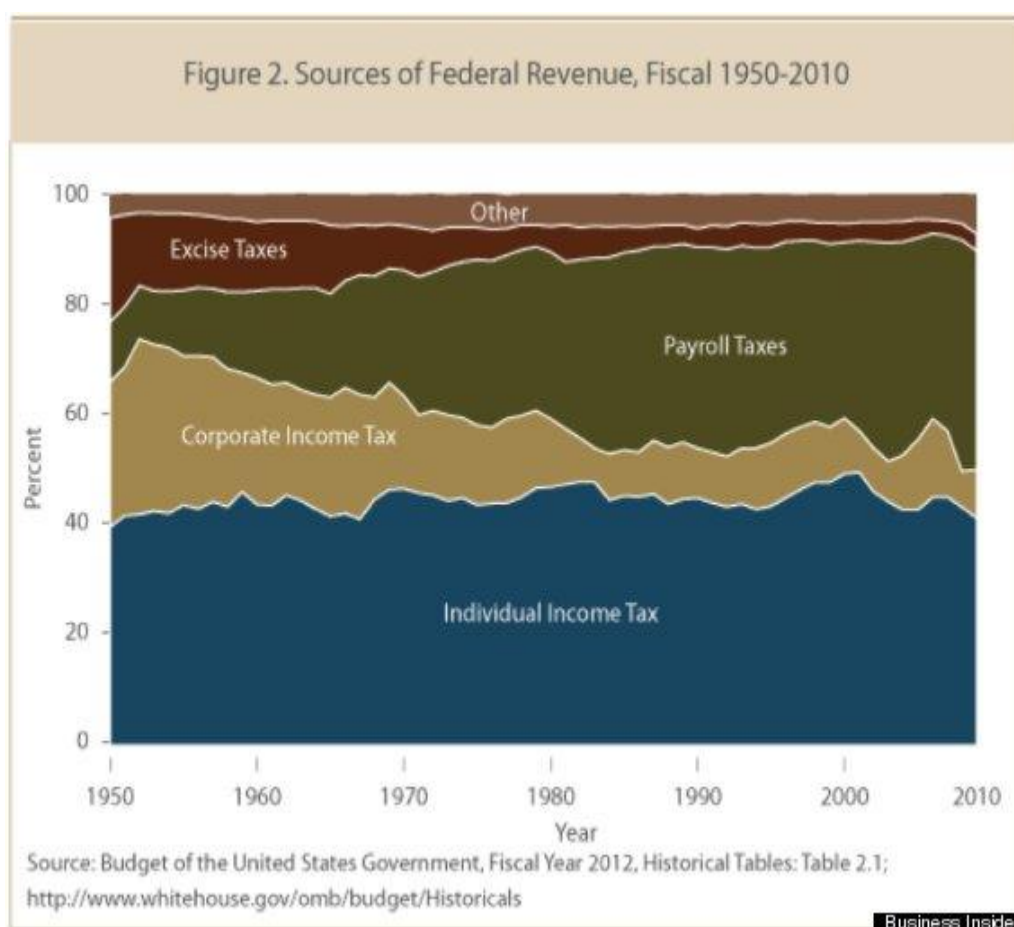
McMurtry believes that Galbraith’s identified tendency for production and economic organisation to oligopoly has now become a tendency to monopoly (McMurtry, 2002, 245). McMurtry noted that by the 1990’s the ‘largest 300 corporations, for example, control 98 percent of all foreign direct investment and 60 percent of all land cultivated for export (McMurtry, 2002, 245).’

Corporate domination of global affairs has grown to such an extent that by ‘the beginning of the millennium 51 of the largest 100 economies of the world are companies rather than nation-states’ (Sikka and Willmott, 2010, 345).

Even though corporate domination of economic power has grown, corporate contributions to taxation revenues of the nation states where they operate have declined. Using the United States as an example, it can be seen that, since 1950, federal corporate tax revenues have been shrinking as a proportion of total federal tax revenues and that individual taxpayers and payroll taxes have been making up the shortfall. In September 2012 the United States Senate Permanent Subcommittee on Investigations (‘the Subcommittee’) held a hearing called *Offshore Profit Shifting and the U.S. Tax Code*. The evidence presented to the Subcommittee found that U.S. corporations are taxed at ‘up to a 35% statutory rate on their worldwide income’ (U.S. Senate, 2012, 3) which is one of the highest corporate tax rates in the world. The Subcommittee found that despite the high rate of corporate tax, federal corporate tax revenues have declined since 1952 with the burden of taxation shifting to individual taxpayers.

At its post-WW1 peak in 1952, the corporate tax generated 32.1% of all federal tax revenue. In that same year the individual tax accounted for 42.2% of federal revenue, and the payroll tax accounted for 9.7% of revenue. Today the corporate tax accounts for 8.9% of federal tax revenue, whereas the individual and payroll taxes generate 41.5% and 40.0%, respectively, of federal revenue (U.S. Senate, 2012, 4).

This shift away from federal reliance on corporate taxes is shown in the table below (U.S. Senate, 2012, 5).



The Subcommittee found that the reason that federal corporate tax revenues have been shrinking as a proportion of overall federal tax revenues was due to weaknesses in the transfer pricing regulation in the U.S. tax code and weaknesses in accounting standards that ‘encourage and facilitate the shifting of intellectual property and profits offshore by multinational corporations headquartered in the United States’ (U.S. Senate, 2012, 2). This type of tax minimization, tax avoidance or tax planning as it’s called by the MNEs that engage in these practices is also called, base erosion and profit shifting (‘BEPS’). The common theme to these practices is the ability of MNEs

to move intangible property, intellectual property, around the globe at will (base erosion) and to 'sell' the rights to use that property to group members at prices that maximize the taxation benefits to the MNE (profit shifting).

The Subcommittee found that shifting profits offshore was by way of a combination of the normal use of transfer pricing rules and by aggressive transfer pricing. As an example, the Subcommittee examined the practices of Microsoft Corporation and found that 'despite the research [of Microsoft] largely occurring in the United States and generating U.S. tax credits, profit rights to the intellectual property are largely located in foreign tax havens' (U.S. Senate, 2012, 20). As a result of Microsoft's use of offshore entities to avoid taxation on royalty payments 'Microsoft was able to reduce its 2011 U.S. tax bill by \$2.43 billion (U.S. Senate, 2012, 23). The Subcommittee characterized these transactions as an example of 'aggressive transfer pricing' (U.S. Senate, 2012, 2). The Subcommittee also found that in 2011 Microsoft 'excluded an additional \$2 billion in U.S. taxes on passive income on its offshore activities (U.S. Senate, 2012, 23). In other words in the 2011 financial year Microsoft legally avoided U.S. tax of \$4.43 billion, that is, over \$12 million a day in tax avoided.

An examination of the Microsoft Annual Report for 2011 revealed that the corporation earned income before taxes of \$28.071 billion on which it paid tax of \$4.921 billion, an effective tax rate of 17.5%. Had Microsoft paid the U.S. corporate tax rate of 35% on its profits, then its tax paid would have been \$9.825 billion. The difference between the tax paid by Microsoft and the putative tax payable is \$4.904 billion, half a billion dollars higher than the amount found by the Subcommittee to have been avoided.

In order to reduce the MNE tax avoidance by the use of current transfer pricing and ancillary rule the Subcommittee made recommendations for reforms to tax law 'to eliminate tax loopholes and tighten tax provisions' (U.S. Senate, 2012, 3). These recommendations are made in the face of the voluminous literature in this area which generally reaches the conclusion that 'transfer pricing rules that dominate the sourcing of income... largely fail to reflect the location of observable economic contributors to such income, (Kleinbard, 2011, 147). In other words, transfer pricing rules don't work.

There is another method for attempting to allocate the profits of corporations operating in more than one taxing jurisdiction between those taxing jurisdictions. This method is referred to as the formula apportionment of profits. This method is currently employed in Canada and the United States to allocate corporate profits between the provinces (in Canada) and the states (within the U.S).

In order to explain the operation of formula apportionment, the United States is used as an example.

Formula Apportionment within the United States

The Uniform Division of Income for Tax Purposes Act

In 1957, the US National Conference of Commissioners on Uniform State Laws recognized that the ‘need for a uniform division of income for tax purposes among the several taxing jurisdictions [in the US] has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results’ (National Conference, 1957, preface). The National Conference drafted a *Uniform Division of Income for Tax Purposes Act* (‘UDITPA’) that proposed the adoption by all of the U.S. states of a ‘three factor formula’ (National Conference, 1957, preface) for determining business income for each state. The formula adopted was:

Section 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (UDITPA, s9).

The UDITPA also defines all the terms of the formula. The numerators of the formula are defined as follows:

- The property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer’s real and tangible personal property owned or rented and used during the tax period (UDITPA, s10).
- The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period (UDITPA, s13).
- The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period (UDITPA, s15).

This attempt at uniformity recognised that the above formula may not ‘fairly represent the extent of the taxpayer’s business’ (UDITPA, s18) in the state. In this case the UDITPA provides that “the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

- (a) Separate accounting;

- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income (UDITPA, s18).

In 2005 the most common formula used in the states was actually the 'double-weighted sales formula' where the weight on the sales factor is twice the weight on the property and payroll factors (Martens-Weiner, 2006, 33 and 44). The UDITPA recommendation placed equal weight on each of the factors.

The UDITPA formula would apportion company profits thus:

$$\text{State Profits} = [1/3(\text{property in state}/\text{total property}) + 1/3(\text{payroll in state}/\text{total payroll}) + 1/3(\text{sales in state}/\text{total sales})] \times \text{total profits}$$

The most common formula to apportion profit between states, actually used in 2005 was:

$$\text{State Profits} = [1/4(\text{property in state}/\text{total property}) + 1/4(\text{payroll in state}/\text{total payroll}) + 1/2(\text{sales in state}/\text{total sales})] \times \text{total profits (Martens-Weiner, 2006, 33)}$$

Even though this was the most common formula used, not all states weighted each of the factors this way, and some states even excluded property and payroll from the formula (Martens-Weiner, 2006, 44).

The UDITPA could only have had a reasonable chance of success if all the states had uniformly adopted the proposal and had adopted the same rate of taxation. Adoption of the proposal with differing tax rates would provide corporations with the incentive required to challenge the formula to shift income 'earned' to low or no taxing states. UDITPA was adopted but, 'not all states with income taxes have adopted it, some states that have adopted UDITPA deviate from it in significant ways or interpret its provisions differently...' (McLure, 2005). There is no uniformity between the US States as to tax rates¹. For example in the 2013 tax year, there is no corporate income tax payable in Nevada, South Dakota, Washington or Wyoming. Whereas the corporate tax rate in other states varies from a progressive 1% to 9.4% in Alaska to a flat rate of 9.8% in Minnesota².

Lack of uniformity in taxation between the states has led to major problems. The three major problems identified by tax commentators in the US (Hildreth et al, 2005) are;

¹http://www.taxadmin.org/fta/rate/corp_inc.pdf (Accessed 10/10/13)

²Ibid

1. Economic inefficiency – ‘differences across states in corporate income tax systems lead to interstate differences in effective tax rates on the return to capital’(Hildreth et al, 2005).
2. Tax competition between the states.
3. The cost of tax compliance – it has been estimated that the cost of complying with US federal company tax rules is approximately 1.4% of the tax liability, while complying with state tax laws costs approximately 2.9% of taxes (Hildreth et al, 2005).

The lack of uniformity in taxation between the states has been a ‘major issue’ (Hildreth et al, 2005), especially for corporate taxpayers, since corporate taxpayers are more likely than individuals to operate in more than one state, since state corporate income taxes were first introduced in Wisconsin in 1911 (Hildreth et al, 2005). By 1930 sixteen US states had adopted corporate income tax (Hildreth et al, 2005). The issue of state corporate income taxes lead to the ‘business community’ lobbying the US Congress for some uniformity. As a result of this lobbying a committee, the Willis Committee, was established to consider uniformity of state corporate taxation. This committee reported in 1965, concluding;

It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach of the taxation of interstate companies as is appears in state and local law, and the practical difficulties of realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States (Hildreth et al, 2005).

Despite the fact that US state corporate taxation cannot be made to operate efficiently or equitably when applied to companies operating in more than one state, the states are loathe to consider giving up their sovereignty by agreeing to uniform taxation. This is even though the states are losing revenues by the companies’ manipulation of the formulary apportionment to avoid paying all or

part of their taxation liabilities. This dilemma of the states was expressed as follows, ‘individual states must be willing to sacrifice sovereignty in order to increase the collective sovereignty of all states’ (McLure, 2005).

The UDITPA formula for apportioning tax is a mechanistic and crude attempt to apportion taxes between jurisdictions. The formula does not take into account externalities produced by the corporation in earning income. The formula does not take into account the different business activities undertaken by corporations and the impact that would have on the formula. For example, a business may operate out of leased premises and have relatively low property values in a jurisdiction even though it may have a large physical impact. However, the UDITPA formula does take account of three important physical factors employed in earning profits, labor, sales and property. The formula does take account of ‘real’ factors of production and does attempt to link those factors with a locality, or taxing jurisdiction. The UDITPA formula is also relatively straightforward to apply resulting in relatively low compliance costs (as opposed to the costs of instituting transfer pricing) for the taxpaying corporation. The formula would also be transparently verifiable by taxing authorities unlike the transfer pricing rules.

However, until national or state taxing authorities agree to give up some of their sovereignty (to tax) and agree to apply the formula uniformly, formula apportionment cannot be made to operate efficiently. In the U.S. the current inefficiencies of applying formula apportionment are considered preferable to the alternative of transfer pricing, otherwise the current corporate taxing methodology would have changed.

The International Situation

The OECD is a forum for member countries to seek solutions to common problems that hinder economic development. The OECD is not a government body and has no legislative authority. However, the OECD does have considerable influence in the setting of government policies by the issuance of ‘guidelines’ on various matters, The *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (‘the OECD Transfer Pricing Guidelines’) influences the tax laws of member states. For example the Australian, Canadian and Japanese taxation authorities have adopted ‘their own versions of the OECD-based transfer pricing’ (Borkowski, 2010, 38) guidelines while the U.S. has have adopted a method ‘that conflicts directly with the OECD’s preference’ (Borkowski, 2010, 38). Even though the OECD Transfer Pricing Guidelines have not been uniformly adopted by member states the OECD’s main objection to the imposition of formula apportionment of corporate taxes is that the transition to a global formulary apportionment system ‘would present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation’ (Susarla and Glaize, 2012, 39).

The OECD has recognized the problems of BEPS, and have instituted a wide ranging *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013) in order to canvass

Fundamental changes [that] are needed to effectively prevent double non-taxation, as well as cases of low or no taxation associated with practices that artificially segregate taxable income from the activities that generate it (OECD, 2013, 13).

The first report under the *Action Plan*, will ‘identify issues raised by the digital economy and possible actions to address them’ (OECD, 2013, 29) and is due to be presented to the OECD in September 2014.

In July 2013, the OECD released a forum piece suggesting that opposition to the use of the arm’s length principle as espoused in the OECD Transfer Pricing Guidelines was ‘simplistic’ and ‘finger pointing’ and not the cause of all the BEPS problems (Saint-Amans and Russo, 2013). The authors of the Forum piece list six key areas that are the causes of MNEs not paying their fair share of tax those being;

1. ‘Hybrids and mismatches which generate arbitrage opportunities’. In other words, tax competition between nations that encourage tax arbitrage, that is, profit shifting to less onerous taxing jurisdictions.
2. ‘The residence-source tax balance, in the context in particular of the digital economy’. In other words, the ability of MNEs, through the use of the digital economy to be able to ‘source’ their sales anywhere in the world.
3. ‘Intragroup financing, with companies in high-tax countries being loaded with debt’. In other words, profit shifting by MNEs facilitated by transfer pricing rules.
4. ‘Transfer pricing issues, such as the treatment of group synergies, location savings’. In other words, the ability of MNEs to shift management fees within their group using the transfer pricing rules.
5. ‘The effectiveness of anti-avoidance rules’. In other words, nation states are unable to effectively impose their anti-tax avoidance rules on MNEs because of the latitude allowed to MNEs in the use of transfer pricing rules.
6. ‘The existence of preferential regimes’. In other words, the existence of tax competition between nation states conducted in order to attract MNEs to their jurisdictions.

Even though not all of the BEPS problems are caused by the OECD Transfer Pricing Guidelines the Guidelines certainly do little to prevent the problems from continuing.

Despite the difficulties of achieving international cooperation, the European Union ('EU') is considering the introduction of formula apportionment of corporate profits. The European Commission ('EC') published a *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)* in 2011. This proposal advocates for 'a system of common rules for computing the tax base of companies which are tax resident in the EU and of EU-located branches of third-country companies' (EC, 2011, 5). The EC's stated intention is to 'tackle some major fiscal impediments to growth' (EC, 2011, 1) in the EU. According to the explanatory memorandum, the lack of common corporate tax law and the operation of national taxation laws leads to 'over-taxation and double taxation ... [with corporations] ... facing heavy administrative burdens and high tax compliance costs' (EC, 2011, 1). It is uncontroversial to assert the MNEs face heavy administrative burdens and high compliance costs while managing their tax obligations under the current transfer pricing rules. However, to assert that MNEs are over taxed or double taxed under the current system is contradicted by the EC later in the same document. The EC asserts that while the introduction of the CCCTB will mean that tax administrations will have to manage two tax systems, this will be compensated 'by the fact that the CCCTB will mean fewer opportunities for tax planning by companies using transfer pricing or mismatches in Member State tax systems' (EC, 2011, 6).

The EC can't have it both ways, the adoption of the CCCTB will in all likelihood reduce MNE compliance cost but it will also, in all likelihood, reduce their opportunities to minimize their tax by the use of transfer pricing.

The proposed CCCTB directive is similar to the UDITPA rules described above. The proposed CCCTB rules would require EU companies to submit consolidated accounts that compute their tax base according to a single set of common rules across the EU (EC, 2011, 8). The resulting taxable profit would then be redistributed according to formula. The formula would 'comprise three equally weighted factors (labor, assets and sales)' (EC, 2011, 14). This formula would not be exactly the same as the formula in UDITPA as the weighting for labor would be a 'computed on the basis of payroll and the number of employees' (EC, 2011, 14, s21). The UDITPA weighting for labor only considers the payroll cost. As is the case in the U.S. the EC CCCTB proposal will also allow the nations within the EU to set their own corporate tax rates on the basis that 'Fair competition on tax rates is to be encouraged'. The term fair competition is interesting, as it acknowledges that unfair competition between nations in attracting corporations has occurred.

Conclusion

Tanzi is not optimistic about the ability of nation state to curb the fiscal termites from avoiding tax. He concludes that nation states will 'need to rely on taxes that will be less affected by the problems described above' (Tanzi, 2001,6), that is, the problems of BEPS employed by MNEs. Tanzi proffers

taxes on 'immobile factors or resources'. The alternative to nations cooperating to impose effective transnational taxes on MNEs, then, is to reduce the tax base from taxes on MNE profits, externalities, currency transactions taxes.

In 'a world imbued with stateless income' Kleinbard (2011-2012, 101) examined the relative merits of the current approach to the taxation of MNEs used by the U.S taxing authorities and a 'form of worldwide tax consolidation' (Kleinbard, 2011-2012, 101), that is, a form of formula apportionment. Kleinbard concluded that

the worldwide tax consolidation approach, if coupled with an appropriately low corporate tax rate (perhaps in the neighborhood of 25-27%) would prove more robust to the corrosive effects of stateless income tax planning, while preserving an authentically competitive environment for both domestic and international activities of U.S. firms' (Kleinbard, 2011-2012, 101).

Morse considered the global formulary apportionment approach and concluded that the issues surrounding the valuation of the elements of the formula, sales, payroll and property, as applied in the U.S., favored an incremental approach to the reform of international taxation of MNE profits. Morse examined 'the idea of global destination sales-based formulary apportionment' (Morse, 2010, 640) as an option.

Variations of the global formulary approach to the taxation of MNEs are being canvassed by taxation scholars and taxing authorities around the globe. The global problem of how to fairly tax corporations is becoming even more pressing as the economic dominance of MNEs becomes greater. The EC proposal for a CCCTB is a good first step in addressing the problem of BEPS by MNEs and, if accompanied by a uniform corporate tax rate, would have some chance of successfully ameliorating the wholesale avoidance of taxation by MNEs.

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