Editorial

Unitary Taxation: The Denouement?

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Within a very short space of time there have been three important developments in relation to the issue of unitary taxation. The decision of the US Supreme Court in the *Barclays* and *Colgate Palmolive* cases[1] has been quickly followed by the publication of a further report by the OECD on transfer pricing methods[2] and by the final version of US regulations issued under Section 482 of the US Internal Revenue Code.[3]

It was always going to be interesting to see how the Supreme Court would approach the *Barclays* case, once it had decided against many expectations to hear the appeal, and to see how it would distinguish, if at all, between a domestic tax payer, Colgate Palmolive, and a foreign tax payer, Barclays. In the event the domestic/foreign distinction was only drawn in the dissenting judgment of the two members of the Court who supported Barclays.

Much of the case turns on US constitutional questions but it is interesting to the outsider to note the approach of the Court to some of the arguments for preferring the separate accounting/arm's length to the unitary approach and to the issue of compliance costs.

To begin with, said the Court, the Due Process and Commerce Clauses of the Constitution prevent States that impose an income tax on residents from taxing value earned outside the taxing State's borders. But when a business enterprise operates in more than one taxing jurisdiction, arriving at precise territorial allocations of value is often an elusive goal both in theory and in practice. Every method of allocation devised, added the majority judgement, involves some degree of arbitrariness. Separate accounting poses a risk that a conglomerate will manipulate transfers of value among its components to minimise its total tax liability. To guard against such manipulation, said the Court, transactions between affiliated corporations must be scrutinised to ensure they are reported on an arm's length basis. In this approach one can see the setting of the scene for a conclusion that arm's length is not white and unitary black.

A state tax, said the Court, would not survive Commerce Clause scrutiny if the tax payer demonstrated that the tax either (1) applies to an activity lacking a substantial nexus to the taxing state; (2) is not fairly apportioned; (3) discriminates against inter-state commerce; or (4) is not fairly related to the services provided by the state. In relation to a tax affecting *foreign* commerce two additional concerns were (5) the enhanced risk of multiple taxation and (6) the capacity of the federal government to speak with one voice when regulating commercial relations with foreign governments.

The Court quickly dismissed concerns 1, 2 and 4 above. When it came to discrimination (3) Barclays pointed to the prohibitive expense of compliance costs. The tax payer would be forced to convert its financial and accounting records from around the world into the language, currency and accounting principles of the United States. Barclays had estimated, and the trail court accepted, that the worldwide reporting scheme would cost more than $5 million to set up and $2 million per annum to maintain. However, the actual compliance costs had been relatively modest and during the years just prior to those at issue ranged from $900 to $1,250 per annum for BBI. The Court noted that California's regulations allowed the Tax Board to accept 'reasonable approximations' and Barclays and the Tax Board had used these provisions to prepare the computations. This allowed Barclays to avoid the large compliance costs of which is complained, said the Court, and therefore on the facts it had failed to demonstrate that the system operated imposed inordinate compliance burdens on foreign enterprises. Barclays' argument that the burden was incompatible with Due Process was rejected on similar grounds – no example could be found of the approximations being rejected by the Tax Board as unreasonable.

[1] 20 June 1994.
[2] 8 July 1994.
[3] 1 July 1994.

The enhanced risk of multiple taxation (5) also failed as an argument. While the Court accepted that there was risk of multiple taxation this was not the 'inevitable result' of the California tax. Moreover the alternative, i.e. the arm's length approach could not eliminate the risk of double taxation. The precise rules for reallocating income under the arm's length approach varied and wherever there was a difference then the possibility of double taxation existed. no mention was made of the possibility of a corresponding adjustment.

Meanwhile the latest OECD report, published with adroit timing, strongly condemns unitary taxation methods. Such taxation disregards market conditions and is inflexible, arbitrary and imprecise. It also imposes an 'intolerable' administrative burden on companies.

Equally the report asserts that, when selecting the appropriate arm's length method, tax authorities should use profit comparisons only as a last resort when transaction based methods are not practicable. The report goes on to set limits for the use of profit comparisons. This is a very useful step because it has sometimes looked as if the proponents of unitary taxation, pressed to use the arm's length method, might corrupt it by applying functional analysis or a profit split as a means of achieving indirectly what they could not achieve directly because of opposition to the unitary method.

Happily the final version of the US regulations, under Section 482 of the Internal Revenue Code, also published in July[4], can be said to give tax payers more freedom than earlier draft proposals and to be less prescriptive on the ways in which they may determine transfer prices. At first sight it would seem that they are broadly consistent with the OECD draft guidelines.

Rather usefully these guidelines are themselves published in draft and, exceptionally for the OECD, are open for public comment before they are finalised. One hopes that all interested tax payers will take the opportunity to either themselves or through representative bodies speak up forcefully in support of the proposed guidelines and in opposition to the unitary method. In this way the latest developments could come to represent the denouement, rather than the start of another chapter in the saga.

[4] *See supra* n. 3.