

Management Incentives for Optimal Investment Decisions under Formula Apportionment

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We investigate how the interplay between taxation under formula apportionment (FA) and management compensation schemes impacts investment decisions of managers. More precisely, we aim answering the following research question: How should managers be incentivized in order to make optimal investment decisions under FA?

Under the tax allocation system “FA” profits of multinational enterprises (MNEs) are allocated to the single group entities on the basis of a certain apportionment formula, which consists e.g. on the factors assets, labor and sales. FA has frequently been discussed as a universal solution to dampen profit shifting activities of MNEs. It increasingly gains in importance for international business taxation: the European Commission proposed a harmonized tax system for EU countries, which is based on FA, the FA-related profit-split-method is more and more applied as one of the transfer pricing methods and, last but not least, many countries established already country-by-country reporting in course of the OECD BEPS project, which also grounds on the idea of FA.

In contrast to separate accounting, formula apportionment can distort locational investment decisions in the way that profitable investments from a pre-tax perspective must not necessarily be profitable from an after-tax perspective. The pre-tax profits of an investment can be overcompensated by tax payments that result from a shift of tax base from a low-tax to a high-tax country. Consequently, FA violates in this respect the neutrality claim for tax systems.

Against this background, it is important to assess how managers need to be incentivized and compensated in order to ensure that they make investment decisions that are desired by the shareholders. Crucial for the manager’s incentivization is on which definition of profits the manager is compensated. In line with common practice for management compensation of German DAX-30 companies, we distinguish two different dimensions: managers can either be compensated on the basis of pre-tax/after-tax profits or on basis of the profits on the single entity level or on the group level.

Preliminary results indicate that none of the currently (under the allocation system “separate accounting”) applied profit definitions for management compensation are appropriate to incentivize managers for optimal investment decisions under FA. In some constellations the currently used profit definitions for management compensation lead to investment decisions counter the intended aim of the shareholders. We aim at giving suggestions in which scenario which management compensation scheme leads to best investment decisions of managers under FA.