

*The Formulary Approach to the
Taxation of Transnational
Corporations: A Realistic Alternative?*

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Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations (California)
APA	Advance Pricing Arrangements/Agreements
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
ASIC	Australian Securities and Investments Commission
AASB	Australian Accounting Standards Board
ATO	Australian Taxation Office
AUD	Australian dollar
BALRM	Basic arm's length return method
BIAC	Business and Industry Advisory Committee
BIS	Bank for International Settlements
BOO	Build-own-operate
BOT	Built-operate-transfer
BTO	Built-transfer-operate
CA	Competent authority
CARICOM	Caribbean Community
CATA	Commonwealth Association of Tax Administrators
CEN	Capital Export Neutrality
CFC	Controlled Foreign Corporations
CIAT	Inter-American Centre of Tax Administrators
CIN	Capital Import Neutrality
CMEA	Council for Mutual Economic Assistance also referred to as COMECON
CPA	Certified Public Accountants
CPM	Comparable Profit Method
CREDAF	Centre de rencontres et d'études des dirigeants des administrations fiscales
CUFT	comparable uncontrolled financial transaction method
CUP	Comparable Uncontrolled Price
DFI	Derivative financial instruments
DISC	Domestic International Sales Corporations
DTA	Double Tax Agreement
ECB	European Central Bank

Abbreviations

ECJ	European Court of Justice
ECOFIN	European Council of Economic Finance Ministers
EEC	European Economic Community
EMU	Treaty on Economic and Monetary Union
EU	European Union
FASB	Financial Accounting Standards Board (U.S.)
FCN	Treaties of Friendship, Commerce and Navigation
FDI	Foreign direct investments
FRC	Financial Reporting Council (Australia)
FOIA	U.S. Freedom of Information Act
FSC	Foreign Sales Corporations
FTB	Franchise Tax Board (California)
FTCS	Foreign Tax Credit System
FTUE	Formulary Taxation of the Unitary Enterprise
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GATS	General Agreement on Tariff and Services
GATT	General Agreement on Tariff and Trade
GDP	Gross Domestic Product
GMM	Gross margin method
GMUM	Gross mark-up method
GNP	Gross National Product
IAFEI	International Association of Financial Executives Institutes
IASs	International accounting standards
IASC	International Accounting Standards Committee
IBRD	International Bank for Reconstruction and Development
ICSID	International Centre for the Settlement of Investment Disputes
IFA	International Fiscal Association
IFS	Institute for Fiscal Studies, London
IFAC	International Federation of Accountants
IIB	Institute of International Bankers
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions

Abbreviations

IOTA	Intra-European Organisation of Tax Administrators
IPA	Interest Paid Adjustment
IPS	International profit shifting
IRC	Internal Revenue Code (U.S.)
IRS	Internal Revenue Service (U.S.)
ITAA	Income Tax Assessment Act (Australia)
JVA	Joint Africa Institute
JVI	Joint Vienna Institute
LDC	Less developed countries
MAATM	<i>Convention on Mutual Administrative Assistance in Tax Matters</i>
MAI	Mutual Agreement on Investments
MAP	Mutual Agreement Procedure
MFN	Most Favoured Nation
MNC	Multinational Corporations/Companies
MNE	Multinational Enterprises
MTC	Multistate Tax Compact
NAFTA	North American Free Trade Association
NTA	National Tax Association (U.S.)
NTA	National Tax Administration (Japan)
OAS	Organisation of American States
OCAM	Organisation Commune Africaine Malgache et Mauricienne
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
OPEC	Organisation of Petroleum Export Countries
OTC	Over-the-counter (derivative products)
PATA	Pacific Association of Tax Administrators
PCM	Profit Comparison Method (Australia, Draft Ruling TR95/D22).
PCS	Pre-Confirmation System
PE	Permanent Establishments
PR	U.S. Proposed Regulation in Global Dealings
QBU	qualified business units
QMV	Qualified majority voting
R & D	Research and Development

Abbreviations

RAROC	Risk adjusted return on capital
RORAC	Return on risk-adjusted capital
SA/AL	Separate Accounting/Arm's Length Method
SE	Société Européenne
SEC	Securities and Exchange Commission
SIC	Standing Interpretations Committee
SGATAR	Study Group on Asian Tax Administrators and Research
SDC	Standards Development Committee (IASC)
TAAS	Tax Administration Advisory Services
TEP	Transatlantic Economic Partnership
TIEA	Tax Information Exchange Agreements
TIN	Tax Identification Number
TNC	Transnational Corporation
TNE	Transnational Enterprise
TNMM	Transactional Net Margin Method
TPM	transfer pricing methodologies
UDITPA	Uniform Division of Income for Tax Purposes Act
U.K.	The United Kingdom
U.N.	The United Nations
UNCTAD	U.N. Conference on Trade and Development
U.S.	The United States of America
USD	U.S. dollar
VAT	Value-added tax
WAIFC	World Association of International Financial Centres
WTO	World Trade Organisation
WUT	Worldwide Unitary Theory
WWCR	Worldwide Combined Reporting

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Synopsis

The central hypotheses of this thesis are:

- that global formulary apportionment is the most appropriate method for the taxation of transnational corporations (TNCs) in lieu of the present system commonly referred to as the separate accounting/arm's length method; and
- that it is essential, in order to implement the proposed global formulary model, to create an international organisation which would fulfil, in the taxation field, a role equivalent to that of the World Trade Organisation (WTO) in international trade.

The world economy is fast integrating and is increasingly dominated by the activities of transnational enterprises. These activities create a dual tax problem for various revenue authorities seeking to tax gains derived thereon:

- Firstly, when two or more countries entertain conflicting tax claims on the same base, there arises what is commonly referred to as a double taxation problem.
- Secondly, an allocation problem arises when different jurisdictions seek to determine the quantum of the gains to be allocated to each jurisdiction for taxation purposes.

The traditional regime for solving both the double taxation and the allocation problem is enshrined in a series of bilateral treaties signed between various nations. These are, in general, based on the Organisation for Economic Co-operation and Development (OECD) Model Treaty.¹ It is submitted, in this thesis, that while highly successful in an environment characterised by the coexistence of various national taxation systems, the traditional regime lacks the essential attributes suitable to the emerging 'borderless world'.

The central theme of this thesis is the allocation problem. The OECD Model attempts to deal with this issue on a bilateral basis. Currently, the allocation problem is resolved through the application of Articles 7 and 9 of the OECD Model. In both instances the solution is based on the 'separate enterprise' standard, also known as the separate entity theory.

¹ OECD, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1992), looseleaf, last updated 2000.

This separate accounts/arm's length system was articulated in the 1930s when international trade consisted of flows of raw materials and other natural products as well as flows of finished manufactured goods. Such trade is highly visible and may be adequately valued both at the port of departure or at the port of entry in a country. It follows that within this particular system of international trade the application of the arm's length principle was relatively easy and proved to be extremely important in resolving both the double taxation and apportionment problems.

Today, however, the conditions under which international trade is conducted are substantially different from those that prevailed until the 1960s.

- Firstly, apart from the significant increase in the volume of traditionally traded goods, trade in services now forms the bulk of international exchanges. In addition, the advent of the information age has dramatically increased the importance of specialised information whose value is notoriously difficult to ascertain for taxation purposes.
- Secondly, the globalisation phenomenon which gathered momentum over the last two decades has enabled existing TNCs to extend their global operations and has favoured the emergence of new transnational firms. Thus, intra-firm trade conducted outside market conditions accounts for a substantial part of international trade.
- Thirdly, further economic integration has been achieved following the end of the Cold War and the acceleration of the globalisation phenomenon. In this new world economic order only TNCs have the necessary resources to take advantage of emerging opportunities.

The very essence of a TNC is 'its ability to achieve higher revenues (or lower costs) from its different subsidiaries *as a whole* compared to the results that would be achieved under separate management on an arm's length basis.'² Yet, the prevailing system for the taxation of TNCs overlooks this critical characteristic and is therefore incapable of fully capturing, for taxation purposes, the aggregate gains of TNCs. The potential revenue loss arising from the inability of the present system to account for and to allocate synergy gains is substantial.

It follows that the perennial questions of international taxation can no longer be addressed within the constraints of the separate entity theory and a narrow definition of national sovereignty. Indeed, in order to mirror the developments occurring in the economic field, taxation needs to move from a national to an international level.

Moreover, a profound reform of the system is imperative in order to avoid harmful tax competition between nations and enhance compliance from TNCs. Such a new international

² R.M. Bird, 'The Interjurisdictional Allocation of Income', (1986) 3 *Australian Tax Forum* 333, at 334.

tax system needs to satisfy the test of simplicity, equity, efficiency, and administrative ease. To achieve these objectives international cooperation is essential. The hallmark of international cooperation has been the emergence, after World War II, of a range of international organisations designed to facilitate the achievement of certain goals deemed essential by various nations. The need for an organisation to deal specifically with taxation matters is now overwhelming.

Consequently, this thesis recommends the creation of an international organisation to administer the proposed system. The main objective of this international organisation would be to initiate and coordinate the multilateral application of a formulary apportionment system which, it is suggested, would deal in a more realistic way with ‘the difficult problems of determining the tax base and allocating it appropriately between jurisdictions’.³

The global formulary apportionment methodology is derived from the unitary entity theory. The unitary theory considers a TNC as a single business which, for convenience, is divided into ‘purely formal, separately-incorporated subsidiaries’.⁴ Under the unitary theory the global income of TNCs needs to be computed, then such income is apportioned between the various component parts of the enterprise by way of a formula which reflects the economic contribution of each part to the derivation of profits.

The question that arises is whether the world of international taxation is ready for such a paradigm shift. It is arguable that this shift has already occurred albeit cautiously and in very subtle ways. Thus, the latest of the OECD Guidelines on the transfer pricing question provides that ‘MNE [Multinational Enterprise] groups retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm’s length principle in accordance with these Guidelines.’⁵ Arguably, the globalisation process has created ‘the specific situation’ allowed for by the OECD. This thesis, therefore, explores the relative obsolescence of the bilateral approach to the taxation of TNCs and then suggests that a multilateral system is better adapted to the emerging globalised economy.

The fundamental building blocks of the model proposed in this thesis are the following:

- First, the administration and coordination of the proposed system is to be achieved by the creation of a specialised tax organisation, called Intertax, to which member countries would devolve a limited part of their fiscal sovereignty.

³ *Id.*, at 333.

⁴ Note, ‘Multinational Corporations and Income Allocations Under Section 482 of the IRC’, (1976) 89 *Harv L.R.* 1202, at 1204.

⁵ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995) at I-27 para. 1.68.

- Second, in order to enable the centralised calculation of TNC's profits, the proposed system requires the formulation of harmonised methods for the measurement of the global profits of TNCs. Therefore, the efforts of the International Accounting Standards Committee (IASC) to produce international accounting standards and harmonised consolidation rules must be recognised and, if needs be, refined and ultimately implemented.
- Third, the major function of Intertax would be to determine the commercial profits of TNCs on a standardised basis and to apportion the latter to relevant countries by way of an appropriate formula/formulas.

Once this is achieved, each country would be free, starting from its share of commercial profits, to determine the taxable income in accordance with the particular tax base that it adopts and, ultimately, the tax payable within its jurisdiction. In the proposed system, therefore, a particular country would be able to independently set whatever depreciation schedules or investment tax credits it chooses, and adopt whatever tax accounting rules it deems fit relative to its policy objectives.

Moreover, this thesis argues that the global formulary apportionment model it proposes is not dramatically opposed to the arm's length principle. Indeed, it suggests that the constant assumption to the contrary, even with regard to the usual formulary apportionment methodology, is extravagant because both methodologies are based on a common endeavour, that is, to give a substantially correct reflex of a TNC's true profits.

It has often been objected that global formulary apportionment is arbitrary and ignores market conditions. This thesis addresses such concerns by rejecting the application of a single all-purpose formula. Rather, it recognises that TNCs operating in different industries require different treatment and, therefore, suggests the adoption of different formulas to satisfy specific industry requirements. For example, the formula applicable to a financial institution would be different to that applicable to the pharmaceutical industry. Each formula needs to be based on the fundamental necessity to capture the functions, taking into consideration assets used, and risks assumed within that industry. In addition, if the need arises, each formula should be able to be fine-tuned to fit specific situations. Moreover, it is also pertinent to note that the OECD already accepts 'the selected application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE group...such as it might be used in a mutual agreement procedure, advance transfer pricing agreement, or other bilateral or multilateral determination.'⁶ The system proposed in this thesis can thus be easily reconciled with the separate accounting/arm's length which the OECD so vehemently advocates. Both models

⁶ *Id.*, at III-20 para. 3.60.

have the same preoccupations so that what is herein proposed may simply be characterised as an institutionalised version of the system advocated by the OECD.

Multilateral formulary apportionment addresses both the double taxation and the allocation problems in international taxation. It resolves the apportionment question ‘without depending on an extraordinary degree of goodwill or compliance from taxpayers.’⁷ It is therefore submitted that, if applied on a multilateral basis with a minimum of central coordination, it also seriously addresses the double taxation problem. Indeed, it is a flexible method given that different formulas may be devised to suit the needs of TNCs operating in different sectors. Consequently, formulary apportionment understood in this sense, is a realistic alternative to the limitations of the present system.

⁷ Bird, *supra* note 2, at 333.

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PART I
SLICING A SHADOW:
THE PROBLEM OF INTERNATIONAL
TAXATION

INTRODUCTION

This thesis is concerned with the taxation of transnational corporations (referred to as TNCs). TNCs are not simply firms engaged in international operations. An enterprise which merely takes foreign orders for its products and exports the required goods is not a TNC. It only trades *with* a foreign country. Conversely, a TNC is an enterprise which establishes a foreign presence and thus trades *within* rather than *with* a foreign country.¹

On the international level the activities of TNCs create a dual international tax problem. Firstly, the country where the TNC is considered to be resident may claim a right to tax any gain derived from the worldwide activities of the enterprise. However, countries where those activities are carried out may also claim a right to tax such gains on account of their being sourced there. If these conflicting claims are not reconciled, then the gains of a single enterprise are likely to be taxed twice. Secondly, because the activities of a TNC are carried out in more than one country, a second problem arises in the determination of the quantum of the gains to be allocated to each jurisdiction for taxation purposes.

The traditional regime for solving both the double taxation and the allocation problem is enshrined in a series of bilateral treaties signed between various nations and based on the Organisation for Economic Co-operation and Development (OECD) Model Treaty.² The double taxation problem is resolved by granting the source country the right to tax business profits arising from the activities of a permanent establishment (PE) of a TNC within its jurisdiction, while the residence country is required to provide the TNC with either a credit or an exemption for source country taxes. Moreover, the OECD Model imposes a limit on the source country tax by targeting exclusively business profits attributable to a PE. A residual right to tax such business profits is then granted to the residence country. In general, a PE is defined as any fixed place of business or an agency relationship which is characterised by a certain degree of permanence. The taxation regime of subsidiary companies, because of their separate legal personality, is determined by the law applicable to corporate entities in their respective country of residence unless they are considered to be PEs of their parent company.

¹ See *Grainger & Sons v. Gough* [1896] AC 325. See also J.D. Adams & R.J. Whalley, *The International Taxation of Multinational Enterprises in Developed Countries* (London: The Institute of Fiscal Studies, 1977). Adams and Whalley use the expression 'multinational enterprises'. For the present purposes the expression 'transnational corporation' rather than 'multinational enterprise' seems more appropriate. The latter expression connotes allegiance to several states when in reality such allegiance transcends national boundaries and vests solely with the parent.

² OECD, *Model Double Taxation Convention on Income and on Capital* (Paris: OECD, 1992), looseleaf, last updated 2000.

The second aspect of the international taxation problem arising from the operation of TNCs is the proper allocation of income generated by multijurisdictional operations. This problem, referred to as the 'allocation problem', forms the central theme of this thesis. The OECD Model deals with the allocation problem on a bilateral basis. Article 7 provides for the methods of apportioning profits derived by PEs operating in different jurisdictions. Article 9, for its part, allows the taxation authorities of a country to re-write the accounts of an associated enterprise of a TNC in order to show the true profits arising within that country. In both instances the solution is based on the 'separate enterprise' standard also known as the separate entity theory.

This theory is based on two hypotheses:

- First, it assumes that the components of a TNC, regardless of their legal form, act as if they are not related to each other. It is thus assumed that members of a TNC compete with each other as if they were separate and independent parties each attempting to maximise its own profits.
- Second, as a result of this competition hypothesis, transactions entered into by various members of the group must be comparable to those which would have been negotiated between unrelated parties dealing at arm's length.

The OECD Model, therefore, requires that the price agreed upon by related parties for a particular good should equate that which unrelated parties would have negotiated for the same, or similar good, under the same conditions and circumstances. Since arm's length prices are charged, or are deemed to be charged, between parties dealing with each other at arm's length, then, notwithstanding their relationship, the profits that are shown in the separate books of the related parties must necessarily reflect the exact commercial significance of the operation. It is that commercial result (profit or loss), sourced in a particular country and adjusted if necessary to reflect an arm's length situation, which forms the tax base upon which that country may assess. In certain jurisdictions, however, further adjustments are necessary to the commercial profits in order to satisfy tax accounting principles.

This separate accounts/arm's length method was articulated in the 1930s and has been highly successful in achieving some coherence in international taxation. However, with the advent of the so-called 'new economy' based on services and information exchanges in increasingly globalised markets, it is doubtful whether the present system could endure further stretching to accommodate these innovations. Indeed, the globalisation phenomenon of the last two decades has enabled existing TNCs to extend their global operations and has favoured the

emergence of new transnational firms.³ In addition, the end of the Cold War, the implosion of the former USSR and the embrace of the market economy by former East European countries and China have opened vast markets in which TNCs can now operate. Furthermore, the removal of trade barriers through multilateral trade negotiations under the General Agreement on Tariff and Trade (GATT), now the World Trade Organisation (WTO), the creation of extensive integrated economic zones, for example the European Union (EU), the North American Free Trade Association (NAFTA), Asia-Pacific Economic Cooperation (APEC), and the Indian Ocean Rim Association for Regional Co-operation, have again opened new markets. In most cases only TNCs have the necessary resources to take advantage of the emerging opportunities. On the taxation front these conditions have irrevocably altered the equilibrium between the interests of the source and the residence country. Indeed, they have even blurred the traditional dichotomy between capital exporting and capital importing countries.

The very essence of a TNC is 'its ability to achieve higher revenues (or lower costs) from its different subsidiaries *as a whole* compared to the results that would be achieved under separate management on an arm's length basis.'⁴ The prevailing system for the taxation of TNCs ignores this critical characteristic. Consequently, the separate entity/arm's length principle is relatively ineffective in capturing, for taxation purposes, the aggregate gains of TNCs. Since TNCs are now the major proponents of international trade, the amount of revenue loss arising from the inability of the present system to account for synergy gains is substantial. Therefore, the perennial questions of international taxation can no longer be addressed within the narrow constraints of the separate entity theory. Moreover, if the current provincialism of taxation authorities based on the principle of fiscal sovereignty remains unchecked, then these problems are likely to remain unresolved. A profound reform of the system is imperative in order to avoid tax competition between nations which could lead to what Thomas Menck has described as a 'star wars between finance administrations'.⁵ Cooperation in solving international problems of any magnitude is crucial. This objective can be achieved efficiently through various international organisations endowed with a clear mandate and appropriate powers.

In the international taxation field there is no international organisation to fulfil an equivalent role to that of the WTO in international trade. An international organisation needs to be set up to initiate and to coordinate the multilateral application of alternative taxation principles in lieu of the actual practice by various nations. The major purpose of an eventual international

³ The United Nations believes that in 1995 there were 39,000 TNCs with 270,000 foreign affiliates representing a total investment of \$2.7 trillion; see United Nations Conference on Trade and Development, *World Investment Report 1996: Overview* (New York & Geneva: United Nations, 1996), at 2.

⁴ R.M. Bird, 'The Interjurisdictional Allocation of Income', (1986) 3 *Australian Tax Forum* 333, at 334.

⁵ T. Menck, 'West Germany', (August 1986) *Tax Notes* 583, at 585.

organisation in the taxation field is therefore to deal in an alternative way with ‘the difficult problems of determining the tax base and allocating it appropriately between jurisdictions’.⁶

An alternative method for the determination and allocation of the tax base to different jurisdictions is the unitary entity theory. This theory considers a TNC as a single business which, for convenience, is divided into ‘purely formal, separately-incorporated subsidiaries’.⁷ Under the unitary theory, the global income of TNCs is first determined. It is then apportioned between the various component parts of the enterprise by way of a formula reflecting the economic contribution of each part the enterprise to the derivation of the aggregated profits.

Global formulary apportionment is not a radically new proposition. The method, or variants thereof, was used by various European states at the beginning of the century. It is still predominant in the U.S. at the State level. In addition, although the arm’s length principle was adopted by the League of Nations as the primary method of apportionment, the formulary apportionment alternative was not totally rejected. Its retention by the League of Nations is echoed by the OECD, which still provides that it is applicable pursuant to article 7(4) of the OECD Model or ‘in specific...situations where other methods give rise to serious difficulties and...the countries concerned are able to adopt a common approach and the necessary information be made available.’⁸ Moreover, the latest of the OECD Guidelines on the transfer pricing question provides that ‘MNE [Multinational Enterprises] groups retain the freedom to apply methods not described in this Report to establish prices provided those prices satisfy the arm’s length principle in accordance with these Guidelines.’⁹ Furthermore, as far as the selection of a proper method for determining transfer prices is concerned, the 1995 Guidelines provides that ‘generally it will be possible to select one method that is apt to provide the best estimation of the arm’s length price.’

It then goes on to recommend the use of ‘a flexible approach’ provided that:

an attempt [is made] to reach a conclusion consistent with the arm’s length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.¹⁰

This thesis is based on the hypothesis that the globalisation process has created ‘the specific situation’ allowed for by the OECD. It further suggests that formulary apportionment is not

⁶ Bird, *supra* note 4, at 333.

⁷ Note, ‘Multinational Corporations and Income Allocations Under Section 482 of the IRC’, (1976) 89 *Harv L.R.* 1202, at 1204.

⁸ OECD, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), at para. 14.

⁹ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995), at I-27 para. 1.68.

¹⁰ *Id.*, at I-27 para. 1.69.

dramatically opposed to the arm's length principle. Indeed, the constant assumption to the contrary is extravagant because in many instances retail prices are often set by merely allowing a certain percentage mark-up of a wholesale price.

Global formulary apportionment addresses both the double taxation and the allocation problems in international taxation. It resolves the apportionment question 'without depending on an extraordinary degree of goodwill or compliance from taxpayers.'¹¹ It is therefore submitted that, if applied on a multilateral basis with a certain form of central coordination through a specialised tax organisation, it seriously addresses the double taxation problem and is, consequently, a realistic alternative to the limitations of the present system.

This study is devoted to the systematic application of the formulary system on a worldwide basis with emphasis on the global financial industry. Part I is concerned with the major problems of the present international tax system. Chapter 1 describes the origins of the basic principles of international taxation. Chapter 2 discusses the limitations of the prevailing system. Chapter 3 studies the proposals for reform that have been suggested to enhance the present system. Part II is concerned with the practical application of formulary apportionment for the taxation of TNCs in a global economy. Chapter 4 is an historical account of the unitary method. Chapter 5 argues for a multilateral approach to the problem of international taxation and proposes the creation of an international tax organisation. Chapter 6 is concerned with the administrative functions of such an organisation, for example, the institution itself, the promotion of international accounting standards, and the calculation of the tax base. Chapter 7 focuses on the application of various possible formulas by the international organisation, their justification and their limitations. Finally, Chapter 8 applies the model that has emerged to the global financial industry.

¹¹ Bird, *supra* note 4, at 333.

The Origins of the General Principles of International Taxation

The difficulties of allocating income among various countries has been described as bearing ‘some resemblance...to slicing a shadow’.¹ A first attempt to address the issue on an international basis was carried out by the League of Nations in the 1920s.²

Section I of this chapter reviews the search for a theoretical rationale linking the state’s power to tax with the concept of jurisdiction to tax. Section II analyses the efforts of the League of Nations to deal with the problem of international double taxation. Finally, Section III considers the problem relative to the proper allocation of multijurisdictional business income.

Section I Development of Rationales for International Jurisdiction to Tax

A fundamental question relative to taxation is the determination of the relationship between a state’s power to tax and that of its jurisdiction to tax.³ Early theoretical studies of this question conceded that mere power to collect tax does not justify the indiscriminate use of that power. In order to satisfy customary international fiscal law, a country must have what is called jurisdiction to tax.⁴

¹ Per Brennan J. in *Container Corp v Franchise Tax Board* (1983) 463 U.S. 159, 192.

² According to Picciotto, since its foundation, the International Chamber of Commerce (ICC) was preoccupied with the question of international double taxation. In 1920 it held an international financial conference, and on its recommendation, the League of Nations took on the task of coordinating the efforts to find a solution to the problem of international business taxation. See S. Picciotto, *International Business Taxation* (London: Weidenfeld & Nicholson, 1992), at 15. A history of the ICC’s involvement with the efforts to solve the problem of double taxation is to be found in Ke Chin Wang, ‘International Double Taxation of Income: Relief through International Agreement 1921-1945’, (1945) 59 *Harv L.R.* 73, at 97ff.

³ The concepts of power to tax and right to tax is explored in A.L. Harding, *Double Taxation of Property and Income* (Cambridge: Harvard University Press, 1933), at 24ff.

⁴ The question as to whether there is in fact a coherent body of international rules that may be termed customary international fiscal law is examined in A.H. Qureshi, *The Public International Law of Taxation: Text, Cases and Materials* (London: Graham & Trotman Limited, 1994), at 2ff. Qureshi uses the expression ‘public international law of taxation’ to describe that branch of public international law which provides an ‘international normative framework in fiscal matters’. See also A. Knechtel, *Basic Problems in International Fiscal Law* (HFL Publishers Ltd, 1979); and R.S. Avi-Yonah, ‘The Structure of International Taxation’, (1996) 74 *Texas Law Review* 1301, at 1305, where Professor Avi-Yonah argues that the international tax regime can be regarded as customary international law.

1 The Earlier Approach

Attempts to reconcile the power and jurisdiction to tax date as far back as the Middle Ages.⁵ However, a comprehensive doctrine dealing with the issue in relation to business income originated towards the end of the nineteenth century with the gradual spread of business taxation.⁶ This initial approach was based on the doctrine of political allegiance and on the so-called equivalence or exchange theory.

A The Doctrine of Political Allegiance

Until the end of the last century, political allegiance, that is, nationality for physical persons and incorporation for legal persons, was widely considered as a reasonable connecting factor or nexus between a taxable subject and a taxing state.⁷ Nationality confers political rights and certain obligations to its holders. Consequently, nationality has been regarded as creating the necessary nexus enabling a country to tax. Thus, the United States (U.S.) taxes American citizens on their property and income even if derived and held abroad.⁸

Political allegiance is, however, an imperfect connecting factor. Apart from the difficulties associated with the enforcement of any tax liability based on nationality, it often results in the double taxation of the citizen in the absence of adequate relief measures. Moreover, ‘the

⁵ E. Seligman, *Double Taxation and International Fiscal Cooperation* (New York: The Macmillan Company, 1928), at 1-16.

⁶ According to Professor Klaus Vogel, two of the most influential authors on the question of the taxation of foreign income are Adolph Wagner and Georg von Schanz. Thus, Henry Simons, author of *Personal Income Taxation* (The University of Chicago Press, 1938), (Midway Reprints), honours Georg von Schanz for originally developing the ideas that form the basis for his definition of income. See K. Vogel, ‘Worldwide vs. Source Taxation of Income-A Review and Re-evaluation of Arguments’, (Part I) [1988/8-9] *Intertax* 216, at 218-19. (Part II [1988/10] *Intertax* 310, Part III [1988/11] *Intertax* 393.)

⁷ This is the so-called nexus question. Nexus ‘describes the amount and degree of business activity that must be present before a state can tax an entity’s income’; see at <<http://www.waicpa.org/members/div/tax/nexus.htm>>. This question will be explored fully in later chapters. Moreover, authors such as Hobbes, Rousseau, Bentham, Duguit, and Austin, to quote but a few, have explored the philosophical basis for taxation. Two schools of thought have emerged. The first makes a clear distinction between sovereign and subject, between ruler and ruled. It then holds that the sovereign or the state is supreme over all and answerable to none. In this view, the state may tax anything, any person, or any act within the reach of its powers. The second school presents a different notion and character of the state. It is based on the conception that individuals or groups of individuals form a state either from choice or from a ‘social instinct’ or from physical necessity. Pursuant to that theory, man establishes a state for definite purposes such as for protection against external aggression or internal strife or to gain for themselves advantages flowing from the creation of a ‘critical mass’. It follows that the state exists for the satisfaction of human wants and that the right for the state to exist is conditional upon it being able to satisfy these wants. To fund its mission thus stated, the state has a right to tax; see Harding, *supra* note 3, at 35ff.

⁸ See *Cook v Tait* (1924) 265 U.S. 47. For a discussion of citizenship as a criterion of income tax liability, see P. Gann, ‘The Concept of an Independent Treaty Foreign Tax Credit’ (1982/83) 38 *Tax Law Review* 58.

natural instinct of every country' is to ignore the nationality of any foreigner residing within its territory and to tax that person's income when derived from sources within the country.⁹

B The Exchange or Equivalence Theory

Tax jurisdiction may further be explained through the equivalence or exchange theory which is expressed in two forms: the cost theory and the benefit theory. The cost theory rests on the premise that taxes represent the cost of services performed by the government. The benefit theory, for its part, holds that taxes are payable in consideration for the benefits conferred by the government on an individual. Basically, the equivalence theory postulates that a taxpayer should pay taxes equivalent to either the costs that he or she causes to the government of a country, or the benefit that he or she derives through the use of the infrastructure of a country.¹⁰

At the international level the exchange or equivalence theory has some significance in that it mainly supports source countries' fiscal aspirations. Indeed, governments, in a bid to attract foreign investors, often engage in heavy public expenses designed to finance additions or enhancements to the country's infrastructure. These facilities are then used by foreign businesses in the course of carrying out their activities. Arguably, a tax on these activities may be levied by the source country in exchange for the expenses it incurs to facilitate business operations.¹¹

As progressive as it may sound, the exchange or equivalence theory exhibits serious practical weaknesses, especially at the national level. These flaws were addressed by what may be referred to as the 'modern' approach to the question of jurisdiction to tax.

⁹ While retaining citizenship as the basic criterion for taxability, the U.S. makes substantial exceptions and concessions to economic and residential allegiance both for its own citizens and for foreigners. See A.A. Skaar, *Permanent Establishments* (Kluwer Law International, 1991), at 22.

¹⁰ *Id.*, at 24.

¹¹ Transnational companies (TNCs) are increasingly involved in infrastructure development as a result of the privatisation of government facilities following the failure of expropriation and nationalisation policies implemented after World War II. Thus, such schemes as Build-own-operate (BOO), Built-operate-transfer (BOT), or Built-transfer-operate (BTO), or any variants thereon, may be viewed as indirectly satisfying the benefit theory. Indeed, infrastructure investments are risky and the involvement of TNCs shifts the risks involved from governments to those enterprises. The compensation paid to those enterprises in the form of profits from the operation of the facilities is meant to compensate for those risks. In other words, the benefit that TNCs derive is increased by a profit element calculated on market conditions; see United Nations Conference on Trade and Development, *World Investment Report 1996* (New York & Geneva: United Nations, 1996), at 18ff.

2 The Modern Approach

The modern approach is characterised by the increasing intervention of economists and their analytical methods in an area which, until then, had been the precinct of lawyers.¹² At the international level, the trend was inaugurated in the 1920s when the Academic Experts of the League of Nations investigated the question.¹³ They concluded that the ability to pay, or the faculty theory, was superior to the earlier theories as a basis for the international allocation of tax jurisdiction.¹⁴

A. The Principle of Ability to Pay

The underlying idea of the ability to pay (or the faculty theory) is that the possession of ability is of itself a sufficient condition to justify the imposition of tax upon a taxpayer. Ability to pay assumes that if a person can pay, then that person should pay.¹⁵ It is also premised on the principle of equal sacrifice. Indeed, the payment of taxes involves the sacrifice by a taxpayer of the enjoyment of that part of his/her property used to effect payment. A greater sacrifice is required from a person that has greater ability compared to one whose ability is inferior.

Arguably, faculty does not attach to things although many taxes known as real or impersonal taxes, as opposed to personal taxes, are imposed on things or objects. Ultimately, however, as the Academic Experts noted, all taxes are paid by persons. Taxes, therefore, shape the economic status of all individuals including their ability to pay. If persons are ultimately responsible for paying taxes, then the rights and obligations associated with personality acquire substantial importance in the quest for an acceptable justification for exercising tax jurisdiction. The question of personality is closely linked to the idea of personal political allegiance or nationality. However, most countries no longer favour nationality as a basis for taxation.

Residence then emerged as an acceptable connecting factor.¹⁶ Mere temporary residence, however, does not create a sufficiently enduring relationship between a person and a particular

¹² Vogel, *supra* note 6, at 216.

¹³ A sub-committee of the Financial Committee (Doc. E. F. S. 253 fixed the terms of reference of these four experts in March 1922. A. 152) as disclosed in the League of Nations, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp (The Academic Experts)* League of Nations Documents E. F. S. 73. F. 19, (5 April 1923) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions* (Washington D.C.: U.S. Government Printing Office, 1962), 4003, at 4006.

¹⁴ See Vogel, *supra* note 6, who traces the paternity of these concepts to Adolph Wagner and Georg von Schanz.

¹⁵ G.S. Cooper, 'The Benefit Theory of Taxation', (1994) *Australian Tax Forum* (No. 4) 397, at 417.

¹⁶ The emergence of the concept of residence as a fundamental principle of the modern international tax regime may be attributed to a very large extent to Edwin Seligman who was the leading economist among the Academic Experts. A

jurisdiction to justify the taxation of that person on the whole of his or her wealth. A stronger nexus is afforded when a person is domiciled in a particular jurisdiction or has his or her permanent residence therein. Thus, residence came to be defined as the place where wealth or income is habitually or permanently consumed or utilised.¹⁷ In essence, therefore, residence taxation is a doctrine pursuant to which those who habitually reside in a particular place must be required to contribute to the expenses incurred for the upkeep of that place.

While the residence criterion appears to be acceptable it still lacks certain attributes that would facilitate its universal application. Residents as well as non-residents may own property in a particular jurisdiction. To rely on taxes levied on residents alone in order to finance the protection of the whole mass of property located in a particular jurisdiction may not only be insufficient, but it is also clearly inequitable. Indeed, non-residents may own some of that property. If costs incurred to protect that property is recouped from residents exclusively, then non-residents would have derived a benefit without incurring any corresponding cost. Clearly, non-residents must have certain obligations to the place where some of their property is located or where their income is derived. Conversely, the revenue of some of the residents of a particular country may be derived from sources outside their jurisdiction of residence, for example, from businesses conducted abroad. If the jurisdiction of residence were to be exclusively allowed to tax such foreign income, then taxation would be achieved at the expense of the source jurisdiction, a solution unacceptable to capital-importing countries.

In practice, tax authorities rely on both the principle of domicile (henceforth the residence principle), and that of location or origin (henceforth the source principle), to articulate their right to tax. Both the residence and source principles are the expression of a broader principle—that of economic interest or economic allegiance. Therefore, an individual is required to share between each of the competing authorities to which he or she owes economic allegiance the total sum which he or she is required to pay as taxes according to his or her ability, that is, according to the total of his or her economic resources. It is convenient to note that the ability to pay theory also expresses the idea of progressivity in taxation.

Once the question of who pays is resolved, the next issue is the determination of the quantum payable to each competing jurisdiction.

serious rivalry arose between Seligman and Thomas Sewall Adams, the U.S. representative on the Expanded Technical Experts Committee (see *infra* Section II, 1, A) who favoured source-based taxation. See M.J. Graetz & M. O’Hear, ‘The “Original Intent” of U.S. International Taxation’, (1997) 46 *Duke L.J.* 1021, at 1075 n 215.

¹⁷ This must be contrasted with the common law concept of ‘domicile’ which includes the place where a person exercises his or her political rights. It therefore expresses a kind of connection related to both nationality and residence.

B. The Doctrine of Economic Allegiance

The determination of the quantum of tax that an individual is required to pay to each competing jurisdiction is closely linked to ascertaining where the true economic interests of that individual are to be found. In the words of the Academic Experts:

[I]t is only after an analysis of the constituent elements of this economic allegiance that we shall be able to determine where a person ought to be taxed or how the division ought to be made as between the various sovereignties that impose tax.¹⁸

The theory of economic allegiance provides the necessary intellectual basis for both residence and source taxation. What then is economic allegiance? Georg von Schanz first articulated the concept in 1892.¹⁹ To Schanz, a person owes what he calls economic allegiance to a state when that person profits from a state's provisions of services. Economic allegiance to a state can be based on either consumption, or business activities, including investments. A state is entitled to tax a person if that person derives an economic advantage or benefit by utilising the services provided by that state.²⁰ If economic allegiance is based on consumption, then Schanz agrees that residence constitutes a suitable criterion for tax jurisdiction. However, when economic allegiance arises from a business activity carried out by a non-resident, or that non-resident derives income in a state as a result of his or her activities there, then economic allegiance is owed to both states. Consequently, the latter must agree to share the revenue arising from a tax on these activities. The criterion for achieving this is the benefit test. A non-resident does not get the full benefit of a state's activities. It would therefore be unfair, according to Schanz, if the state where the income is derived were to tax a non-resident in the same way as a resident who enjoys the full benefit of a state's stock of public goods. Taxation of non-residents, he argued, should be commensurate with the benefits derived by the latter. Moreover, in Schanz's view, the primary right to tax accrues to the state where income is produced. He therefore grants three-fourths of the revenue to that state. As for the residence state, where presumably the foreign income would be consumed, it is given the residual right to tax, that is, one-fourth of the revenue.²¹

¹⁸ League of Nations (1923), *supra* note 13, at 4024.

¹⁹ G. Schanz, 'Zur Frange der Steuerpflicht', 9 II *Finanzarchiv* 1, 4 (1882), in Vogel, *supra* note 6, at 219 n 23.

²⁰ The most important of those benefits are security, economic stability, infrastructures and direct subsidies. Other state activities, such as the level of public health or education, or even the extent of public satisfaction, benefit the investor indirectly. See Vogel, *supra* note 6, at 313.

²¹ Schanz argues that the benefit test does not ignore the question of progressivity in taxation. Progressivity is related to tax rates whereas the benefit test relates to tax basis. See Vogel, *supra* note 6, at 219.

The Academic Experts reviewed all these questions. They considered a number of issues including the following:

1 Where is wealth produced?

Wealth is produced as a result of a series of economic functions culminating to the point where a product is ready to be acquired for the purposes of accumulation or consumption. These various economic steps may be carried out in different jurisdictions. If a person carries out these different functions in different jurisdictions, then it may be said that he or she owes some economic allegiance to each of these jurisdictions.

2 Where is wealth owned?

The possession of wealth is that intermediary stage between its production and its disposition. Ownership of wealth arises from a range of functions, for example, establishing title to the wealth, preserving it and, if needs be, enforcing the legal rights thus created. Again, a person owes economic allegiance to that jurisdiction which enables him or her to enforce his or her property rights over the wealth in his or her possession.

3. Where is wealth disposed of?

The disposition of wealth occurs at that stage where it has reached its final owner who may use or dispose of it as he or she thinks fit. The law of the land where the final owner resides normally determines his or her action involving his or her wealth. For instance, if he or she decides to invest it, then he or she must abide by the law of where he or she resides. Again, therefore, he or she owes economic allegiance to this particular jurisdiction.

The Academic Experts²² found that four factors ultimately bear some incidence on the sharing of the tax base, namely:

- the principle of production or acquisition corresponding to the place of origin of the wealth;
- the principle of location, that is, the situs of the wealth;
- the principle of legal rights assimilated to the place of enforcement of the rights to the wealth; and
- the principle of consumption or appropriation or disposition of wealth which is the place of residence or domicile of the ultimate owner.

²² League of Nations (1923), *supra* note 13, at 4027.

The most important of these four factors for the determination of international tax competence are, according to the Academic Experts, the origin of wealth and the residence or domicile of the owner who consumes the wealth. Therefore, an equitable sharing of tax jurisdiction requires the apportioning of economic allegiance between origin (source) and domicile (residence). This reasoning is similar to that put forward by Schanz as mentioned earlier. However, the solution recommended by the Academic Experts for sharing tax competence is the opposite of that proposed by Schanz. Instead of a proper sharing of jurisdiction to tax, the proposed solution required that states reciprocally exempt non-residents from income taxation effectively yielding such jurisdiction to the state of residence.²³

Still under the aegis of the League of Nations, a second group of experts, the Technical Experts, were also required to consider these questions. They were administrative practitioners representing various European governments, in general capital-importing countries. Their practical experience most obviously would have required them to recognise the importance that worldwide taxation of income had achieved for some of the most powerful capital-exporting countries. A compromise between the interests of capital exporting and capital importing countries was inevitable. Indeed, the Technical Experts concluded that the most 'reasonable' or 'genuine' connecting factors are concurrently the residence of the taxpayer and the source of the income. Consequently, these were considered as determinative of economic allegiance.

The Technical Experts also held the view that source taxation could not be fully premised on the benefit theory. In their opinion, source taxation finds its justification in the economic connection between the source country and the income arising within its borders.²⁴ Moreover, according to the Technical Experts, residence taxation is also a consequence of the economic allegiance theory. It arises because of the economic contacts, which occur when an individual lives in a particular jurisdiction. The League eventually subscribed to these principles. In general, therefore, until the advent of the globalisation process, which has irremediably changed the environment in which business is carried out, the jurisdictional basis for international taxation premised on residence and source has remained unchallenged.

²³ Vogel, *supra* note 6, at 220. The primacy of residence taxation in the Academic Experts' report is ascribed to Seligman; see Graetz & O'Hear, *supra* note 16, at 1076. As Vogel points out, starting from the same theory of economic allegiance as Schanz, Seligman comes to the opposite conclusion when he advises for an exclusive residence taxation system.

²⁴ It is arguable, however, that the Economic Experts retained a benefit-like component and its corollary: the cost theory. See League of Nations (1923), *supra* note 13, at 4022.

C The Neutrality Theory

Until recently, the system of international taxation put forward by the League of Nations' system was considered as achieving an equitable sharing of the tax base between residence and source countries. In the 1960s, however, the issue of the proper allocation of taxing power resurfaced relative to the question of the influence of residence-state or source-state taxation upon the inter-nation allocation of economic resources.²⁵

Inter-nation equity is a term used by Professor Peggy Musgrave²⁶ to describe the distribution of competence to tax among different countries. The term is not used relative to the amounts of tax paid by individual taxpayers to their respective governments but rather, relative to the distribution of the tax base as between competing jurisdictions. In other words, a distinction is made between inter-individual equity, that is, justice in the national context, and inter-nation equity, that is, justice in the international context.²⁷

The Musgraves²⁸ view the question of inter-nation equity in terms of the equitable allocation of national gain and loss, that is, revenue sharing, between the country of residence and the country of source. In their opinion, real efficiency in capital movements is achieved in the presence of this equitable sharing of the tax pie. Thus defined, the question that arises is

²⁵ Inter-nation equity is related to the question of capital import and capital export neutrality. Nonetheless, it is submitted that inter-nation equity poses the question of why countries should consent to tax in a particular way. It is a search for the optimum achievable system. It thus relates to the jurisdictional question, but at a higher level, given its emphasis on the idea of fairness. See A. Easson, 'Taxing International Income', in R. Krever, ed., *Tax Conversations; A Guide to Key Issues in the Tax Reform Debate* (Kluwer Law International, 1997), at 419ff. Capital import and capital export neutrality are raised in connection to how countries should tax within a prevailing system in order to achieve the most efficient allocation of resources. The concepts therefore do not relate directly to the jurisdiction question discussed in this chapter. See, however, Chapter 2, Section I, 1, B, ii, at 48ff.

²⁶ P. Brewer-Richman (now Musgrave), *Taxation of Foreign Investment Income - An Economic Analysis* (John Hopkins Press, 1963).

²⁷ R.B. Musgrave & P.G. Musgrave, 'Inter-nation Equity', in R.M. Bird & J.G. Head, eds, *Modern Fiscal Issues: Essays in Honour of Carl Shoup* (University of Toronto Press, 1972), at 63. According to Vogel, the term equity cannot be defined, although it connotes the idea of justice and is an attempt to bridge the distance between ethics and the law. See Vogel, *supra* note 6, at 393.

²⁸ *Ibid.* The value of the concept of inter-nation equity has been questioned. The principles underlying revenue sharing as agreed on through bilateral treaty negotiations reflect an overall balance of advantage that exists between contracting parties and is not based on any concept of each party obtaining its fair share of the tax pie. Indeed, it is difficult to measure each country's fair share. Even if that were possible, the system wrought out to achieve apportionment of that fair share would need to be constantly revised in order to adjust each country's position as its share of world trade changes; see M. Gammie, 'The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement', (1994) 49 *Tax Law Review* 615, at 631 n 62. See also H.J. Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices', (1992) 47 *Tax Law Review* 565, at 577, where Professor Ault also maintains that inter-nation equity 'ignores the interaction between the tax system of two countries and their simultaneous roles as residence and source country and, if taken seriously, has obvious implications for the evaluation of treaty policy as it affects integration.'

whether inter-nation equity is achieved under the present principles of international taxation. The basic thrust of the Musgraves' argument is that if a system of benefit taxation had been in place, that is, one where each jurisdiction charges for the services it has rendered, then inter-nation equity 'would be self-implementing'.²⁹ To the Musgraves, however, the fact is that most taxes are not imposed on a benefit basis. It is therefore necessary to find another allocation rule to deal with general non-benefit taxation. The solution proposed is to implement a benefit-based system whereby gains would be allocated among nations commensurate to the cost of public services which each jurisdiction would have provided to the foreign investor.

The Musgraves' theory is premised on the assumption that the country of residence of the investor has a residual interest in all of the latter's income. This right is based inter alia on the idea that the residence country 'owns' the capital and would have been entitled to tax any income it produces (or accretion thereon) had it not been invested abroad. This view is in contrast with that of the Academic Experts who held that the ownership of the income-producing capital is not relevant per se given that their focus is on where that income-producing capital is employed. If the economic allegiance theory were to be imported in the inter-nation equity paradigm, then the residence country's taxation rights would be dependent on the extent of the taxpayer's economic interest in the source country. Indeed, the latter often determines the quantum of tax he or she is required to pay in the jurisdiction where such interests are located. Therefore, as Vogel suggests,³⁰ taxation by the source state always affects the residence state because it reduces income that the taxpayer may dispose of in the residence state. If the source state were to forgo its taxation rights, then the tax base of the residence country would be restored. However, given that the source state had provided the economic opportunities for the income to arise, it would be unreasonable to require it to accept such a sacrifice. The residence state, however, having provided nothing comparable to the source state for the derivation of that income, on equity grounds, it should be rewarded on a residual basis. In other words, the benefit theory remains the only valid legitimation even in the context of the principles of inter-nation equity.³¹

²⁹ Musgrave & Musgrave, *supra* note 27, at 71.

³⁰ Vogel, *supra* note 6 (Part III), at 398.

³¹ For a further analysis of the question involving, inter alia, the rate of source country taxation, see P.A. Harris, *Corporate Shareholder Income Taxation and Allocating Taxing Rights Between Countries* (Amsterdam: IBFD Publication BV, 1996).

D The Integration Theory

This thesis proposes a system of global formulary apportionment for the taxation of TNCs. The question that arises, therefore, is that of the relation of the proposed system to the above theories. It is crucial to understand, though, that global formulary apportionment relates only marginally to the concept of source as generally conceived.³² Global formulary apportionment allocates income to a country where the factors that contribute to the profitability of a business are located. It matters little whether the allocated income is sourced in that country or is foreign-sourced.³³ A positive return on the factors of production in a particular jurisdiction demonstrates that a business has made a profitable use of the benefits provided by the state where these factors are located. Thus, pursuant to the benefit theory, tax liability which is dependent upon an economic relation between the business and the state where it is located³⁴ is fully incurred in the state where the factors are located. In general, such income will have its source in the jurisdiction where the factors are situated. However, global formulary apportionment also allocates to the country where the factors are present income that may be considered as foreign-sourced. As such, it may be argued that the system ignores the accepted jurisdictional threshold rules of a link, a nexus, or connection between the income and the taxing jurisdiction.

It is submitted, however, that the required connection between that income and the taxing jurisdiction prevails. Only factors of production produce income as a result of certain economic activities, as will be examined in more detail in Chapter 5 of this thesis. For the moment, what needs to be noted is that when the total income of a TNC is allocated to various factors, and if in the aggregate that income turns out to be higher than what would have been allocated through the traditional separate accounting/arm's length standard, then the excess of income thus allocated is still income produced by such factors. This additional income, known as synergy gains or unallocated profits,³⁵ arises as a result of factors of production being efficiently integrated in a worldwide income-producing system and located at a specific place. Under the current system those synergy gains escape allocation and,

³² See R.D. Pomp, 'Issues in the Design of Formulary Apportionment in the Context of NAFTA', (1994) 49 *Tax Law Review* 795, at 801. There is some confusion as to what the concept of source really means. This question will be studied in more detail in later chapters, but see Vogel, *supra* note 6, at 233ff.

³³ See M.J. McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance', (1994) 49 *Tax Law Review* 769, at 776.

³⁴ See Schanz as studied in Vogel, *supra* note 6, at 219.

³⁵ See M.J. McIntyre, *The International Income Tax Rules of The United States*, (Massachusetts: Butterworths, 1989), at 5-34 § 5/D1b.

therefore, taxation. In other words, formulary apportionment manages to allocate the true amount of income produced by factors located at a particular situs regardless as to where that income is sourced.

The question of how synergy gains can be related to the factors of production located in a particular jurisdiction needs further analysis. In this regard, the integration theory of taxation expounded by Harding in the context of American states' taxation provides the necessary connecting link with the taxing jurisdiction. Pursuant to the integration theory of taxation, a state may tax all the factors of production which have become identified with the economic structure of the state. Therefore:

[A]s a matter of jurisdiction, it would seem to follow that every such place of integration may claim the right to tax the income which has been made possible through the economic activity within its borders.³⁶

In Harding's mind, the state in which the property yielding the income is located 'in the direct manner has jurisdiction to tax the whole of such income'.³⁷ It follows that a state's right to tax is not restricted to income that is sourced within that state but extends to any gains that may be imputed to the factors of production located within it regardless as to whether that income is sourced outside its jurisdiction. The whole of such income must necessarily comprise the synergy gains that are not accounted for under the traditional separate accounting/arm's length standard.

Section II The League's First Compromise: The Allocation of Taxing Rights

As early as the 1920s, international business strongly objected to double taxation which arose with the steady expansion of business taxation worldwide. It campaigned through the newly founded International Chamber of Commerce (ICC) for its elimination.³⁸ In 1920 the ICC held an international financial conference which recommended that the League of Nations coordinate the efforts to find a solution to the problem.³⁹ The League agreed to do so and

³⁶ See Harding, *supra* note 3, at 42.

³⁷ *Supra* note 3, at 159.

³⁸ Picciotto, *supra* note 2, at 15. Until 1925, the ICC effectively exercised primary leadership in the movement against international double taxation. However, because of dissension among its members, it relinquished that role to the League of Nations and endorsed the League's work without any innovative input in the debate. See Graetz & O'Hear, *supra* note 16, at 1073-74.

³⁹ Seligman, *supra* note 5, at 115.

entrusted that task to its Financial Committee. As already mentioned, four economists (the Academic Experts) were appointed to study the theoretical aspects of double taxation and to come up with a solution.⁴⁰ In March 1923 the Academic Experts reported to the Financial Committee.⁴¹

1 The Birth of Modern Double Taxation Agreements

One of the fundamental questions in international taxation is the allocation of taxing jurisdiction between competing countries. A country's right to tax is theoretically unlimited. However, this right is constrained by the country's ability to enforce it. Enforcement of tax liability is facilitated when the potential taxpayer, or property to be taxed, is closely linked to the jurisdiction seeking to tax. It is generally agreed that the term 'residence' is used to describe a *person's* closest economic connection with a country. The closest direct economic connection of *income* is, in normal circumstances, the country where it originates, that is, the source country.⁴² Since a person may reside in one country and derive income in another, there arises a conflict of interest between the residence and the source countries. Thus, the interaction of both countries' right to tax may lead to double taxation.

In order 'to avoid or solve the problem of double taxation',⁴³ the Academic Experts were required to deal with two fundamental questions. First, there was the problem of allocating taxing rights between different states, and second, the apportionment of cross-border business income had to be satisfactorily achieved. To resolve these questions on a sound basis, the Academic Experts explored the theoretical rationale underlying countries' jurisdiction to tax.

A The Search for a Solution

The Academic Experts were unable to propose one general principle applicable to international taxation. However, 'three great principles...shaped the [Academic Experts'] 1923 Report':⁴⁴

⁴⁰ League of Nations (1923), *supra* note 13, at 4003.

⁴¹ *Supra* note 13, at 4003-55.

⁴² See V. Krishna, 'International Income Taxation of Electronic Commerce', (January 1999) 9 *Canadian Current Tax* (No. 4) 33, at 35.

⁴³ League of Nations (1923), *supra* note 13, at 4022.

⁴⁴ See Graetz & O'Hear, *supra* note 16, at 1076.

- The classification and assignment of specific categories of income to source or residence should be determined by an objective test based on ‘economic allegiance’. The purpose of the test is to weigh the various contributions made by different states to the production and enjoyment of income;
- Existing tax practices across the globe tended to underestimate the contribution of residence and to reflect the misguided belief in the naturalness and rightness of source-based taxation; and
- Progressive taxes on global income were fundamentally different from other taxes and ought to be the unique province of residence-based taxation.

The report identified four possible methods of reconciling the different conflicting approaches to the taxation of international income. These methods were all premised on the existence of an unequivocal distinction between taxes on global income and all other taxes. Thus, the state of residence would have the primary right to impose global taxes on the income of its residents while all other taxes were to be shared between the country of residence and the country of source. In addition, the Academic Experts held that returns on investments, such as interests and dividends, should be taxed in the country of residence of the recipient.

Prior to obtaining the Academic Experts’ report, the League of Nations set up a second committee of experts, the Technical Experts, who reported to the Financial Committee in February 1925.⁴⁵ The Technical Experts, concurring with the Academic Experts, found that it was impossible to propose a single system of international taxation that would be equitable and that would prevent double taxation.⁴⁶ Contrary to the Academic Experts, the Technical Experts were not much concerned by theoretical niceties: ‘[T]he division we have established...has been made for purely practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact.’⁴⁷ Instead, following the classification of existing taxes into *impôts réel* or schedular taxes, imposed on things or objects, and *impôts personnel* or general or personal taxes on income, they suggested that

⁴⁵ See League of Nations, *Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations* League of Nations Document, C 115. M 55 1925 (F. 212), (7 February 1925), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13, at 4057ff.

⁴⁶ *Supra* note 13, at 4074.

⁴⁷ *Supra* note 13, at 4075.

the first category of taxes be applied by the state where the source of income is situated, while the state of residence be given preference to levy the second category of taxes.⁴⁸

In 1925, the Financial Committee appointed an expanded committee composed of 12 members, and later 13, when a U.S. expert, Thomas Sewall Adams, was appointed to the Expanded Committee of Technical Experts with observer status, given that the U.S. was not a member of the League. The Expanded Committee of Technical Experts was required to consider the possibility of drawing up preliminary draft conventions on the basis of the February 1925 Resolutions adopted by the Technical Experts.

In June 1927 the Expanded Committee of Technical Experts issued its report together with a draft model convention which was transmitted to all member nations for comments.⁴⁹ By August 1928 the League had received a certain number of observations.⁵⁰ A General Meeting of Government Experts was then convened in Geneva in October 1928 for the purposes of discussing the report and designing an international model.

B. The Contents of the Earlier Models

The General Meeting hosted by the League in October 1928 was attended by government experts from 27 countries. It endorsed the principles adopted by the Financial Committee following the report of the Technical Experts submitted in 1927. These were enshrined in three separate draft models:

- Draft Ia, the original draft drawn up by the Technical Experts, was geared towards countries such as France, Italy and Belgium.
- Drafts Ib and Ic sought to accommodate different tax systems in more specific ways.

⁴⁸ In this regard it is interesting to note that the Academic Experts followed the principles found in existing double tax treaty practice and in particular the Czechoslovakia/Italy Double Tax Treaty of 1 March 1924. The Italian negotiation team was comprised of the Italian Director of Taxes who was also involved with the work of the League of Nations. Presumably, there would have been, in this instance, a degree of mutual influence. See Harris, *supra* note 31, at 299, 302.

⁴⁹ League of Nations, *Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion* League of Nations Document, C. 216. M. 85. (1927), chap. II, in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13, at 411ff.

⁵⁰ See *Summary of the Observations Received by August 30th, 1928, From the Governments on the Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Document, C. 495. M. 147. (1928) chap. II, in S. Langbein, 'The Unitary Method and the Myth of Arm's Length', (17 February 1986) 30 *Tax Notes* 625.

In general, however, the three drafts ‘were essentially similar in form and in the concepts employed but differed in the methods used to give double tax relief.’⁵¹ They may be considered as an attempt at reconciling different tax systems. Indeed, the drafts refined the distinction between personal and impersonal taxes.⁵² Personal taxes were defined as ‘taxes imposed on persons as such or on persons in relation to wealth.’⁵³ Income tax was classified as a form of personal tax. Impersonal taxes, the earliest form of taxation, were considered to be the ordinary indirect taxes levied on commodities and transactions.

The solution proposed by the Committee of Technical Experts, based on the distinction between personal and impersonal taxes, was not acceptable to the U.S. whose aim was to protect its ability to tax non-residents on U.S.-sourced income.⁵⁴ The British too were not satisfied with the distinction, as they sought to restrict as far as possible the source country’s right to tax foreign-owned business. A compromise was eventually reached. It conceded to the source state, pursuant to the benefit theory, the right to tax business profits derived through a PE. The state of residence, in line with the ability to pay concept, was allowed to tax the returns on investments. Source, in this context, applies to income arising within the geographic borders of the country levying the tax, whereas residence taxation applies to the income of a resident of the country imposing the tax.⁵⁵

To prevent double taxation, the residence country was required to yield tax jurisdiction to the source country, either unilaterally by virtue of a provision in its domestic tax laws, or bilaterally through a tax treaty.⁵⁶

⁵¹ See D.R. Davies, *Principles of International Double Taxation Relief* (London: Sweet & Maxwell, 1985), at 34 para. 3.9. For the Models, see League of Nations, *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, (League of Nations Document C. 562. M. 178. 1928 II, (October 1928) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*, see *supra* note 13, at 4155ff.

⁵² Seligman, *supra* note 5, at 69.

⁵³ *Supra* note 5, at 59.

⁵⁴ M.B. Carroll, ‘International Tax Law. Benefit for American Investors and Enterprises Abroad’, (1965) 2 *The International Lawyer* 692.

⁵⁵ N.H. Kaufman, ‘Fairness and the Taxation of International Income’, (1998) 29 *Law and Policy in International Business* 145, at 146-47.

⁵⁶ Typically, the system that has evolved consists of the residence country exempting residents from taxation on their foreign source income, or at least on certain types of foreign source income—the exemption system; or it may grant residents a tax credit applied against domestic taxes imposed on foreign source income for the amount of foreign taxes paid—the credit system. See R.A. Green, ‘The Future of Source-Based Taxation of the Income of Multinational Enterprises’, (1993) 79 *Cornell Law Review* 18, at 23.

With regard to business taxation, a general definition of the permanent establishment (PE) concept was achieved. It institutionalised the trade-off between residence and source-based taxation. The PE concept is founded on the dual idea that a country may tax business income if an enterprise trades *in* (or *within*) rather than *with* a country and to the extent that such profits are attributable to the PE. To trade in a country, an enterprise needs to be present therein. The PE concept, as wrought out by the League, determines the depth of this presence. Basically, a sufficient economic presence is required to allow a foreign enterprise to be taxable under a country's domestic law. Sufficiency of presence at a specific geographical point is measured by the degree of stability achieved by that enterprise. If the latter trades from an established place with a certain degree of durability, then that enterprise has a PE within that country. Permanence, therefore, connotes the idea of stability, that is, one that is not temporary or tentative.

The PE concept was to become the cornerstone in the compromise over jurisdiction to tax.⁵⁷ It established a separation between the taxation of business profits, which could be attributed to a PE considered as 'impersonal' income and taxed at source, and the taxation of investment profits, which could be treated as 'personal' income and taxed in the country of residence of the investor. The concept was further refined by the introduction of provisions defining the necessary threshold for the existence of a PE. It was thus agreed that a PE is constituted when business is transacted at a fixed place for a certain period of time, or when a foreign enterprise grants an agent authority to enter into business dealings on its behalf.⁵⁸

2 The Post-War Models

In 1939, the Fiscal Committee, at its ninth session, suggested a revision of the 1928 models to incorporate the work done by the committee in the 1930s. However, the advent of the Second World War disturbed these plans. Nonetheless, its officials pursued the work of the

⁵⁷ M.B. Carroll, 'Allocation of Business Income: The Draft Convention of The League of Nations', (1934) 34 *Columbia L.R.* 473, at 477.

⁵⁸ A recent Canadian case (*Dudney v. The Queen* 99 DTC 147) considers the question as to whether the length of time alone is decisive in determining whether there is a permanent establishment within the meaning of Article 5 of the OECD Model Convention on Income and Capital (1992 update) or a fixed base within the meaning of Article 14. The Federal Court of Appeal 'concluded that the length of time, alone, is not decisive.' See N. Boidman, 'Does Time Alone Create a Permanent Establishment? The Courts and Revenue Canada Go Their Separate Ways', (July 2000) 54 *Bulletin For International Fiscal Documentation* (No. 7) 339. See also F. Vincent, 'Canadian Courts Tackle International Issues In Recent Decisions', (6 March 2000) 20 *Tax Notes Int'l* (No. 10) 1050. (Note: The OECD has recommended the elimination of Article 14, dealing with independent service income on the basis that the notion is covered by Article 7.) See K. Vogel, 'Tax Treaty News', (January 2000) 54 *Bulletin for International Fiscal Documentation* (No. 3) 98.

League's Fiscal Committee during World War II from The Institute of Advanced Studies at Princeton University in the United States.⁵⁹

A The Final Contribution of the League and the Advent of the OECD Models

During World War II, the League's Fiscal Committee organised the Mexico Regional Tax Conferences. These meetings considered the League's draft conventions as well as the existing bilateral treaties signed mainly by the continental European states.⁶⁰ The aim was to consolidate all useful provisions into an acceptable model.

i The Mexico and London Draft Models

The Mexico meetings culminated in the consolidation of the 1928 and 1935 conventions into a single draft *Model Bilateral Convention for the Prevention of the Double Taxation of Income*, which came to be known as the Mexico Model of 1943. Article IV(1) of the Mexico Model expanded the notion of the permanent establishment.⁶¹ It provides that if an enterprise had engaged in business activities in a foreign country and if these activities could not be considered as isolated or occasional transactions, then that enterprise was liable to tax on the profits derived from these activities. By broadening the PE definition, the Mexico Model explicitly favoured the primacy of the right to tax business income at source.

After the Second World War the Fiscal Committee reconsidered the whole matter at its meeting in London in 1946. A new draft was published, the London Model, which included provisions concerning property and wealth taxation but which also amended some important aspects of the Mexico Model. It reasserted the principles developed in the League's pre-war models, in particular the limitation of taxation at source of income produced by a PE. The Fiscal Committee then published both the Mexico and London Models together with a commentary.⁶²

The aim of the Fiscal Committee at the end of the war was to continue its work in the taxation area under the auspices of the United Nations. One of its main objectives was the

⁵⁹ See M.B. Carroll, 'IFA's Growth With International Tax Law', (1971) 5 *International Lawyer* 558, at 561.

⁶⁰ The Mexico meetings were dominated by the capital-importing countries of Latin America and by Canada, the latter arguing for the strengthening of the source rules when it concluded its treaty with the U.S. in 1942.

⁶¹ League of Nations, *London and Mexico Model Tax Conventions, Commentary and Texts*, League of Nations Document C. 88. M. 88. 1946. II. A., (November 1946), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions* (Washington D.C.: U.S. Government Printing Office, 1962), at 4333.

⁶² *Id.*, at 4321ff.

reconciliation of the Mexico and London Models. In 1946–47 the UN’s Economic and Social Council established a Financial and Fiscal Commission composed of 15 experts chosen by member states which was to deal inter alia with international tax matters. However, the presence of the Soviet bloc, dissension between continental Europe and the Anglo-Saxon countries, and the emergence of new states through decolonisation, all meant that it was extremely difficult to arrive at any meaningful agreement.⁶³ In addition, by that time, the International Monetary Fund and the International Bank for Reconstruction and Development had become more prominent with regard to international financial issues. Since consensus on the main principles of international taxation seemed to be unattainable, the UN’s Fiscal Commission ceased to meet in 1954.

ii *The OECD Models*

The political and economic situation during the Cold War prevented to a large extent any dialogue on a truly worldwide basis. However, the League’s Fiscal Committee’s work was pursued by the Organisation for European Economic Cooperation (OEEC), an organisation which had been set by the Western democracies to deal with economic matters and which later became the Organisation for Economic Co-operation and Development (OECD).⁶⁴

In March 1956, the OEEC set up a Fiscal Committee with instruction to draft a convention for the avoidance of double imposition of taxes on income and capital. Working from the London Model,⁶⁵ the Fiscal Committee of the OEEC published between 1958 and 1960 three interim reports. In the third report, submitted to the Council in 1960,⁶⁶ the Fiscal Committee dealt with the principles of profit allocation to PEs and associated enterprises. Basically, Articles XV and XVI of the OEEC proposed draft convention reproduced the relevant provisions of the Mexico and London Models.⁶⁷

On 30 September 1961, the OECD superseded the OEEC and its Fiscal Committee pursued the task of drafting the model already undertaken by the OEEC. Finally, in 1963 the Fiscal

⁶³ Picciotto, *supra* note 2, at 52.

⁶⁴ *Supra* note 2, at 52.

⁶⁵ M.B. Carroll, ‘The Historical Development of Tax Treaties’, in J.E. Bischel, ed., *Income Tax Treaties* (New York: Practising Law Institute, 1978), at 59.

⁶⁶ OEEC, Third Report of the Fiscal Committee of the OEEC, *The Elimination of Double Taxation*, (1960), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions* (Washington D.C.: U.S. Government Printing Office, 1962), at 4565ff.

⁶⁷ *Id.*, at 4581 para. 18.

Committee completed a report containing a draft double taxation convention.⁶⁸ On 30 July 1963, the Council of the OECD adopted a Recommendation concerning the avoidance of double taxation which urged all members to conform to that draft convention when concluding or revising existing bilateral conventions between them.⁶⁹

From the outset the Fiscal Committee, which had in the meantime been changed into the Committee on Fiscal Affairs, recognised the necessity of periodic revision of the draft. The first revision of the 1963 Draft Model was finalised in 1977. A further revision was initiated which led to the publication in 1992 of the Model Convention in loose leaf format to facilitate future revisions. Thus, revisions of the Model have been carried out in 1994, 1997, 1998 and 2000, with further regular revisions anticipated.⁷⁰

B The United Nations Model Convention

The bilateral tax conventions that were negotiated in the 1960s involved primarily developed countries. Only a relatively small number of such treaties had been concluded between developed countries and Less Developed Countries (LDCs). An explanation for the paucity of such treaties was that 'the traditional tax conventions have not commended themselves to developing countries.'⁷¹

The desire to cater for the needs of LDCs was recognised and the Economic and Social Council of the United Nations in its Resolution 1273 (XLIII) adopted on 4 August 1967 requested that the Secretary-General of the United Nations (U.N.) to find ways for facilitating the conclusion of tax treaties between developed and developing countries.⁷²

⁶⁸ OECD, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963).

⁶⁹ OECD, Committee on Fiscal Affairs *Model Tax Convention on Income and Capital* (Paris: OECD, 1992), loose leaf (1997 update), at 1-2. (Note: A 2000 update is now available.)

⁷⁰ *Ibid.*

⁷¹ OECD, *Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee* (Paris: OECD, 1965), at 57 para. 164.

⁷² United Nations, Department of International Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (United Nations publication ST/ESA/102, 1980) 2. See also United Nations, *Tax Treaties Between Developed and Developing Countries, Eight Report* (United Nations publications, Sales No. E 80 XVI). Pursuant to that resolution, in 1968, the Secretary-General set up the ad hoc group of experts between developed and developing countries. The ad hoc group of experts was composed of tax officials and experts from Argentina, Chile, France, the Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom, and the USA. Tax officials and experts were appointed in their personal capacity rather than acting as representative of their particular country. In 1972 an expert from Sri Lanka and in 1973 one from Brazil joined the group at the request of the Economic and Social Council. In addition, there were observers from Austria, Belgium, Finland, the Republic of Korea, Mexico, Nigeria, Spain, Swaziland, and Venezuela. The following international organisations were also

The U.N. Model Convention is widely considered to have achieved a compromise between the source and the residence principles.⁷³ By broadening the definition of a PE the U.N. Model certainly gives more weight to the source principle than does the OECD Model. The fact is, however, that the UN Model did not adopt any new approach to tax treaties. No attempt was made to challenge the basic tenets of the OECD Model. There were numerous cases where the experts from the First and Third World failed to reach any agreement. Thus, although the Model is regarded as favouring taxation at source, this preference is not expressed in any general principle comparable to Article IV(1) of the Mexico Model.

Section III The League's Second Compromise: The Apportionment of Business Profits

Once the problem of allocating primary taxing rights was resolved, the League was required to develop an acceptable method for the proper allocation of business profits accruing to an enterprise operating in two or more jurisdictions.⁷⁴ The Academic Experts and the Technical Experts, as well as the 1928 General Meeting of the League of Nations, did not specifically address the problem of apportionment of income and expenses of enterprises operating globally. It would appear, however, that the experts were inclined to favour some sort of formulary apportionment to achieve this apportionment objective.⁷⁵

represented at the workings of the group of experts: the International Monetary Fund, the International Fiscal Association, the Organisation for Economic Co-operation and Development, the Organisation of American States and the International Chamber of Commerce. The Fiscal and Financial Branch of the Department of International Economic and Social Affairs of the United Nations Secretariat undertook the task of preparing a draft model convention. The draft model (ST/SG/AC.8/L.29) used the 1977 OECD Model Double Taxation Convention as its main reference text. However, the group of experts made it clear that it did not postulate the correctness of the Convention nor were its decisions governed by the OECD text. The group of experts reviewed the draft model and adopted the final text of the Convention as well as the commentary at its eighth meeting held in Geneva in December 1979.

⁷³ United Nations, Department of International Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (United Nations publication ST/ESA/102, 1980), at 5.

⁷⁴ Indeed, T.S. Adams, the U.S. representative on the Expanded Technical Experts Committee was of the view that the apportionment of business income was 'the most important technical problem in this field'. See Graetz & O'Hear, *supra* note 16, at 1075 n 217.

⁷⁵ The Academic Experts included an addendum on apportionment which while failing to make any recommendation nevertheless advised that research be directed towards the experience of the American states on the problem. In fact, Graetz and O'Hear suggest that the U.S. representative on the Expanded Technical Experts Committee, T.S. Adams 'would have been sympathetic to a formulary system such as the one he developed in Wisconsin, as he seems to suggest in an essay written shortly before his death'; see T.S. Adams, 'Interstate and International Double Taxation', in *Lectures on Taxation* 101, at 102 (Roswell Magill, ed., 1932). Moreover, the U.S. *Revenue Act of 1921* drafted by Adams called for the Commissioner of Internal Revenue to develop 'formulas of general apportionment' to allocate income from sources partly within and partly without the United States, such as income arising from the manufacture

Thus Langbein notes that:

the community of experts designing the models appeared to be going in the direction of adopting some form of formula apportionment rules for allocating business profits. Thus the reference to separate accounting in the original draft of the model was dropped in the final version. The pre-existing conventions, notably that among the Central European powers, included an allocation provision that called for formula apportionment, that convention had been a principal source of precedent for the entire effort made in the 1920s. And the commentary to the 1928 models suggested formula⁷⁶ or empirical methods were to predominate in making allocations under the model provisions.

What then caused the abandonment of the prevailing attitude regarding the apportionment of income derived by enterprises operating globally? It will be recalled that the original draft convention of the Expanded Committee of Technical Experts introduced the concept of the PE which, over the years, became the primary nexus triggering a country's right to tax business income derived within its borders. PEs were defined as the 'real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots.'⁷⁷ The draft convention then provided that if an undertaking had a PE in two contracting states, each state would be entitled to tax the portion of income produced in its territory. In order to determine the profits thus produced within a territory, the authorities were to rely on the financial statements of the establishment. Moreover, in 'the absence of accounts showing this income in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment.'⁷⁸

The models approved by the General Meeting substantially altered the business operations that would have constituted a PE under the 1927 Draft Convention. Thus, 'affiliated companies' were not included in the list of operations that would constitute a PE. In addition, instead of referring to the use of a taxpayer's separate accounts for the allocation of profits, the approved draft simply suggested that the relevant administrations should 'come to an arrangement as to the basis for apportionment'.⁷⁹

These amendments left many questions unresolved. In view of the uncertainty in the area, the General Meeting recommended that the matter be further studied. The League's Council then appointed a Fiscal Committee to which was given the task of studying inter alia the allocation

of goods in one country and sale in another.' See *Revenue Act of 1921*, chap. 136, § 217(e), 42 Stat. 227, 244-45, in Graetz & O'Hear, *supra* note 16, at 1089 n 275.

⁷⁶ Langbein, *supra* note 50, at 632.

⁷⁷ League of Nations (1927), *supra* note 49, at 4125.

⁷⁸ League of Nations (1927), *supra* note 49, at 4112.

⁷⁹ League of Nations (1927), *supra* note 49, Article 5 at 4162, and Commentary on Article 5 at 4166.

problem.⁸⁰ At the Fiscal Committee's first meeting held in October 1929 it was resolved 'that, in order to do any useful work, it would be essential to have a detailed knowledge of the practice of various countries.'⁸¹ The study of the practices regarding the allocation question that began in 1930 was entrusted to Mitchell B Carroll, an American lawyer who had been involved with the earlier works of the Expanded Committee of Technical Experts.

1 The *Carroll Report*

If the experts of the League were more or less in favour of some form of formulary apportionment as a solution to the allocation of multijurisdictional income then, as Langbein argues, the *Carroll Report* 'represents a turning point in the development of the allocation rules for model conventions'.⁸²

A Carroll's Methodology

Mitchell Carroll never underestimated the difficulties relating to the allocation problem:

[T]he subject of allocation may be described as being at the cross-roads of all sciences. It involves not only the fiscal sovereignty of States, and civil, commercial and sometimes penal law, but also commercial geography, economics, business management, and last, but not least—accounting.⁸³

He then proceeded to analyse on a comparative basis the apportionment question. His method of analysis proceeded along the lines as set out below.

i The Search for any Existing Legislation

Carroll found virtually no legislation in most countries on the apportionment question. Most countries taxed the profits attributable to a branch operating in their jurisdiction according to

⁸⁰ The Fiscal Committee was a permanent committee of the League of Nations composed of ten regular members, nationals of Belgium, Bolivia, France, Great Britain, Greece, Holland, Italy, Spain, Switzerland and the United States, and 36 corresponding members, nationals of South Africa, Albania, Australia, Austria, Brazil, Bulgaria, Canada, Colombia, Cuba, Czechoslovakia, Danzig, Denmark, Ecuador, Egypt, Estonia, Finland, Hungary, Iceland, Irish Free State, Japan, Latvia, Luxembourg, Mexico, New Zealand, Norway, Paraguay, Persia, Poland, Portugal, Romania, San Salvador, Sweden, Turkey, Uruguay, Venezuela and Yugoslavia. In most instances the member or corresponding member is the principal official in the tax administration of his country. Each serves on the committee, however, in his/her private capacity as expert. See Carroll (1934), *supra* note 57, at 473 n 1.

⁸¹ League of Nations, *Report to the Council on the Work of the Second Session of The Committee League of Nations* Document No. C. 516. M. 175. II. (31 May 1930), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13 at 4199.

⁸² Langbein, *supra* note 50, at 631.

⁸³ M.B. Carroll, *Taxation of Foreign and National Enterprises (Volume IV)—Methods of Allocating Taxable Income, (Carroll Report)*, League of Nations Document No. C. 425. M. 217(b). IIA. (30 September 1933), at 13 para. 9.

purely administrative practices. The only legislation on apportionment he found were the formulary apportionment systems in existence in Spain, Austria, Wisconsin, New York, and Massachusetts.

ii The Methods of Allocation

Carroll found that most tax authorities were inclined to use a combination of three methods of allocating business profits of a multijurisdictional enterprise to its local PE.⁸⁴

a. Separate Accounting

The most common method used for the determination of a branch's income was the separate accounting method which 'means taking the declaration of income, supported by accounts of the local branch, as a basis of assessment.'⁸⁵ Therefore, it was important for the financial statements submitted to be accurate. In order to establish that these documents were indeed a true reflection of the business dealings, the tax authorities were required to compare them with those of a similar but independent enterprise. In essence, the method entailed that if the price charged for one transaction is comparable to that charged in a second transaction, then the price charged in the first transaction between two unrelated parties is to be used as a benchmark for the determination of the price that should be charged in the second transaction among related parties. This method of determining the correct transfer price between related enterprises came to be known as the 'arm's length standard'.⁸⁶

b. Empirical Methods

When it was impossible to establish separate accounts, Carroll found that most systems would rely on empirical methods to determine the income of a PE. At the base of the empirical methods is the assumption that a local establishment would approximately make the same percentage profit as the other establishments of the enterprise to which it belongs, or as other enterprises engaged in a similar type of business.⁸⁷ Empirical methods therefore involved an attempt by authorities 'to estimate an income by comparing the given enterprise with similar enterprises, or taking into account turnover, assets or other readily ascertainable factors.'⁸⁸

⁸⁴ *Id.*, at 45 para. 120.

⁸⁵ *Id.*, at 45 para. 120.

⁸⁶ S. Surrey, 'Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions', (1978) 10 *Law and Policy in International Business* 409, at 414.

⁸⁷ *Carroll Report*, *supra* note 83, at 45 para. 121.

⁸⁸ *Supra* note 83 at 45 para. 121.

c. Fractional Apportionment

In a certain number of countries Carroll found that fractional apportionment was either ‘the primary or the only basis of allocation’. Fractional apportionment is defined in the report as the ‘determination of the income of one establishment of an enterprise by dividing total net income in the ratio of certain factors, for example, assets, turnover, payroll, or a fixed percentage.’⁸⁹ This system prevailed, for example, in Spain where it was claimed that separate accounting had to be abandoned because a certain number of branches of foreign companies operating there showed little or no profits.

Several other countries used fractional apportionment as the primary method of apportionment. France was another country where tax on income from securities was computed in proportion to assets represented by the local branch. Fractional apportionment was also used in the U.S., more specifically, in Wisconsin, New York and Massachusetts. Well-developed formulary systems prevailed by statute in Switzerland, and Austria, and by international agreement in Austria, Hungary and Czechoslovakia.

The critical point to note is that Carroll found no widespread use of separate accounting based on legislative provisions to determine a branch’s taxable income. Rather, he documented the use of the method as an administrative practice. Yet, he concluded that a ‘predilection for the method of separate accounting is evinced by the great majority of countries.’⁹⁰

B The Identification of the Transfer Pricing Problem

Mitchell Carroll’s objective was to ‘formulate a system of allocating or apportioning the income of business enterprises which would be fair, logical and suitable for all types of businesses.’⁹¹ It is indisputable that Carroll was among the first persons to clearly identify the problem of transfer pricing as one of the key issues of international taxation.⁹² Having acknowledged the problem, Carroll set himself to finding a solution to it.

⁸⁹ *Supra* note 83, at 46 para. 122.

⁹⁰ *Supra* note 83, at 88 para. 293.

⁹¹ League of Nations, *Report to the Council on the Fourth Session of the Committee*, League of Nations Document No. C. 399. M. 204. IIA. (26 June 1933), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13, at 4241.

⁹² However, Carroll’s senior at the League of Nations conferences, T.S. Adams, was well aware of the transfer-pricing problem since he described it during hearings on the U.S. 1921 Revenue Act. See *Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H. R. 8245, 67*, reprinted in *95A Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents* (Bernard D. Reams, Jr., ed., 1979) in Graetz & O’Hear, see *supra* note 16, at n 39.

2 The Articulation of the Arm's Length Principle

In Carroll's mind, to deal with the apportionment problem meant to solve the 'diversion of income' problem. He believed that any corrective measures had to substitute market for manipulated prices. He came to firmly believe that the only plausible method for the apportionment of business income that would prevent manipulation between the various PEs of a TNC or subsidiaries in a group of companies was the 'separate accounting' method.

A The Emergence of the Arm's Length Principle

According to Carroll, separate accounting was 'the primary method of allocating income to the various countries in which an enterprise has permanent establishments [which] is preferred by the great majority of governments, and business enterprises represented in the International Chamber of Commerce, as well as other authoritative groups.'⁹³ However, in spite of his preference for the separate accounting standard, it would appear that Carroll could not make up his mind as to the most appropriate method to apply the standard to factual situations. Thus, in one instance he held that it was 'undesirable to endeavour to prescribe detailed rules of separate accounting'⁹⁴ and in another he suggested that a treaty embodying the principle should incorporate 'definite and precise rules for application'⁹⁵ in order to solve the problems that would arise if two jurisdictions claim the right to tax the profits of one enterprise.

Notwithstanding these hesitations, Carroll identified two distinct criteria for allocating profits to a branch. These were the 'remuneration for services' and the 'sales between independents' criterions.⁹⁶ Under the remuneration for services criterion, a branch is allocated profits that are strictly imputable to the services that the branch has performed. The sales between independents criterion was construed as a three-steps process. It involved:

- a fictional transfer of title to the goods;
- the allotment of sufficient capital to the branch for it to carry out its operations; and
- the apportionment of losses or risk of losses that would be carried by similar independent enterprises.

⁹³ *Carroll Report, supra* note 83, at 189 para. 671.

⁹⁴ *Supra* note 83, at 190 para. 672.

⁹⁵ *Supra* note 83, at 191 para. 675.

⁹⁶ *Supra* note 83, at 202 para. 713.

Carroll was in favour of the adoption of the remuneration for services criterion. He argued against the ‘sales between independents’ criterion. One of his objections is that the criterion would involve ‘checking prices...[against] independent dealers in other countries and allowing for deviations due to the condition of the branch.’⁹⁷ He recommended the remuneration for services criterion because of its administrative simplicity and fairness:

[I]f we recognize the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would have been paid to an independent enterprise rendering such services.⁹⁸

B The Arm’s Length Principle in the 1935 Allocation Convention

At its fourth meeting in May–June 1933, the Fiscal Committee approved the *Carroll Report*. That report was then used as a basis for a draft convention on the allocation question that was also published in 1933.⁹⁹ The Fiscal Committee further recommended that the *Carroll Report* be used as a guide for the interpretation of that draft convention. The latter was then sent through the Council to all member states for comment.

As a result of this process, the Fiscal Committee decided to rewrite the text as a model for bilateral treaties. The draft convention resulting from Carroll’s work was published in 1935.¹⁰⁰ But it was never approved by any formal inter-governmental conference nor used on its own as a basis for bilateral treaties.¹⁰¹ However, its provisions were later incorporated in bilateral treaties that were entered into by several countries, and eventually in the model conventions that succeeded the 1928 models. Although the 1935 Draft Convention never became a ‘model’ convention, it is the only document approaching an international model, together with the London and Mexico Models, where the expression ‘arm’s length’ is actually used.¹⁰²

⁹⁷ *Supra* note 83, at 196 para. 690.

⁹⁸ *Supra* note 83, at 192 para. 677. Again, Carroll was merely reproducing T.S. Adams’s recommendations to the U.S. Senate debating the 1921 Revenue Act. See Graetz & O’Hear, *supra* note 16 at 1060.

⁹⁹ League of Nations (1933), *supra* note 91, at 4241.

¹⁰⁰ League of Nations, *Report to the Council on the Fifth Session of the Committee*, League of Nations Document C. 252. M. 124. IIA (17 June 1935) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*, see *supra* note 13, at 4253-54.

¹⁰¹ Langbein, *supra* note 50, at 633.

¹⁰² *Supra* note 50, at 633. The arm’s length principle had already been introduced in the context of the permanent establishment clause in Draft Convention Ia, Article 5; see League of Nations (1928) *supra* note 51, at 4162. Indeed, ‘the words “*bona fide* agent of independent status” are intended to imply absolute independence, both from the legal

Article III of the Draft Convention, the ancestor to the present Article 7 of the OECD Model, provided that where an enterprise carries on business in a number of states, each PE through which such business was carried out would be attributed ‘the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions.’¹⁰³ Pursuant to Article III, this net income would, in principle, ‘be determined on the basis of separate accounts pertaining to such establishment.’¹⁰⁴ The right to rewrite those accounts is present:

The fiscal authorities of the contracting States shall, when necessary...rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would have prevailed between independent persons dealing at arm’s length.¹⁰⁵

The question of affiliated enterprises is dealt with in Article VI of the ‘Carroll Convention’.¹⁰⁶ Although the 1935 Draft Convention advocated separate accounting as the prime method for the apportionment of transnational income, empirical methods and fractional apportionment were not completely rejected. They were retained in case the arm’s length principle could not be applied. However, their eventual application was constrained by an important proviso. They were required to be used in such a way as to yield results approaching as closely as possible to those which would be reflected by separate accounting.¹⁰⁷

The 1935 Draft Convention marks the birth of the separate accounting/arm’s length principle. The principle did not suddenly gain its status as an international norm, rather, ‘the language of the 1935 draft supplied the basis for the text later inserted into the general international models.’¹⁰⁸ In arguing for the separate accounting standard Carroll chose, however, to object

and economic point of view. The agent’s remuneration must not be below what would be regarded as a normal consideration.’ See Graetz & O’Hear, *supra* note 16, at 1089 n 274.

¹⁰³ League of Nations (1935), *supra* note 100, at 4253-54.

¹⁰⁴ *Id.*, at 4254.

¹⁰⁵ *Ibid.*

¹⁰⁶ Article VI is the direct ancestor of the present Article 9 of the OECD Model. It reads as follows: ‘When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such a situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.’ Carroll, *supra* note 57, at 496.

¹⁰⁷ Carroll, *supra* note 57, at 495.

¹⁰⁸ Langbein, *supra* note 50, at 634.

to fractional apportionment. Thus, it is reasonable to say that Carroll in fact did not convincingly commend the separate enterprise standard on its own merits. Rather, he justified his preference for the separate accounting standard by focusing on what he saw as the weaknesses of fractional apportionment.¹⁰⁹ Notwithstanding this, the Fiscal Committee fully embraced the method of separate accounting as proposed by Carroll.

C The Consolidation of the Arm's Length Principle

It would appear that at the time of its articulation the arm's length principle did not cause any controversy in contrast to the continued disagreement between the primacy of source or residence taxation. Supporters of both the London and Mexico Models did not reopen the debate on arm's length and fractional apportionment. The provisions for the allocation of income were identical in both models and merely reproduced the 1935 allocation provisions as a Protocol. Article VI of the Protocol to both models reproduced Article III of the 1935 Draft Convention relating to the allocation of income and expenses among PEs. Article VII of the Protocol reproduced Article VI of the 1935 Draft Convention relating to independent enterprises. Furthermore, just as in the 1935 Draft Convention, both the Mexico and London Models retained empirical methods and fractional apportionment as back-up methods for allocating income and expenses if separate accounting failed to achieve its purpose.

As far as the arm's length principle is concerned, it is obvious that officially the views of the members of the OECD have not changed. The original or revised versions of the draft conventions produced by the OECD, as well as the Organisation's Guidelines published in 1995,¹¹⁰ are all articulated on the premise that the arm's length standard is the fundamental principle underlying the allocation of income and expenses both in the branch and in the subsidiary context.

The emergence of the arm's length principle as the 'international norm'¹¹¹ for the taxation of business profits was not achieved overnight. As mentioned, Article III(1) of the draft convention of 1935 provided that if an enterprise with its fiscal domicile in one contracting state has PEs in other Contracting States:

¹⁰⁹ *Carroll Report*, *supra* note 83, at 187-89 paras 664-70.

¹¹⁰ OECD, Report of the OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995), (OECD 1995 Guidelines).

¹¹¹ This 'international norm' status is vehemently contested by Langbein; see S. Langbein, *supra* note 50. In 1989 the German Government, in expressing its reservations to the OECD report on thin capitalisation rules noted, 'the consensus regarding the actual application of the "arm's length principle" is extremely vague and precarious'. See Green, *supra* note 56, at 37 n 70. Obviously German reticence is obsolete as that country now fully embraces the OECD 1995 Guidelines.

there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions.¹¹²

In order to enable the relevant fiscal authorities to carry out this attribution, they were allowed to rectify the accounts produced so that these accounts reflect ‘the value which would prevail between independent persons dealing at arm’s length’. Article III, substantially modified, is still the basis for Article 7 of the OECD Model. Article 7(2) of the current OECD Model reads as follows:

[S]ubject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.¹¹³

Article 7 deals with the attribution of income between home enterprises in one Contracting State and their branches in another contracting state. This has been referred to as the ‘branch’ or ‘permanent establishment’ context.

The ‘associated enterprises’ or ‘related enterprises’ context is dealt with in Article 9 of the OECD Model. Article 9 of the OECD Model reproduces the provisions of Article VI of the 1935 Draft Model.¹¹⁴ Both provisions provide that the arm’s length standard is to be applied primarily in the relations between an enterprise and its subsidiaries, parents or sister entities in another state. The text of the 1935 Draft Model is exactly the same as the original text of Article 5 proposed in the 1933 League of Nations Draft Convention.¹¹⁵

Article 9(1) states:

1. Where
 - (a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
 - (b) the same persons participates directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of another Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial and financial relations which differ from those which would be made between independent

¹¹² League of Nations (1935), *supra* note 100, at 4253-54.

¹¹³ OECD (1992), *supra* note 69, at M-15.

¹¹⁴ Article VI is reproduced at *supra* n 106.

¹¹⁵ League of Nations (1933), *supra* note 91, at 4245.

enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.¹¹⁶

Article 7, but not Article 9, contains an explicit qualification on the commitment of the model to pure arm's length principle. Article 9 does not prescribe the methods by which an arm's length price is to be determined. This feature, together with the fact that Article 9(1) especially deviates from the original versions of the League of Nations drafts of the 1930s, has led to serious interpretative problems as to its scope and nature. These problems have blurred the legal basis for transfer pricing adjustments at the present time. In this context, two questions need to be addressed. What are the international obligations in the transfer pricing area and is there any latitude for states to use an apportionment method other than the arm's length standard in the associated enterprise context?

Article 9 is probably one of the most important articles in the OECD Model. Yet both the League of Nations and the OEEC/OECD have not fully explored its implications. Rather, emphasis was laid on Article 7 of the OEEC/OECD Model (the permanent establishment article) and its various ancestors originating from the League's work. This was justified on the grounds, that at that time, companies that engaged in cross-border transactions did so through PEs rather than through subsidiaries or associated enterprises.¹¹⁷ Thus Commentaries to Article 9 of the OEEC Draft, which became Article 9 of the OECD 1963 Draft Model Convention, and Article 9(1) of the 1977 and 1992 models, were quite brief and were rounded in one paragraph of four sentences, while those relative to Article 7 consisted of 'especially detailed commentaries'¹¹⁸ covering 26 paragraphs over eight pages. It would thus appear that even in the 1960s, the problem of transfer pricing involving associated enterprises was still regarded as minor.¹¹⁹ Consequently, when the problem reached significant proportions, countries were already 'locked into the structure of the associated enterprise Article'.¹²⁰

What then are the consequences of this relative neglect in the proper articulation of Article 9(1)? To appreciate them it is necessary to compare the original texts and the current Article 9. The two provisions seem to be very close but there are differences in their wording which pose a real problem of interpretation in their scope and effect.

¹¹⁶ OECD (1992), *supra* note 69, at M-15.

¹¹⁷ Langbein, *supra* note 50, at 628-37.

¹¹⁸ R.J. Vann (1996), unpublished lecture notes, University of Sydney.

¹¹⁹ Langbein, *supra* note 50, at 638-42.

¹²⁰ Vann, *supra* note 118.

These differences lie first in the absence of the word ‘loss’ and the use of ‘may’ instead of ‘shall’ in the current Article 9(1). Consequently, one of the most pertinent questions that arises is whether Article 9(1) states a rule which applies to the exclusion of the domestic law of countries which have adopted the OECD Model for their Double Tax Agreements. Further, does Article 9(1) create an independent rule for adjustment, and is the provision concerned with profits alone to the exclusion of losses? In short, is Article 9(1) to be interpreted restrictively or expansively? The ultimate consequence of a restrictive interpretation is that Article 9(1) establishes the arm’s length standard as the exclusive method for apportioning the profits of a TNC, thus rejecting formulary apportionment as an alternative.

This problem of interpretation did not arise with the original texts, for example, Article VI of the 1935 League of Nations Draft. This provision stated clearly that transfer pricing adjustments were to be made in conformity to it regardless of whether domestic rules provided for alternative methods. The changes to be carried out pursuant to Article VI were ‘obligatory...[and] the provision gives a power to make adjustments independent of domestic law and that changes are to be made whether they turn profits into losses, profits into bigger or smaller profits or losses into bigger or smaller losses.’¹²¹

Article 9(1) uses the word ‘may’ in lieu of ‘shall’ as in Article 5 of the 1933 League’s Model. Does this change mean that the intention is to give countries a discretion rather than an obligation to make any upward or downward adjustments to profits? It would appear that is the case. However, if an adjustment is made, then that change must necessarily be effected according to the arm’s length standard. In other words, countries are not forced to adjust transfer prices, but if they do, then they must do so according to the arm’s length principle.

The prominent double tax agreement specialist, Professor Dr Klaus Vogel, supports the mandatory nature of the arm’s length principle, notwithstanding the word ‘may’ in Article 9(1).¹²² In addition, the OECD report on thin capitalisation examines the nature of Article 9(1) and concludes too that it is restrictive by nature and sets the arm’s length standard as the only acceptable apportionment method. Furthermore, the same report seems to suggest that Article 9(1) sets its own scope of application, that is, it sets the maximum to which profits can be adjusted:

[T]he Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic

¹²¹ *Supra* note 118.

¹²² K. Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD, UN, And U.S. Model Conventions for the Avoidance of Double Taxation of Income and Capital* (Kluwer: 1991), at 422-23.

enterprise to any amount greater the arm's length profit, that this principle should be followed in applying existing tax treaties, in particular in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, and that it should also be followed in the negotiation of bilateral treaties in the future.¹²³

As mentioned earlier, Article 5 of the 1933 League of Nations Model does not pose interpretative problems as the text is clearer. The confusion and interpretative problems that impair Article 9(1) arise because the latter departs from the former. Thus, while the Fiscal Committee of the OEEC gave the assurance that these changes were only cosmetic and not intended to be of any substance, the reality is quite different.

The question then is why was it necessary to make the changes in the first place? It is suggested that the main reason was to align the OEEC/OECD drafts with contemporary U.S. practice in the area. The thrust of the U.S. practices was, it would appear, different from that of the OEEC/OECD drafts, and uniformity was needed. The Fiscal Committee stated:

[A]nother consideration is that the application of common rules by Member countries of the OEEC may, because of their position in the world economy, be an inducement for other countries to adopt the same rules. The Fiscal Committee wishes to express its appreciation of the fact that Representatives of the United States have attended its meeting from the beginning and have taken part in its discussions.¹²⁴

Uniformity therefore meant that all member countries of the OEEC were required to adopt the rules of the dominant economic power, that is, the United States. The suggestion of using the U.S. system as the international benchmark in the transfer pricing debate was not new. For instance, in discussing the London Model, the Fiscal Committee of the League of Nations said:

the general structure of the Model Convention drafted at the present session is similar to that of the Mexico Model. On other points, new articles have been inserted to make use of certain innovations contained in conventions, such as those between the United Kingdom and the United States concluded since the 1943 meeting.¹²⁵

In reality, even prior to the U.K.–U.S. Convention, the U.S. had managed to impose its views on earlier conventions. For example, one of the earliest conventions in which a variant of the OEEC Articles XI and XVI are used is that concluded in 1939 between France and the

¹²³ OECD, *Issues in International Taxation No. 2, Thin Capitalisation* (Paris: OECD, 1987), at 22 para. 50.

¹²⁴ OEEC, Report of the Fiscal Committee of the OEEC, *The Elimination of Double Taxation*, (1958) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13, at 4461.

¹²⁵ League of Nations, *Report on the Work of the Tenth Session of the Committee*, League of Nations Document C. 37. M. 37. IIA. (1946), in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*; see *supra* note 13, at 4306.

U.S.¹²⁶ Similarly, Articles III and IV of the Double Tax Convention between Canada and the U.S. signed in 1942 are drafted in such terms as to make the application of the arm's length principle an obligation.¹²⁷

Moreover, it is true that the U.K.–U.S. Tax Convention signed in 1945 seems to have crystallised the language used in this context. Thus, Articles III and IV of that Convention¹²⁸ are reproduced almost verbatim at Articles III and IV of the convention between Australia and the U.K. signed in 1946.¹²⁹

The question that arises, therefore, relates to the origins of these concepts which in 1960 the OEEC was promoting as the standard applicable between its members. The influence of the 1963 OECD Draft Model Convention on U.S. treaties has been described in the following terms: 'The new treaties are quite similar to the OECD Draft. They continue the old convention authorization for similar reallocations between related persons to approximate section 482.'¹³⁰

It is therefore clear that rather than the 1963 OECD Draft having an influence on U.S. tax treaties, it was well and truly the contrary. Section 482 and its regulations as reproduced in the treaties signed by the U.S. were being imposed on a worldwide basis through the OEEC and later the OECD. Thus the 1963 OECD Draft Model Convention and the 1977 OECD Model Convention, while rearranging the articles relative to the OEEC draft, merely reproduced the same concepts.

Basically, section 482 authorises the Internal Revenue Service (IRS) to allocate the gross income, deductions, and credits between related taxpayers to the extent necessary to prevent evasion of taxes or clearly reflect the income of related taxpayers.¹³¹ Section 482 does not specify any 'method or theory to guide the Commissioner in making income allocations.'¹³² A study of the legislative history of section 482, and more especially the regulations implementing

¹²⁶ WH Diamond & DB Diamond eds, *International Tax Treaties of All Nations, France and United States* (New York: Oceana Publications, 1975), Vol. I, Articles 4 & 5, 308, at 309.

¹²⁷ *Id.*, at 324.

¹²⁸ *Id.*, at 341-42.

¹²⁹ *Id.*, at 380-81.

¹³⁰ H.I. Lazerow, *The OECD Draft Influence on the United States Income Tax Treaties* (Amsterdam: International Bureau of Fiscal Documentation, 1976), at 48.

¹³¹ Note, 'Multinational Corporations and Income Allocations Under Section 482 of the IRC', (1976) 89 *Harv L.R.* 1202, at 1204.

¹³² *Ibid.*

it, evolved in parallel with the work of the League of Nations. The earliest predecessor of section 482 is section 240(d) of the U.S. *Revenue Act* 1921.¹³³ This provision enabled the Commissioner to consolidate and redistribute income and expenses of related trades or businesses. In the U.S. *Revenue Act* of 1928, the provisions of section 240(d) of the 1921 *Revenue Act* was replaced by section 45.¹³⁴ This provision is the direct ancestor of the current section 482 which was incorporated in the Revenue Code in 1954.¹³⁵ At the time Carroll was writing his report for the League of Nations, section 45 was already in force in the U.S. In fact Carroll refers to it in his report to the League.¹³⁶ However, section 45, and later section 482, do not specify any method or theory for income allocations and ‘there is no mention in any of section 45’s legislative history of transfer price reviews, an arm’s length standard, or separate entity treatment.’¹³⁷ This particular method of income allocation is selected in the Treasury Regulations implementing section 45. In other words, Treasury bureaucrats of whom Carroll was a member made the choice of this particular methodology.

The original Regulations under section 45 were published in 1934 and they set forth ‘for the first time the arm’s length standard in the United States.’¹³⁸ In 1935, as already mentioned, the League of Nations published its Model Convention, otherwise known as the Carroll Model. These are the only two documents where the words ‘arm’s length’ are actually used. The ‘temporal coincidence is striking.’¹³⁹

The arm’s length principle as introduced in Treasury Regulation 86 Article 45-1 ‘established beyond a doubt that the arm’s length standard was the fundamental principle to be applied in intercompany transfer pricing.’¹⁴⁰ Furthermore, Federal Tax Regulations in force on 1 January

¹³³ The Statutes at Large of the United States of America, (Washington D.C.: U.S. Government Printing Office, 1923), Vol. XLII Part I, at 260. For an explanation of the purpose of section 240(d) by the U.S. Senate, see H. LaMont, ‘Multinational Enterprises, Transfer Pricing, and the 482 Mess’, (1975) 14 *Columbia Journal of Transnational Law* 383, at 385.

¹³⁴ See Note, *supra* note 131, at 1211.

¹³⁵ See The Statutes at Large of the United States of America, (Washington D.C.: U.S. Government Printing Office, 1929), Vol. XLV Part I, at 806, and The Statutes at Large of the United States Of America, (Washington D.C.: U.S. Government Printing Office, 1954), Vol. 68A, *Internal Revenue Code*, at 162 for a reprint of ss. 45 and 482 respectively.

¹³⁶ *Carroll Report*, *supra* note 83, at 110 para. 387.

¹³⁷ See Note, *supra* note 131, at 1211.

¹³⁸ Langbein, *supra* note 50, at 632.

¹³⁹ *Supra* note 50, at 632.

¹⁴⁰ R.M. Hammer, ‘Will the Arm’s Length Standard Stand the Test of Time? The Specter of Apportionment’, (January 1996) 24 *Intertax* 2.

1964 clearly stated that the '[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.'¹⁴¹ Such language was already present in the Double Tax Convention between Canada and the United States signed in 1942.

Article IV

(b) In order to effect the inclusion of such profits in the taxable profits of the Canadian enterprise, the competent authority of Canada may...re-establish the prices or remuneration entered in the books at the values which would prevail between independent persons dealing at arm's length.¹⁴²

Finally, Article 9(1) of the OECD Model really mirrors section 482 of the Internal Revenue Code 1986 in yet another way. It does not specify any method or theory to guide signatories in making income allocations. The Committee on Fiscal Affairs has published three reports addressing this issue.¹⁴³ The 1979 Report recommended four methods for determining an arm's length price:

- the comparable uncontrolled price method;
- the resale price method,
- the cost-plus method, and
- any other acceptable method.

The 1984 Report is an elaboration of the principles that emerged in the 1979 Report as applicable to three specific situations. In 1992, the OECD started to work on a major revision of the 1979 Report. On 8 July 1995, the OECD published a major part of the revised Guidelines.¹⁴⁴ In its 1995 Guidelines, the OECD endorses the view that in certain circumstances the traditional transaction-based methods for the determination of arm's length prices could be inappropriate. It therefore suggests two new methods to be used as a matter of last resort for this purpose. These so-called transactional profit-based methods which will be examined in detail in later chapters, are:

¹⁴¹ United States, *Federal Tax Regulations 1964* (West Publishing Co.: 1964), Vol. 1, at 853-54.

¹⁴² W.H. Diamond & D.B. Diamond, *International Tax Treaties of All Nations, 21 Canada and United States*, (New York: Oceana Publications Inc, 1975), Vol. 21, Articles III & IV, at 324.

¹⁴³ OECD, Report of the Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), (OECD 1979 Report); OECD, Report of the OECD Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises - Three Taxation Issues* (Paris: OECD, 1984), (OECD 1984 Report); Report of the OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD 1995), (OECD 1995 Guidelines).

¹⁴⁴ *Id.*, OECD 1995 Guidelines.

- the transactional net margin method, and
- the profit split method.

The arm's length principle is now regarded as the 'international norm' as far as the taxation of business profits are concerned. However, as will be examined later, there appears to be in recent years a subtle move away from the strict interpretation of what the arm's length principle stands for. This shift or, more accurately, this perceived readiness to adopt a more realistic approach to the arm's length standard, especially by the U.S., is the result of the frustration that arises because of its inherent problems when the principle is applied in the complex economic model of the 1990s. The arm's length principle is no doubt a highly artificial concept. It is premised on certain theoretical weaknesses that need to be examined.

The Limitations of the Present System of International Taxation

The ultimate result of the work initiated by the League of Nations is the OECD Model Double Tax Convention on Income and Capital (the OECD Model).¹ The main function of the OECD Model is to divide international income between the source and residence countries. The source country is where income is produced, and the residence country is where the investor deriving income from the source country resides. In the words of Professor Alvin Warren: '[T]he jurisdictional basis for taxation is territorial in the first instance and personal in the second.'²

The purpose of this chapter is to examine in Section I the premises on which this conventional resolution of the basic policy issue is achieved. Section II focuses on the general limitations of the conventional approach.³ Finally, Section III demonstrates that the separate accounting/arm's length principle, anchored as it is in a bygone era, is likely to fail in an increasingly globalised world economy.

Section I The Main Features of the Present System of International Taxation

1 The Conventional Approach

The division of the international tax base as proposed by the conventional approach is articulated on three assumptions:⁴ Firstly, source and residence countries have a concurrent and legitimate jurisdiction to tax; secondly, corporations and their investors are subject to separate taxation; and thirdly, corporations and investors are taxable on their income.

¹ OECD, *Model Tax Convention on Income and Capital*, (Paris: OECD, 1992), loose leaf, (1997 update), at C (7)-5 para. 2(11). (Note: A 2000 update is now available.)

² A.C. Warren, Jr., 'Alternatives for International Tax Reform', (1994) 49 *Tax Law Review* 599.

³ OECD (1992), *supra* note 1, at C (9)-1 para. 1(1).

⁴ Warren, *supra* note 2, at 599. See also H.J. Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices', (1992) 47 *Tax Law Review* 565, at 569.

A The Practice of the Conventional Approach

The current consensus regarding the proper division of the income tax base rests on the ‘method of classification and assignment of sources’.⁵ Pursuant to this method, the primary jurisdiction over corporate income is exercisable by the country where that income is sourced, while the residence country has primary jurisdiction over investor taxation.⁶ Thus, active business income is taxed in the country where it originates (the source country), and passive income is taxed in the country where the recipient of the income resides (the resident country).⁷

Currently, the conventional approach operates through a bilateral treaty network of more than 1500 tax treaties. These are, in general, based on the OECD Model.⁸ At the core of the OECD Model⁹ is the precise delineation of an active business operation carried out in a particular country.¹⁰ An active business operation is carried out in a particular country if an enterprise has a permanent establishment (PE) therein.¹¹ In such cases, the country where the PE is located, that is, the source country, has the primary right to tax the profits attributable to the PE.¹² To avoid double taxation, the residence country, that is, the country where the investor resides, is required to exempt those profits from tax or grant a foreign tax credit with respect to tax paid to the source country on that income.¹³

⁵ *Id.*, Ault, at 568.

⁶ Ke Chin Wang, ‘International Double Taxation of Income: Relief through International Agreement 1921-1945’, (1945) 59 *Harv L.R.* 73.

⁷ R.S. Avi-Yonah, ‘The Structure of International Taxation’, 74 *Texas Law Review* (1996) 1301, at 1306-09. The terms ‘active’ and ‘passive’ income in this context broadly represents respectively the taxation of profits of the firm and the taxation of the division of those profits among investors in the firm. Moreover, the expressions active and passive income reflect the degree of control exercised over the activity. Hence, active income is generally derived from activities on which the taxpayer exercises direct control whereas passive income is derived pursuant to activities on which the investor has little control.

⁸ R.J. Vann, ‘Improving Tax Law Improvement: An International Perspective’, (1995) 12 *Australian Tax Forum* 193, at 197.

⁹ OECD (1992), *supra* note 1.

¹⁰ This is the distinction between trading *within* as opposed to trading *with* a foreign country. See *Grainger & Son v Gough* [1896] AC 325, and also J.D. Adams & R.J. Whalley, *The International Taxation of Multinational Enterprises in Developed Countries* (London: The Institute of Fiscal Studies, 1977).

¹¹ OECD (1992), *supra* note 1 Articles 5 & 7.

¹² As noted in Chapter 1, the permanent establishment concept is a compromise between aspirations of the source and residence countries. Not all business income is taxable primarily in the source country, but rather only income attributable to a PE.

¹³ OECD (1992), *supra* note 1 Articles 23A & 23B. In practice, the residence country allows a credit equal to its own the tax rate on that income.

Concurrently, primary jurisdiction is accorded to the residence country as far as passive business income is concerned. Passive income comprises investment income such as dividends and interests. However, the source country may first levy withholding tax on these items although at substantially reduced rates.¹⁴ Thus, for instance, the OECD Model Treaty provides for tax rates of five to 15 per cent on dividends, 10 per cent on interest, and zero per cent on royalties.¹⁵ To avoid double taxation, the residence country is required to give credit for any withholding taxes imposed by the source country.¹⁶ It is to be noted that this neat assignment of income is now under threat with the advent of electronic commerce. Indeed, countries are increasingly worried about losing their tax base and are interpreting 'existing laws in a manner that allows imposition of withholding tax on payments arising from electronic commerce transactions or passing new laws that provide such withholding.'¹⁷

B The Principles Underlying the Conventional Approach

These practices, embodied in the OECD Model Treaty, are designed to implement three principles underlying the conventional approach to international taxation. These principles are that of non-discrimination, neutrality and reciprocity.

i Non-Discrimination

One of the most important concepts of international economic law is the non-discrimination principle.¹⁸ This principle is achieved through the so-called most favoured nation clause

¹⁴ For a description of the U.S. practice in this area, see U.S., Joint Committee on Taxation, *Description and Analysis of Present Law Rules Relating to International Taxation*, Tax Analysts Document Number: Doc 1999-22342 JCX-40-99 (28 June 1999), see at <<http://taxbase.tax.org/>>.

¹⁵ This too is a compromise since it allows the source country to impose tax on some of the income derived by foreigners within its territory although the international consensus is that such income is to be taxed primarily by the residence country. In the absence of a treaty, the source country usually imposes much higher rates on these items of income.

¹⁶ The credit method is required for dividends and interest even if the exemption method is used for other income. See OECD Model (1992), *supra* note 1, Article 23A.

¹⁷ On 28 April 1999, 'Indian tax authorities ruled that payments received by a U.S. company from an Indian company for the use of computer systems located outside of India were royalties arising in India and thus subject to tax in India by way of withholding.' See Pandit & Goradia, 'Indian AAR Issues Landmark Ruling on E-Commerce Taxation under U.S.-India Tax Treaty, (5 July 1999) 19 *Tax Notes Int'l* 11 in J. VanderWolk, 'Direct Taxation in the Internet Age: A Fundamental Approach', (April 2000) 54 *Bulletin for International Fiscal Documentation* (No. 4) 173, at 177 n 15.

¹⁸ The principle of non-discrimination originates from the so-called Treaties of Friendship, Commerce and Navigation (FCN) and Treaties of Establishment which punctuated the expansion of commercial ventures in the sixteenth century. See J.G. O'Brien, 'The Non-discrimination Article in Tax Treaties', (1978) 10 *Law and Policy in International Business* 545, at 546. The basis of the non-discrimination principle is the 'most favoured nation' and national treatment principle contained in these FCNs. For example, the MFN provision first appeared in the 1642 treaty between Portugal and Great Britain; see A.J. Rädler, 'Most Favoured Nation

(MFN) and the national treatment obligation.¹⁹ Both concepts are now incorporated in most Double Taxation Agreements (DTAs).

Modern DTAs, following Article 24 of the OECD Model,²⁰ contain the standard provision; the non-discrimination principle. It provides that treaty countries are not to discriminate against business activities carried out in one Contracting State by the nationals of the other Contracting State by taxing those activities more severely than those carried out by their own nationals.²¹ In fact, in three specific cases,²² it is required that the tax treatment of non-residents be equivalent to that of residents. Moreover, the non-discrimination provisions are confined to the tax treatment afforded in the source country to the exclusion of the residence country.²³

Concept in Tax Treaties', in M. Lang, ed., *Multilateral Tax Treaties: New Developments in International Tax Law*, (Kluwer Law International, 1998) 3, at 3. It was also present in the first American commercial treaty, Article II-IV, Treaty of Amity and Commerce signed on 6 February 1778 between the U.S. and France. 8 Stat 12, TS No. 83; see also Lidstone, 'Liberal Construction of Tax Treaties - An Analysis of Congressional and Administrative Limitations of an Old Doctrine', (1962) 47 *Cornell LQ* 529, at 537-38, in W.C. Gifford, 'Permanent Establishment Under the Non-discrimination Clause in Income Tax Treaties', (1978) 11 *Cornell International Law Journal* 51, at 52 n 3.

As for the national treatment principle, it first appeared in the 1654 treaty between Portugal and Great Britain. It provided that the subjects of Great Britain 'shall enjoy the same liberties, privileges and exceptions as the Portugese [sic] themselves.' It again appeared in the treaty between Great Britain and Denmark in 1660-61, in the 1667 Treaty of Peace and Commerce between Great Britain and Spain, and subsequently in all early British Commercial treaties; see also Lidstone, 'Liberal Construction of Tax Treaties-An Analysis of Congressional and Administrative Limitations of an Old Doctrine', (1962) 47 *Cornell LQ* 529, at 537-38, in W.C. Gifford, 'Permanent Establishment Under the Non-discrimination Clause in Income Tax Treaties', (1978) 11 *Cornell International Law Journal* 51, at 52 n 3.

¹⁹ There is a major difference between the MFN and the national treatment obligation: The former merely secures for foreign nationals treatment equal to that afforded to all other foreigners in similar situations; and the latter requires that all foreigners receive the same treatment as domestic nationals; see Wurzel, 'Trade Agreements and Tax Privileges' (1940) 18 *Taxes* 484, at 486. In general, the principle of non-discrimination is construed as requiring the satisfaction of a certain degree of fairness, or reasonableness, or the common public interest standard. In other words, the principle will not be regarded as prohibiting all distinctions within the field in question, but only those which cannot be justified by reference to such standards; see Gifford, *supra* note 18, at 42.

²⁰ OECD (1992), *supra* note 1, at M-43. The Commentaries are at C (24)-1.

²¹ J.F. Avery-Jones et al., 'The Non-Discrimination Article in Tax Treaties,' [1991] *BTR* 359, at 360.

²² The permanent establishment of non-resident enterprises, Article 24(4); deductible payments to non-residents by resident enterprises, Article 24(5); and foreign-owned resident enterprises, Article 24(6). See OECD Model (1992), *supra* note 1.

²³ This exclusion, according to Professor Vann, could be attributed to the relationship which Article 24 has with the preceding provisions. Indeed, Articles 23A and 23B of the OECD Model are concerned with the methods by which the elimination of double taxation is sought. These are the exemption and the credit method respectively; see R.J. Vann, 'The Future of International Tax Treaty or Institution? Small Step or Great Leap?' (1996), unpublished paper. For a discussion of the interaction between the principle of non-discrimination and the permanent establishment concept, see the report of J. Weiner on the seminar held by Linklaters & Alliance in Brussels on 4 April 2000, in J. Weiner, 'Consortium of EU-Based Law Firms Discusses EC Law's Direct

ii Neutrality

The principles of non-discrimination and neutrality are closely related: Both aim at achieving efficiency in the worldwide allocation of capital. The concept of efficiency is based on the assumption that productivity will be highest when income-producing factors are distributed by market mechanism without public interference.²⁴

Another fundamental principle of tax policy is neutrality. It requires a tax system to treat income in a similar manner whether it is earned domestically or out of the country. In international taxation, neutrality is apprehended at three levels: capital import neutrality, capital export neutrality, and national efficiency.²⁵

Article 23A of the OECD Model, recommending the exemption method to relieve double taxation, is justified on the ground of capital-import neutrality (CIN). A tax system favours CIN when domestic and foreign investors receive equal after-tax yields from an identical investment. This means that domestic and foreign investors are placed on a level playing field as far as the taxation of their investment is concerned.

CIN requires the fulfilment of two conditions:

- First, the capital-importing country needs to tax income from foreign-owned investment at the same rate as domestically-owned investment.
- Second, the capital-exporting country must exempt foreign-source income from taxation.

On a practical basis, CIN is achieved by according national treatment to the foreign enterprise.

Relief of international double taxation by way of the credit system is provided for pursuant to Article 23B of the OECD Model. Its application postulates the pursuit of capital export neutrality (CEN). The objective of CEN is to secure the equal treatment of investors, whether they invest at home or abroad. CEN is desirable because it avoids distortion of the locational decisions of TNCs. A country achieves CEN when investors in that country 'pay the same amount of tax on investments with equal pre-tax yields whether the investment is domestic or

Impact on Direct Taxation' (10 April 2000) 20 *Tax Notes Int'l* (No. 15) 1629, at 1632 analysing the *Saint Gobain Case* decided by the ECJ in 1999. See also R. Offermanns & C. Romano, 'Treaty Benefits for Permanent Establishments: The Saint Gobain Case', (May 2000) *European Taxation* (No. 5) 180.

²⁴ See K. Vogel, 'Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part I)', [1988/8-9] *Intertax* 216, at 218-19. (Part II [1988/10] *Intertax* 310, Part III [1988/11] *Intertax* 393.)

²⁵ *Ibid.* There seems to be some uncertainty regarding whether within the efficiency concept, a 'national' and an 'international aspect' or 'world aspect' should be distinguished.

foreign.²⁶ CEN is achieved by taxing foreign-sourced income on a current basis and allowing a full credit for foreign tax paid on that income.

CEN is, however, rarely reflected in the tax rules of traditional capital-exporting countries. In most cases, these countries defer the taxation of income accumulated in foreign companies until repatriation, except for specific cases as covered by the various CFC regimes.²⁷ A long enough deferral period is equal to an exemption of the foreign-sourced income.

National efficiency suggests that each nation should be concerned about maximising its own welfare. Thus, a residence country that abandons part of its revenue to the source country undermines its national efficiency. Consequently, it has been suggested that, for neutrality purposes, a deduction for foreign taxes paid is more appropriate than a credit for paid taxes or an exemption of foreign income.²⁸

Moreover, the concept of neutrality in an international environment requires the achievement of inter-nation neutrality. In other words, countries need to concern themselves with the combined effects of their tax laws on investors' behaviour.²⁹ Inter-nation neutrality, therefore, means that taxation should 'not alter the (explicit or implicit) relative prices of goods, services, activities, production inputs, and so forth, in the private sector.'³⁰

Many countries combine the principles of CIN and CEN but, as will be explored in a later chapter, it is doubtful whether these purely economic principles have had any appreciable impact on international tax policy.³¹

²⁶ M. Rigby, 'A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism', (1991) 8 *Australian Tax Forum* 302, at 413.

²⁷ J.R. Hines, *Tax Policy and the Activities of Multinational Corporations*, Working Paper 5589 (Cambridge, Mass: National Bureau of Economic Research, 1996).

²⁸ See P.B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* 134 (1969), in Warren, *supra* note 2, at 602 n 12.

²⁹ Norman Ture and Professor Klaus Vogel have advocated such a concept. See N. Ture, 'Taxing Foreign Source Income', in *U.S. Taxation of American Business Abroad* (1975), at 37, in Vogel, *supra* note 24, at 222 n 38.

³⁰ Ture, at 38, in Vogel, *supra* note 24, at 313.

³¹ M.J. McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance', (1994) 49 *Tax Law Review* 769, at 777. CEN does not apply directly to TNCs as it does to portfolio investments. First, the bulk of the world's international investment is now in the form of portfolio investment. It follows that the role of TNCs, although growing in absolute terms, is diminishing relative to the growth of portfolio investments. Second, TNCs use financial manoeuvring, for example, debt financing and transfer pricing manipulation to achieve CEN by lowering their tax payable in high tax jurisdictions. Third, in the U.S. debate about CEN as applied to TNCs relates only to those enterprises whose parents are incorporated in the U.S., which is a purely formal distinction. For a more detailed examination of these issues, see Avi-Yonah, *supra* note 7, at 1314-16.

iii Tax Rate Reciprocity

One of the major characteristics of the conventional system is that it tends to allocate the right to tax investment income almost exclusively to the residence country. Indeed, the system attempts to reduce or even eliminate the source country's right to tax such income through the use of the withholding tax mechanism. This is achieved through the principle of tax rate reciprocity. Tax rate reciprocity requires the reciprocal reduction of withholding tax rates to relatively low rates by source countries. The rates are reciprocal in the sense that both states party to a DTA must apply them in their capacity as source country.³² Reciprocity of tax rates is premised on the idea of equal sacrifice between both the source and the resident country. There is equal sacrifice, in the case of dividends, if both parties have similar corporate tax systems and, in the case of interest income, if both are economically comparable.³³

Moreover, withholding taxes on investment income of non-residents are levied on a gross basis in most developed countries. This means that no deductions are allowed as with the usual domestic net-basis taxation. The low rate of withholding taxes on portfolio dividends is justified in that it approximates source country taxation of domestic shareholders who benefit from deductions not available to foreign shareholders. As for the even lower rate on direct dividends, its rationale stems from the fact that it is an additional tax levied by the source country on corporate income. Finally, the nil rate on interest arises because associated non-deductible expenses are greater than for dividends. It has, however, been suggested that the real reason for the zero rate arises because of capital importing countries' desire to attract foreign debt.³⁴

³² For a historical explanation of the principle of reciprocity for investment income, see Ault, *supra* note 4, at 569-70.

³³ P.A. Harris, *Corporate/Shareholder Income Taxation* (Amsterdam: IBFD Publications 1996), at 314-15. Under Article 10(2) the OECD Model, the maximum rates applicable to dividends paid to corporate investors owning more than 25 per cent of the paying corporation is limited to 5 per cent. As for interests, the maximum rate pursuant to Article 11(2) is 10 per cent; see OECD (1992), *supra* note 1.

³⁴ Warren, *supra* note 2, at 603. If, as is the case, some countries have an integration system and others a classical system for the taxation of dividends, 'the sacrifice consequent on a reduction in source taxation of dividends to a specific withholding tax rate is unlikely to be equal'; see Harris, *supra* note 33, at 314. An alternative approach suggested by M. Sato and R.M. Bird is that, in the case of corporate income, it is better to compare effective rates of tax levied; the so-called effective reciprocity rather than actual withholding tax rates; see M. Sato & R.M. Bird, *International Aspects of the Taxation of Corporations and Shareholders*, (1975) IMF Staff Papers 384, 426-29, in Warren, *supra* note 2, at 603 n 20.

2 The Conventional Approach: General Problems

The present system of international division of the international tax base is plagued by obsolescence. Its conceptual foundation which assumes separate corporate and investor taxation is inconsistent with present domestic tax rules of most developed nations. Yet, it remains at the very heart of the OECD Model Treaty which epitomises bilateral cooperation in tax matters. Arguably, the Model's reliance on the separate accounting/arm's length standard no longer fits the conditions of international commerce.³⁵

A Conceptual Discontinuity

The central organising principle of the conventional system is the distinction between the corporation and the investor. This classical system of two-tier taxation, although eliminated in the domestic system of most industrialised countries other than the U.S., has been maintained for the taxation of international income. The two-tier system of taxation (the classical system) has the 'effect of imposing a relatively higher total tax burden on foreign investors and on the foreign income of domestic investors.'³⁶ This is a relic from the past. The consensus wrought out by the League of Nations was designed to apply in an environment when separate taxation of corporations and their shareholders was the norm. That environment has all but disappeared. Indeed, the separate taxation of corporations and their shareholders induces several serious economic distortions ranging from a disincentive for investment in new corporate capital, an incentive for corporate financing by debt or retained earnings, or the incentive to retain or distribute corporate earnings.³⁷ To counter these manoeuvres, domestic systems have moved from the classical to an integration method whereby corporate and investor taxes are treated in a unified and coordinated manner. However, in the field of international taxation, the conventional model endures. It is therefore difficult and illogical, as Professor Ault argues, to continue applying the traditional rules of international tax jurisdiction as developed in DTAs.³⁸ The interaction of domestic integration and classical international separate taxation results in international income being taxed more heavily than domestic income both at the source and the residence levels. For instance, foreign investment is likely to be subject to higher taxation than domestic investment in a source country given that shareholder integration credits (imputation credits) are denied to foreign investors. In the

³⁵ Chang Hee Lee, 'A Strategic approach for Capital-Importing Countries Under the Arm's Length Constraint', (1999) 10 *Tax Notes Int'l* (No. 7) 677.

³⁶ Ault, *supra* note 4, at 582.

³⁷ Warren, *supra* note 2, at 604.

³⁸ Ault, *supra* note 4, at 566.

residence country, income from investment abroad can be taxed more heavily than income from investment at home because the foreign tax credit or exemption for corporate income earned abroad is not generally available to shareholders when that income is distributed as dividends.³⁹

B Operational Problems

The current system is extremely formalistic due to its schedular nature. It is exceedingly complex.⁴⁰ As such, it promotes treaty shopping. Its bilateral nature results in an ever-increasing number of treaties which is becoming increasingly irrelevant in a globalised world where, for example, the sophistication of modern capital markets have made the enforcement of source-based taxation of portfolio income problematic.⁴¹

Finally, and most importantly, the reliance on the separate accounting/arm's length principle for the sharing of the income tax base between competing jurisdictions is unrealistic and unworkable.⁴²

i The Schedular Nature of the Model

The schedular nature of tax treaties based on the OECD Model has considerable significance on the investment decisions of TNCs. In essence, under a schedular tax system different categories (schedules) of income are taxed on a different basis and at different rates according to their respective sources. For international tax purposes, income is derived from four sources: business, investments, services, and employment. Each of these is taxed on a different basis; for example, business profits are taxed on a net-of-expense basis while investment income is taxed on a gross-revenue basis. In order to minimise tax, taxpayers may seek to manipulate the various categories in order to fall, for example, within the most favourable tax rate.⁴³ The OECD Model encourages this behaviour since it disregards the concept of global

³⁹ The full consequence of such tax differentials is attenuated if source countries extend shareholders credits to foreign investors. However, while this has been achieved as far as foreign portfolio investors are concerned, notably by France, extension of credits to direct corporate investors is extremely rare, for example, the 1975 U.S.-U.K. Treaty. See Ault, *supra* note 4, at 585-87.

⁴⁰ For example, IRC § 904, the U.S. provisions limiting the foreign tax credit to the U.S. rate; or IRC §§ 951-64 the controlled foreign corporations provisions.

⁴¹ Thus, the U.S. has all but abandoned the taxation of U.S. source portfolio interest, see IRC §§ 871(h), 881(h).

⁴² Warren, *supra* note 2, at 606.

⁴³ For example, if a treaty between A and B contains a zero rate of taxation on royalties, while business profits sourced in any one of the Contracting States are taxed at the current corporate rate, then it is likely that a TNC resident in A doing business in B through a subsidiary, will endeavour to recharacterise business profits as royalties to minimise tax costs; see V. Krishna, 'International Income Taxation of Electronic Commerce' (January 1999), 9 *Canadian Current Tax* (No. 4) 33, at 35.

income and considers the various members of a transnational group as separate entities dealing with each other at arm's length. Furthermore, the schedular system of the OECD Model seems to satisfy the argument that source countries should have a different claim on various categories of income. The economic justification has been questioned⁴⁴ and it has been argued that a single flat rate of tax applied to all non-resident income is the most reasonable alternative.⁴⁵

The real justification in preserving the schedular nature of tax treaties lies in the administrative convenience that it entails. In most tax systems, collection of tax from non-residents on passive income is achieved by withholding at source, that is, before it leaves the country. Withholding tax is calculated on gross income because if a net basis had been adopted, the taxpayer would have been entitled to a deduction for costs incurred in deriving that income. To demand a substantiation of these costs on the part of the foreign taxpayer and devising a system that could verify their reality is considered as being virtually impossible. On the other hand, a net basis approach is appropriate for business income because a business has usually sufficient 'presence' to justify costs and other expenses incurred in the process of creating a profit.

Tax treaties adopt the same practice as far as revenue collection is concerned. In other words, Contracting States anticipate problems of collection in spite of the fact that a provision for assistance in collection may be included in the treaty. The severity of such problems would certainly be mitigated if an international body, acting as an agent of one revenue authority, could track down the recalcitrant taxpayer and obtain payment of taxes due.

ii Treaty Shopping

Treaty shopping occurs when a person in country A, entitled to receive income from country B, uses an entity in country C to receive that income on his or her behalf because the B/C double tax treaty contains more beneficial provisions than the A/C treaty if indeed one exists.⁴⁶ This is what basically happens with the 'Netherlands royalty route'. Most of the Netherlands

⁴⁴ While there has been, until 1985, a move away from schedular taxation, it has recently returned in new forms with, for example, the introduction of anti-shelter provisions in the U.S. For further details, see K. Messere, 'OECD Tax Developments in the 1990s', (July 1997) 51 *Bulletin for International Fiscal Documentation* 298, at 300.

⁴⁵ See P. Musgrave, 'The Taxation of International Capital Income', in J.G. Head, ed., *Taxation Issues of the 1980s* (Sydney: Australian Tax Research Foundation, 1984), at 279-94. For a contrary view as to the appropriateness of the single flat rate of tax, see 'Flattening might get you nowhere', at <<http://dialog.krinfo.com/cgi-bin/dwclient.cgi>>, Document No. 00567653/7.

⁴⁶ R. Saunders, 'How Much Longer Will Treaty Shopping Be Allowed?', (January 1995) 22 *Tax Planning International Review* 1, at 20.

treaties have a zero tax rate on royalties. Therefore, if a TNC manages to be governed by any one of these treaties, it will end up receiving or paying tax-free royalties.

The real cause of treaty shopping lies not with the OECD Model per se, but it arises because of the different tax rates each country applies to the same type of income. In fact, the Model tries to solve the problem through Articles 10, 11 and 12, which state that the lower rates applicable to dividends, interest and royalties are available only if the non-resident recipient is the beneficial owner of the income. Therefore, the reduced rates do not apply if the non-resident deriving the income is not the beneficial owner but is merely acting as an agent or nominee for a resident of a third country. However, arbitrage opportunities remain because the concept of beneficial owner⁴⁷ is more accurately defined in some jurisdictions than in others. For instance, Article 37 of the Italian Unified Tax Code of Income Tax uses the ‘more precise legal concept of effective owner’ rather than that of ‘beneficial owner’.⁴⁸

In the treaty shopping area, TNCs often use the ‘conduit company’ method to exploit the different tax rates that each country applies to the same type of income. A conduit company is one whose constitutive powers are so narrow that it may be regarded as ‘a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company).’⁴⁹ When such a vehicle is interposed between the payer and the recipient, the Model, relying on the concept of beneficial owner, denies the concessional tax treatment that would have normally been available in the source country.⁵⁰ The term ‘beneficial ownership’ first appeared in the 1977 OECD Model Tax Convention.⁵¹ However, no definition of the term was given either in the convention or in the commentaries. Therefore, tax practitioners around the world have struggled to understand what the expression really means.⁵²

⁴⁷ For an examination of the concept of ‘beneficial owner’, see *J Sainsbury Plc v. O’Connor (Inspector of Taxes)* Chancery Division, [1990] STC 516, more especially the judgement of Millett J., at 530ff. See also A. Rowland, ‘Beneficial Ownership in a Corporate Context: What is It? When is it Lost? Where does it Go?’, [1997] 3 *BTR*, at 178-87.

⁴⁸ Article 37 of the Italian Unified Tax Code of Income Tax (TUIR), in G Palumbo, ‘Anti-Avoidance and the 1992 OECD Model Convention’, (September 1994) 21 *Tax Planning International Review* 3, at 4.

⁴⁹ OECD, ‘Double Taxation Conventions and the Use of Conduit Companies’, in OECD, *International Tax Avoidance and Evasion, Four Related Studies* (Paris: OECD, 1987) 93, at para. 14(b).

⁵⁰ OECD (1992), *supra* note 1, Commentaries on Article 10, at C (10)-3 para. 12; Article 11, at C (11)-3 para. 8; and Article 12, at C (12)-1 para. 4.

⁵¹ OECD, *Double Taxation Convention on Income and Capital* (Paris: OECD, 1977).

⁵² For an analysis of the term and its meaning, see J.D.B. Oliver, et al., ‘Beneficial Ownership’ (July 2000) 54 *Bulletin for International Fiscal Documentation* (No. 7) 310.

Treaty shopping has certainly not been reined in by the beneficial ownership requirement. Leaving aside the confusion as to the meaning of the term, it is fair to say that the success of the concept in policing the application of tax treaties is limited because:

- firstly, it does not apply where a conduit company engages in other activities concurrent to acting in a fiduciary capacity; and
- secondly, it is extremely difficult for the source country to establish that the non-resident conduit company is not the beneficial owner of the income.

The truth is that treaty shopping persists because of tax rates differentials existing between various jurisdictions. If tax rates were relatively comparable worldwide, then, to engage in treaty shopping would probably be an unattractive proposition. Unfortunately, the standardisation of tax rates on a worldwide basis is impossible to achieve in the present framework.

While treaty shopping is normally portrayed as being undesirable,⁵³ it has however been argued that it serves to remove the impediments to international trade caused by the absence of double tax treaties between two particular countries. Furthermore, it provides 'equal opportunities to maximise the return on one's investments, thereby encouraging and facilitating such investments.'⁵⁴

The traditional policy response to the question of treaty shopping aims at limiting the attractiveness of the mechanism. This is achieved by the inclusion of the so-called 'limitation-on-benefit' article in the relevant treaty as pioneered by the U.S.⁵⁵ As the term suggests, the intention is to limit the benefit of a treaty to a resident of either of the Contracting State by narrowly defining the concept of residence.⁵⁶ However, it appears that, as a result of the limitation-on-benefit provision between Canada and the U.S:

⁵³ J.G. Russell, 'The New Limitation-on-Benefits Article', (1995) 43 *Canadian Tax Journal* 964, at 966.

⁵⁴ Saunders, *supra* note 46, at 21.

⁵⁵ See section 894 of the IRC and the temporary regulations thereunder with effect from 1 January 1998. Foreign persons are denied the reduced rates of withholding tax under all treaties with the U.S. on income derived through a fiscally transparent entity if the income is not treated as the income of the foreign person in the foreign country; the treaty does not address income derived through fiscally transparent entities; and the foreign country does not tax distributions from the entity to the foreign person. These provisions illustrate conspicuously the readiness of the U.S. to unilaterally override its treaty obligations. Moreover, in Australia the weakness of similar provisions has been demonstrated in *Federal Commissioner of Taxation v Lamesa Holdings BV* 97 ATC 4752. In any event, the complexity of international tax laws is such that TNCs are now forcefully lobbying to simplify these rules, at least in the U.S. context; see R.J. Donmoyer, 'Multinationals Beg Senate Finance Committee to Simplify Int'l Laws' (1999) 18 *Tax Notes Int'l* (No. 12) 1103.

⁵⁶ For an analysis of the new limitation on benefit article applicable pursuant to the 17 March 1995 protocol to the Canada-U.S. Treaty, see Russell, *supra* note 53, at 966.

many taxpayers not involved in treaty shopping may be adversely affected. For example, foreign controlled corporations, highly leveraged private corporations, and trusts with non-resident beneficiaries.⁵⁷

Nonetheless, the U.S. initiative is a novel response to the problem of treaty shopping as there is no similar limitation-on-benefit provision in the OECD Model Convention, although the problem is discussed at length in the commentary on Article 1 and countries are permitted to include such limitations in their conventions.⁵⁸

iii The Irrelevancy of the Model

The OECD Model is increasingly irrelevant because new principles of taxation are emerging in the field of international taxation. Tax planning activities of TNCs reduce the tax take of both source and residence countries. As a result, countries have introduced innovative legislation in order to combat elaborate forms of tax avoidance or evasion. These measures were not anticipated in the years when the ancestors of the present Model were being articulated. The question arises as to how these measures should be reconciled with the provisions of existing treaties. Different modifications of the Model have been suggested to accommodate these developments. However, the value of such an approach is debatable because of the inflexible nature of the Model. Consequently, more and more countries resort to treaty override in order to boost the chances of success of their legislation. Treaty override, an American term, means that ‘the rules of a double taxation agreement can be superseded by a subsequent national law, making the treaty rules ineffective.’⁵⁹ Thus, in the U.S., the practice is that when a particular legislation is passed ‘that is at variance with the U.S. treaties, a transitional period is allowed for the treaty partners to agree to a protocol varying the treaty provisions to allow for the imposition of the new domestic law.’⁶⁰ Unfortunately, while in the past most countries regarded ‘treaty override as unlawful and immoral’, some now ‘behave as if treaty override is a minor misdemeanour’ rather than a serious breach of the requirement that an international agreement should be executed in complete good faith.⁶¹

⁵⁷ Russell, *supra* note 53, at 964.

⁵⁸ OECD (1992), *supra* note 1, Commentaries on Article 1 at C (1)-2 paras 7-26.

⁵⁹ H. Becker, ‘Treaty Override or: Beware of the Beginning’, (February 1997) 25 *Intertax* 38.

⁶⁰ Saunders, *supra* note 46, at 22. For example, the incidence of *The Foreign Investment in Real Property Act of 1980* (FIRPTA) modifying section 897 of the Internal Revenue Code on the U.S. treaties is explored in Rigby, *supra* note 26, at 401.

⁶¹ Becker, *supra* note 59, at 38.

Section II The Conventional Approach: Problems Specific to the Separate Accounting/Arm's length Method

The separate entity theory is based on the concept that, regardless of their juridical form, the various components of a TNC are to be treated, for taxation purposes, as if they are truly independent to each other.⁶² It therefore requires these entities to deal with each other at arm's length. Consequently, it assumes that their transfer prices are not biased by any relationship that may exist between them.⁶³

1 The Main Features and the Limitations of the Separate Accounting/Arm's Length Method

In theory, the separate entity/arm's length principle enables tax administrators to demand that dealings between related enterprises be commensurate with conditions prevailing in an open market where full and free competitive conditions prevail.⁶⁴ In practice, this objective is achieved, if at all, by means of a complex set of regulations in constant evolution and whose utility is debatable.

A The Classical Expression of the Arm's length Principle

In its classical expression, the arm's length principle refers to an arm's length price for a particular transaction.⁶⁵ The principle is thus applied on a transaction-by-transaction basis.⁶⁶ The application of the arm's length principle requires that a comparison be made between a controlled transaction and a transaction selected on the open market. A transaction is comparable to another if:

⁶² P. Musgrave, 'International Tax Base Division and the Multinational Corporation', (1972) 27 *Pub. Finance* 383, at 402.

⁶³ J.P. Le Gall, 'Some Thoughts on the Arm's Length Principle', (August 1994) 1 *International Transfer Pricing Journal* 5.

⁶⁴ OECD, Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995), at I-1 para. 1.2. (OECD 1995 Guidelines.)

⁶⁵ G. Maisto, General Report, 46th Congress of the International Fiscal Association, Cancun 1992, 'Transfer Pricing in the Absence of Comparable Prices', *Cahiers de Droit Fiscal International* (1992) Volume LXXVIIa 19, at 28.

⁶⁶ OECD 1995 Guidelines, *supra* note 64, at I17 para. 1-42. However, 'transaction' may comprise several controlled transactions that are appropriately aggregated if separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Often, it will also be necessary to define an arm's length range rather than focus on an elaborate search for 'a single figure' as one would have to do if a purely transactional basis is contemplated.

none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.⁶⁷

Therefore, insofar as market conditions contemporaneous with the transaction are known, the arm's length price needs to be established on the basis of data which are available to the taxpayer when the transaction occurred.⁶⁸

To determine an acceptable transfer price in the context of a particular case, tax administrators are required to perform what is called a functional and comparability analysis. A functional analysis is an exercise which focuses on the functions of the enterprise. The functions of an enterprise are those economically significant activities which are ultimately responsible for the enterprise deriving a profit or a loss.⁶⁹ In performing this functional analysis, regard must be had to the assets used by the enterprise and the risks it assumes. Thus, the whole objective is to find similar but not identical transactions and to match their prices.

B The Arm's Length Principle: Theoretical Problems

i. The Artificiality of the Arm's Length Principle

The major theoretical weakness of the arm's length principle is that it is based on the assumption that members of a global enterprise will treat each other as independent and separate entities subject to market forces in their dealings. The appropriateness of this assumption is open to doubt. In reality:

affiliates of a MNC would not necessarily be expected to treat other affiliates as wholly separate corporations or to choose arm's length prices for their transfers, since affiliation may give rise to a variety of synergistic effects which alter the costs and benefits of transacting intercompany business.⁷⁰

The existence of such synergistic gains was not unknown to Mitchell Carroll when he examined the question of allocation rules as reviewed in Chapter 1. He even conceded that the separate accounting/arm's length methodology he was advocating would not capture these gains.

It is obvious that the proportion of work to capital varies from business to business and that, in the alchemy of a successful business, the intangible, immeasurable element of brainwork is a very important factor, if not the most vital factor. This is impossible to measure accurately, and only

⁶⁷ *Supra* note 64, at I-7 para. 1.15.

⁶⁸ Maisto, *supra* note 65, at 28.

⁶⁹ OECD 1995 Guidelines, *supra* note 64, at I-9 para. 1.20.

⁷⁰ See Note, 'Multinational Corporations and Income Allocations Under Section 482 of the IRC', (1976) 89 *Harv L.R.* 1202, at 1215.

formal recognition is in the *préciput* ranging from 10 to 25 per cent of the total net profit which is allotted by the Swiss cantonal authorities to the seat of management.⁷¹

Since Carroll's time, much more is known about how TNCs operate.⁷² An enterprise chooses to operate as a TNC because this organisational structure produces synergistic efficiencies so that, in the aggregate, the members of a TNC earn more than the sum of what each party in the conglomerate would have earned had it operated individually. Therefore, the common acceptance of the 'fiscal myth' that every subsidiary or branch of a TNC is an entity separate from its parent or head office and is capable of dealing independently with either the parent or any other member of the group is at the very root of the problem relative to the allocation of income within the group. The ability for TNCs to act as a single mind in order to derive a competitive edge is the essence of the TNC. To ignore this and to reason on the assumption that intra-firm transactions should satisfy a hypothetical arm's length norm 'flies in the face of reality'.⁷³ The ultimate result of such a method is that it does not produce a fair division of income between related parties.⁷⁴

A TNC consists of an amalgamation of branches and subsidiaries. The OECD Model Treaty applies the arm's length principle to both permanent establishments and to subsidiaries.⁷⁵ The exact relationship between Article 7, which attributes income to a permanent establishment, and Article 9, which adjust profits between associated enterprises, is not clear. It has been argued that there is a close relationship between these two articles and that they are mutually exclusive.⁷⁶ If this is the case, then 'this has important consequences'⁷⁷ in terms of potential double taxation since, unlike Article 9, Article 7 does not have a corresponding adjustment provision.⁷⁸

⁷¹ M.B. Carroll, *Taxation of Foreign and National Enterprises (Volume IV) – Methods of Allocating Taxable Income, (Carroll Report)*, League of Nations Document No. C. 425. M. 217(b). IIA. (30 September 1933), at 191 para. 676.

⁷² See, for example J. Kay, *Foundations of Corporate Success* (Oxford: Oxford University Press, 1993).

⁷³ R.M. Bird, 'Shaping a New International Tax Order', (1988) 42 *Bull Int'l Fiscal Documentation* 292, at 294.

⁷⁴ Staff of Joint Comm. on Taxation, 99th Cong., 2nd Sess., *General Explanation of the Tax Reform Act of 1986* in M.M. Lewey, & S.C. Ruchelman, 'Section 482 - The Super Royalty Provisions Adopt the Commensurate Standard', (1987-1988) 41 *Tax Lawyer* 611, at 629.

⁷⁵ For a critique of the application of the arm's length principle to both branch and subsidiary operations, see Lee, *supra* note 35, at 678ff.

⁷⁶ P. Baker, *Double Taxation Agreements and International Tax Law* (London: Sweet and Maxwell, 1991), at 122.

⁷⁷ *Ibid*, n 19.

⁷⁸ The original Article III of the 1935 Draft Model Treaty does contain the adjustment provision; see Fiscal Committee, *Report to the Council on the Fifth Session of the Committee*, League of Nations Document C. 252.

The implementation of the arm's length principle may also lead to uncertainty and conflict between different taxation authorities.⁷⁹ In theory, arm's length prices should be equivalent to those that would be arrived at as a result of bona fide bargaining between independent enterprises. In practice, however, prices that are negotiated merely reflect the bargaining strength of the parties.⁸⁰ Thus '[e]conomic theory and practice strongly teach that the arm's standard can, at best lead to a range of reasonableness.'⁸¹

ii The Different Concepts of Arm's Length.

A divergence exists between the Anglo-Saxon and the European perception of the arm's length principle.⁸² In its classical expression, the arm's length principle postulates that, for taxation purposes, the financial and commercial relationships between the various components of a TNC need to be neutral. This neutrality is expressed either 'by reference to a result, i.e. a price' or 'by reference to a method, i.e. a bargaining'.⁸³ If the price arrived at by two associated enterprises is identical to that which either of them would have reached with an independent enterprise, it follows that the two associated enterprises have acted as if they were independent from each other. Conversely, if it is demonstrated that two associated enterprises in their financial relations behave as if they are completely independent from each other, then, notwithstanding their associated status, the economic result, that is, the price that they have agreed to, will be arm's length.

The second method of determining an arm's length price, the arm's length bargaining method, is not favoured by the OECD although it is admitted that TNCs 'often bargain with each other as though they were independent enterprises'. However, it is also admitted that 'evidence of hard bargaining alone is not sufficient to establish the dealings are at arm's length.'⁸⁴

M. 124. IIA (17 June 1935) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions* (Washington D.C.: U.S. Government Printing Office, 1962), at 4253-54.

⁷⁹ C. Chandler & I. Plotkin, 'Economic Issues in Intercompany Transfer Pricing', (20 October 1993) 2 *Tax Management Transfer Pricing, Special Report 2*.

⁸⁰ See L.J. Dicker & G.N. Carlson, 'The Proposed Transfer Pricing Regulations: Comments and Concern,' (1992) 45 *Nat'l Tax J.*, at 235-36 on the expectation-based approach relative to the determination of a present price for an intangible asset.

⁸¹ *Ibid.*

⁸² Le Gall, *supra* note 63, at 5. For an overview of the application of the arm's length principle in the U.S., Canada and Mexico, see L. Eden, 'The Arm's Length Standard in North America', Tax Analysts Document Number: Doc 2000-3645 (22 January 2000).

⁸³ *Supra* note 63, 6.

⁸⁴ OECD 1995 Guidelines, *supra* note 64, at I-2 para. 1.5.

Professor Le Gall believes that ‘a trend is developing towards a considerably different conception of the arm’s length principle.’⁸⁵ This trend, as evidenced by certain provisions in the 1979 OECD Report,⁸⁶ ignores reference to prices prevailing between independent parties. Instead, it purports to establish a price different from the market price and closer to what may be considered a normal price given the facts and circumstances. Thus, it is admitted that start up prices, or new market penetration prices, are acceptable although they may be different from strict market prices.

In the present context, it is less important to examine the reasons for this shift from the concept of ‘price identity (i.e. from a quantitative, objective analysis) to price normality (i.e. to a qualitative, subjective analysis)’⁸⁷ than to examine whether this trend is confirmed and the necessary consequences it may have in the transfer pricing area.

That this trend is now well established is evidenced by the OECD’s acceptance of transactional profit-based methods, albeit as methods of last resort. The existence of two schools of thought on the subject matter, one more or less Anglo-Saxon and the other rather European,⁸⁸ became quite apparent at the International Fiscal Association (IFA) Conference held in Cancun in 1992.⁸⁹

The major difference between the two approaches is the following:⁹⁰

- In the Anglo-Saxon model, the market dictates the behaviour of the entrepreneur. Consequently, the market fixes, in a mechanical and objective manner, both the transaction price and the profit margin.
- Conversely, the European approach places the entrepreneur at the centre of the price determination exercise and only his decision is submitted to control by comparing it to that of another entrepreneur faced with similar conditions.

In spite of the lobbying by European countries with the support of the International Chamber of Commerce,⁹¹ the OECD does not favour this approach, although it concedes that business

⁸⁵ Le Gall, *supra* note 63, at 6.

⁸⁶ OECD, Report of the OECD Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (Paris: OECD 1979), (OECD 1979 Report), at 29-31 paras 40-43.

⁸⁷ Le Gall, *supra* note 63, at 7.

⁸⁸ *Supra* note 63, 8.

⁸⁹ For the General Report, see Maisto, *supra* note 65.

⁹⁰ Lee has also illustrated the instability of the arm’s length principle, *supra* note 35, at 680.

⁹¹ See letter of the Secretary of the International Chamber of Commerce to the American Secretary of State and to Mrs Scrivener, then an official with the OECD, in Le Gall, *supra* note 63, at 9-10.

strategies must also be examined in determining comparability for transfer pricing purposes.⁹² Likewise, it is reasonable to say that the OECD does not particularly favour the Anglo-Saxon approach, although it did introduce two transactional profit methods in its 1995 Transfer Pricing Guidelines. However, the selected profit methods are perceived as satisfying the arm's length method⁹³ and are recognised 'as methods that assist in determining cases of last resort whether transfer pricing complies with the arm's length principle.'⁹⁴

It is submitted that the indecision of the OECD relates to its quasi aversion of fractional apportionment. Being the successor of the earlier League's models, the OECD Model actually proposes two methods of allocation of transnational income. The principal method is the separate accounting/arm's length, while the auxiliary method, referable only as a matter of last resort, is the method of fractional apportionment as per Article 7(4). The viability of this second method, it is true, is severely constrained by the requirements that its results satisfy the arm's length principle. In fact, these two methods may then be regarded as the extreme ends of a continuum. The advent of the profit methodologies has, in reality, shifted the focus towards the fractional apportionment methodology. In view of this shift, it is suggested that the OECD's objective is to ensure that the profit methodologies become the extreme end of the continuum rather than having this place occupied by the fractional apportionment methodologies. Thus recently, the OECD has been canvassing the possible removal of Article 7(4) from the Model. If this is achieved, then a new continuum will emerge with the separate accounting/arm's length at one end and the profit-based methodologies at the other.

iii The Practical Limitations of the Arm's Length Principle

The OECD advocates three traditional transaction-based methods and two transactional profit-based methods for ascertaining an arm's length price or result.⁹⁵ The two transactional profit-based methods, introduced in the 1995 Guidelines, are the Transactional Net Margin Method (TNMM), and the Profit-Split Method.

a The Direct Method: The Comparable Uncontrolled Price

In ascertaining an arm's length price, the 1995 Guidelines express a clear preference for the Comparable Uncontrolled Price Method (CUP). The CUP Method is viewed as 'the most

⁹² OECD 1995 Guidelines, *supra* note 64, at I-13 para. 1.31.

⁹³ *Supra* note 64, at III-1 para. 3.1.

⁹⁴ *Supra* note 64, at III-18 para. 3.54.

⁹⁵ G.N. Carlson et al., 'The U.S. Final Transfer Pricing Regulations: The More Things Change, the More They Stay the Same', (1 August 1994) 9 *Tax Notes Int'l* 5 333, at 334.

direct way to establish whether the conditions made or imposed between associated enterprises are arm's length.⁹⁶

Until the revision of the OECD 1979 Report, both business and tax administrators came to the view that the CUP Method had been applied too rigidly.⁹⁷ The 1995 Guidelines adopt a 'more flexible approach to enable the CUP Method to be used.'⁹⁸ However, there is still the need to make 'reasonably accurate adjustments'⁹⁹ in order to arrive at an acceptable standard of comparability between the controlled and uncontrolled transaction. In these circumstances, it is submitted that the CUP Method can no longer be regarded as an objective test since it requires the substitution of judgment on the part of taxing authorities.

The limitations of the CUP Method in the current context of international trade, where the share of services is constantly increasing, are becoming more apparent. It is undeniable that it served its purpose at a time when most transactions were basically of a manufacturing nature involving the processing of raw materials into finished goods. In such a model, there is a profusion of comparable transactions capable of generating an uncontroversial comparable price. This situation prevailed from the eighteenth century mercantile age up to the mid twentieth century. During this period, 'international related-party trade was not only limited compared with today, but also consisted primarily of fungible basic commodities and was backed up by customs officers at every port of entry.'¹⁰⁰ Today, specialised information, which by its nature is unique and invisible, is becoming rapidly the most traded commodity. Clearly, the CUP Method which proceeds on a transaction-by-transaction basis is unsuitable in the context of this type of trade.

Moreover, Professor Le Gall briefly explores yet another serious limitation of the CUP Method relative to competition law.¹⁰¹ A free market system is based on two ideas: Firstly, market forces will determine the price of a given commodity without any need for external intervention; and secondly, economic operators will adjust their prices to suit market

⁹⁶ OECD 1995 Guidelines, *supra* note 64, at II-2 para. 2.5.

⁹⁷ D. Hay, et al., 'Past and Present Work in the OECD on Transfer Pricing and Selected Issues', 9 *Tax Notes Int'l* (25 July 1994) 249, at 258. See also F.M. Horner, 'International Cooperation and Understanding: What's New About the OECD's Transfer Pricing Guidelines', (April 1996) 50 *University of Miami Law Review* 577, at 586.

⁹⁸ OECD 1995 Guidelines, *supra* note 64, at II-3 para. 2.9.

⁹⁹ *Supra* note 64, at II-3 para. 2.9. On the difficulties of making adjustments for such economically relevant factors such as 'volume discounts', 'location savings', 'market risks', and 'market penetration strategies', see D. R. Bucks & M. Mazerov, 'The State Solution to the Federal Government's Interpricing Problem', (September 1993) XLVI *National Tax Journal* 385, at 387.

¹⁰⁰ M. Mazerov, 'Why Arm's Length Fall Short', (February 1994) *International Tax Review* 28, at 30.

¹⁰¹ Le Gall, *supra* note 63, at 7-8.

conditions, for example, in order to penetrate or otherwise increase their share in a given market. The determination of prices in a free economy is, therefore, a dynamic process. This process inevitably produces a range of arm's length prices reflecting the economic strengths of each operator. The OECD acknowledges the existence of a range of arm's length prices. However, it maintains that the CUP Method, one which aligns a controlled transaction with an uncontrolled one, is most appropriate in determining transfer prices. Price alignment is condemned by competition law but:

[i]t is quite surprising to observe how the incompatibility of the C.U.P method with the law of competition is totally ignored by tax lawyers, who are no doubt locked within boundaries of their own discipline and blinded by it.¹⁰²

b The Indirect Methods

The OECD, however, recognises that there will be cases in which it would be unrealistic if not impossible, to apply the CUP Method. It therefore proposes other methods aimed at achieving a reasonable approximation of the arm's length price. These alternative methods, also known as the indirect methods, are: the resale price method, and the cost plus method.

In theory, the aim of the resale price method and the cost plus method is to determine an arm's length price in situations where the CUP Method is inapplicable. These two methods are variations of the CUP Method in that both take gross margin data from uncontrolled 'comparables', calculate gross margins, and apply these to a controlled transaction.¹⁰³ Basically, the resale price method entails deducting the gross margin from the selling price,¹⁰⁴ whereas the cost plus approach adds a gross margin, the so-called gross mark-up, to the cost of sales.¹⁰⁵ Such mark-up is determined by functional analyses carried out along the lines advocated by the OECD.¹⁰⁶ The use of the resale price method or the cost plus method is often necessary because of the unavailability of transaction-specific data.

A number of observations need to be made relative to the resale price and the cost plus methods. To start with, transfer prices that are calculated under these approaches suffer from the same limitations as those calculated under the CUP Method. Since all three traditional transactional methods rely on the existence of comparable uncontrolled transactions, their usefulness is severely limited in the absence of information concerning these uncontrolled

¹⁰² *Supra* note 63, at 7-8.

¹⁰³ Chandler & Plotkin, *supra* note 79, at 6.

¹⁰⁴ OECD 1995 Guidelines, *supra* note 64, at II-5 para. 2.14.

¹⁰⁵ *Supra* note 64, at II-11 para. 2.32.

¹⁰⁶ *Supra* note 64, at I-9 para. 1.20.

transactions. Thus, the lack of information may result in a failure to identify the most appropriate benchmarks available for determining the gross margin. It also becomes extremely difficult to determine ‘the specific adjustments needed to compensate for the attributes of the companies whose result give rise to the arm’s length benchmarks and the attributes of the related party whose arm’s length price is being determined.’¹⁰⁷ In addition, both the resale price and the cost-plus methods are one-sided solutions. The first concentrates on transactions from the point of view of the intercompany purchaser and thus neglects to put the intercompany supplier at par with an independent supplier, whereas the situation is the converse with the cost-plus approach. Consequently, this leads to a fundamentally different allocation of risks: all residual profits or loss are placed with the supplying location under the resale price approach and with the purchasing location under the cost plus approach.¹⁰⁸

Finally, in applying these methods a certain number of difficulties arise:¹⁰⁹

- first, it is difficult to convincingly determine that the uncontrolled prices used to develop arm’s length mark-ups over costs are in fact sufficiently comparable;
- second, the determination of the proper cost base to which the arm’s length mark-up should be applied is also fraught with uncertainties;
- third, problems inevitably arise when it becomes necessary to make adjustments for the inescapable differences between a firm’s proposed comparables and the controlled tested party; and
- fourth, with regard to the accepted concept of the arm’s length range, specific issues will still need to be solved.

Undoubtedly the transactional methods used to ascertain the arm’s length price have had reasonable success in a world where trade was primarily conducted on a bilateral basis since in these circumstances it is much easier to identify specific transactions. This bilateral trading pattern is now on the verge of becoming totally obsolete. The nature of present-day TNCs requires them to engage in activities which tend to benefit the group as a whole. This strategy generally renders the successful application of the arm’s length principle highly improbable. This situation is well documented in the case of services and intangibles where numerous judicial decisions have exposed the weaknesses of the traditional transactional

¹⁰⁷ Chandler & Plotkin, *supra* note 79, at 6.

¹⁰⁸ *Supra* note 79, at 6.

¹⁰⁹ E. King, *Transfer Pricing and Valuation in Corporate Taxation: Federal Legislation vs. Administrative Practice* (Kluwer Academic Publishers, 1994) 115.

methodologies.¹¹⁰ Such transactions consist of activities carried out for the joint benefit of many if not all of the companies in a TNC. This means that it is extremely hard for the tax administrator to identify a single transaction and then proceed to either find a CUP or an appropriate mark-up to satisfy the resale price or the cost plus methods.

Moreover, a relationship might appear to involve an outright bilateral relationship. Yet, on analysis it may well be found that in fact such a relationship involves several transactions. The unbundling of such transactions thus becomes an important preliminary step before any decision is taken as to who benefits from what in this sort of transaction. For example, one transaction may consist of two or more discrete dealings. A sale of a tangible such as an active ingredient in a drug may be paired with a simultaneous transfer of intangibles as well as the rights to the patents embodied in it. Similarly, a transaction may be reciprocal in the sense that ‘a patent licence will commonly include a grant-back clause for development patents, which must be dealt with by provisions for set-offs.’¹¹¹

Often it is extremely difficult to find comparable transactions suitable for the determination of an arm’s length price.¹¹² In other cases, the nature of the transaction prevents the use of one of the three traditional transactional methods. Until the publication of its 1995 Guidelines, the OECD left open the possibility for a party to rely on some other method to demonstrate that its transfer pricing policy satisfies the arm’s length principle. The 1995 Guidelines, however, now only allows for the use of two transactional profit-based methods to achieve this objective. While these two methods are thought of as satisfying the arm’s length principle, their use is however restricted to cases where the traditional transactional methods are likely to be unsuitable. In other words, their intervention is permitted as a matter of last resort. A full analysis of these transactional profit-based methods is carried out in a later chapter.

2 The Separate Accounting/Arm’s Length Principle in Practice

The enforcement and administration of the arm’s length principle are often viewed as being especially difficult in an increasingly globalised economy. The saga of the American tax authorities, and to a lesser extent the Australian authorities, illustrate this predicament.

¹¹⁰ See, for example, D.K. Dolan, ‘Intercompany Transfer Pricing for the Layman’, (8 October 1990) *Tax Notes* 211, at 217ff.

¹¹¹ S. Picciotto, *International Business Taxation* (London: Weidenfeld and Nicholson, 1992), at 194.

¹¹² For an attempt to create a database of transfer prices, see M. Cools, ‘International Commercial Databases for Transfer Pricing studies’, (1999) 6 *International Transfer Pricing Journal* (No. 5) 167.

A The American Experience

The IRS's experience in dealing with the arm's length concept is conveniently summarised in the Treasury *White Paper* published in 1988, and in three reports published by the U.S. General Accounting Office (GAO).¹¹³ These documents examine the magnitude of the problem and the causes of the apparent inefficiency of section 482 of the U.S. Internal Revenue Code (IRC).

The 1992 GAO Report documented a major difference between the tax yield of domestic corporations and foreign controlled corporations (FCCs).¹¹⁴ The Report nevertheless conceded that whether FCCs had minimised tax by setting improper transfer prices was unproven. The 1995 GAO Report confirmed the earlier findings that a majority of FCCs as well as U.S. - controlled corporations paid no U.S. income taxes.¹¹⁵

To remedy the situation a policing effort was suggested. The IRS launched a campaign of simultaneous audits with other tax authorities. However, from 1986 to 1990 the service conducted only 12 simultaneous audits, some of which did not involve transfer pricing. This low performance was ascribed to difficulties arising from differences in language and audit periods. The IRS also cited budget, staffing, and planning considerations as major hindrances to its audit effort. It is probably fair to say that the obvious reason for the non-enforcement of section 482 is the undue complexity of the regulations issued to implement this provision.

i The Difficulties With Section 482 Regulations

In 1968 the Department of Treasury promulgated regulations embracing the exclusive use of the separate entity/arm's length standard for income allocations under section 482.¹¹⁶ The Regulations required that commonly controlled entities be treated as if they were unrelated separate enterprises for the purpose of determining income from inter-company

¹¹³ United States, Department of Treasury & IRS, *A Study of Intercompany Pricing, Discussion Draft (White Paper)* (18 October 1988). See also General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices*, Report to the Ranking Minority Member, Committee on Foreign Relations (U.S. Senate GAO/GGD-92-89, 1992) (1992 GAO Report); General Accounting Office, *International Taxation: Updated Information on Transfer Pricing* Testimony Before the Committee on Governmental Affairs (U.S. Senate GAO/T-GGD-93-16, 1993) (1993 GAO Report); General Accounting Office, Report by the Comptroller General to the Congress *International Taxation: Transfer Pricing and Information on Nonpayment of Tax* (GAO/GGD-95-101, 1995) (1995 GAO Report).

¹¹⁴ 1992 GAO Report, *supra* note 113, at 22.

¹¹⁵ 1995 GAO Report, *supra* note 113, at 3. Again these findings have been confirmed in another more recent GAO report on these questions; see United States, General Accounting Office, *Tax Administration: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95*, (23 March 99) GAO/ GGD-99-39, (1999 GAO Report); see at <<http://www.gao.gov>>.

¹¹⁶ United States, Treas. Reg. § 1.482.

transactions.¹¹⁷ The method adopted by the Regulations requires the IRS to proceed through several steps. First, the fact of common control had to be established. Second, an examination of the inter-company transactions was required. The Commissioner, it was assumed, would then be in a position to decide whether a reallocation of income under section 482 was warranted.¹¹⁸ Notwithstanding this effort, the difficulty in applying the 1968 regulations is evidenced by the regular publication of numerous rulings and other regulations in the area of transfer pricing.

ii The Absence of Comparable Transactions

At first sight, the separate entity approach seems simple and easy to apply.¹¹⁹ There is no need to reconstruct all of the TNC's transactions as the performance of other affiliates of the TNC is irrelevant for the calculation of the audited one. In addition, the facts surrounding the relevant transaction may be found in the affiliate's own books.¹²⁰ Therefore, it is unnecessary for the IRS to draw on other information 'unless evidence of arm's length prices cannot be culled from the taxpayer's records of dealings with unrelated parties.'¹²¹ In reality, the application of the principle is fraught with several enforcement problems.

In 1986 the U.S. Congress was made aware of the loss in revenue arising from inadequate transfer pricing laws.¹²² Thus, the 1986 Tax Reform was initiated; section 482 was amended; the arm's length standard was reaffirmed; and its articulation strengthened.¹²³ Concurrently, the U.S. Treasury conducted an in-depth study of section 482 and its regulations. Its findings and recommendations were published in the so-called 1988 *White Paper*. According to the *White Paper*, the primary administrative difficulty with the enforcement of section 482 was that existing regulations were silent as to what method of income allocation ought to be used when

¹¹⁷ *Id.*, Treas. Reg. § 1.482-I (b) (I) (1968).

¹¹⁸ *Id.*, Treas. Reg. § 1.482-I (c) (1968).

¹¹⁹ R.G. Clark, 'Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures From Multinational Cacophony', (1993) 42 *Am. U. L. Rev.* 1155, at 1168 n 28.

¹²⁰ Musgrave, *supra* note 62, at 402.

¹²¹ See Note, *supra* note 70, at 1220.

¹²² United States, 136 CONG. Rec. H928 (daily ed. 20 March 1990) (statement of Rep. Rostenkowski pointing out that in 1986, foreign-controlled U.S. companies reported 'negative tax liability of over \$1 billion while also reporting over \$500 billion in gross income', in R.G. Clark, *supra* note 119, at 1168 n 130. This is an ongoing concern as evidenced by the most recent inquest of the U.S. Senate on this question; see 1999 GAO Report), *supra* note 115.

¹²³ United States, *Tax Reform Act of 1986*, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562 (codified at 26 U.S.C. § 482 (1988)).

comparable uncontrolled prices are non-existent. As a result of the *White Paper*, a serious effort was put to empower section 482.

iii The Subjective Nature of the Arm's Length Principle

In 1990, at transfer pricing hearings held by the Sub-committee on Oversight, House Committee on Ways and Means, the Joint Committee on Taxation emphasised the complexity of the regulations. The Joint Committee found that, regardless of which method is used for the determination of the arm's length price for tangible assets, controversy is most likely to arise between the IRS and taxpayers in establishing proper comparables.¹²⁴

In his testimony before the Joint Committee, the IRS Commissioner admitted that 'transfer pricing cases were inherently factual and subjective in nature'.¹²⁵ The Commissioner further acknowledged that these cases 'required a great deal of cost, pricing, and market data about a taxpayer and its competitors and, as a result, were extremely difficult, time consuming, and costly to develop'.¹²⁶ In short, the Commissioner admitted that because of inadequate resources, problems in accessing the books of the firm under examination, or inadequacy of documentation, section 482 and its regulations were incapable of efficiently countering international profit shifting.

B The Elusive Search for Effective Regulations

Recommendations of the Treasury *White Paper* and from the U.S. General Accounting Office, adverse results of litigation¹²⁷ as well as the hostility of practitioners and TNCs have undoubtedly spurred the U.S. authorities to produce regulations that would permit a more effective application of section 482.

In fact, as far back as 1968, regulations under section 482 had been issued.¹²⁸ However, these were not extensively used until the 1970s when the IRS started to audit American companies that had taken advantage of certain provisions of Puerto Rican legislation designed

¹²⁴ *Id.*, at 36.

¹²⁵ *Ibid.*

¹²⁶ *Ibid.*

¹²⁷ The IRS' difficulties in the litigation of transfer pricing cases are notorious. The IRS admitted that in 1990 only 3 of the 20 major transfer pricing cases that had been decided in court since 1964 were inbound. Inbound cases cover the prices a foreign parent corporation charges its controlled U.S. entity. The IRS lost all three; 1 in 1973 and 2 in 1985; see 1992 GAO Report, *supra* note 113.

¹²⁸ For the latest review of the origin of the U.S. regulations, see L. Eden, 'The Arm's Length Standard in North America' Tax Analysts Document Number: Doc 2000-3645 (22 January 2000).

to attract mainly U.S. investors.¹²⁹ A series of cases well known to practitioners in the transfer pricing area were litigated with limited success for the IRS.¹³⁰ It was felt within the IRS that the U.S. was being deprived of its fair share of taxes by the actions of powerful TNCs. Moreover, it also came to be known that the U.S. was fast becoming a net capital importer. Congress felt that it was opportune to demand that TNCs pay their fair share of taxes. It was widely felt that such action would affect mostly FCCs rather than U.S. - owned TNCs.

Tax reform was initiated¹³¹ through the *Tax Reform Act of 1986*. The so-called ‘super royalty provision’ in section 482¹³² was introduced amid claims by practitioners that the provision would generate more difficulties and that further guidance was required to facilitate compliance with the new provisions.¹³³

The super royalty or commensurate with income standard represents a novel approach to transfer pricing. It addresses more directly the transfer pricing question in two ways: First, it provides for a transfer pricing standard for the transfer of intangible; and secondly, it codifies transfer pricing methods that could be used under the so-called fourth methods.¹³⁴ The debate is still open as to whether such an approach is consistent with the arm’s length standard.¹³⁵

To implement the commensurate with income requirement, the IRS/Treasury published the so-called *White Paper*.¹³⁶ The methods proposed by the *White Paper* for achieving these

¹²⁹ Companies that set up operations in Puerto Rico were exempt from income tax save a ‘tollgate’ tax of 10 per cent on amounts repatriated.

¹³⁰ *Eli Lilly & Co. v Comr*, 84 TC 966 (1985); *G. D. Searle & Co. v Comr*, 88 TC 252 (1987); *Bausch & Lomb v Comr*, 91-1 USTC 933 F 2d 1084 (2nd Cir 1991); *Sundstrand v Comr*, 96 TC 226 (1991).

¹³¹ The first measures consisted of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) which amended section 936(h) so that companies with manufacturing affiliates in Puerto Rico came to be treated as contract manufacturers (the so-called Dole Rule) unless they ‘elect out.’ Companies choosing to elect out of the amended provisions were given two options: they had to engage in a cost sharing agreement, or they had to agree to a 50/50 split. Section 367(d) which provided that transfers of intangibles to foreign corporations in either an exchange described under section 351, or in a reorganisation under section 361, were to be treated as a sale of intangibles.

¹³² The additional sentence to section 482 reads as follows: ‘In case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.’

¹³³ R.L. Kaplan, ‘International Tax Enforcement and the Special Challenge of Transfer Pricing’, (1990) *Illinois Law Review* 299. See also N. Boidman, ‘Revenue Canada’s Transfer Pricing Circular: Selected Commentary’, (1988) 36 *Can. Tax J.* 405.

¹³⁴ Clark, *supra* note 119, at 1155.

¹³⁵ *Supra* note 119, at 1155.

¹³⁶ King, *supra* note 109, at 25. See also OECD, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations* (Paris: OECD, 1993), at 6 para. 1.24.

objective, the basic arm's length return method (BALRM) and BALRM with profit split,¹³⁷ gave rise to much controversy.¹³⁸ The *White Paper* was therefore not a popular document.¹³⁹ Numerous practitioners from all over the world have commented on it and often argued that it represents a departure from the arm's length standard.¹⁴⁰

Congress then directed Treasury 'to study application and administration of Section 482.'¹⁴¹ The ensuing report was published in April 1992 and a set of Proposed Regulations were issued in January 1992 (the 1992 Proposed Regulations) with a request for comments from treaty partners and other interested parties.¹⁴² In 1993 Temporary Regulations (the 1993 Temporary Regulations) were issued. The 1993 Temporary Regulations embraced the more acceptable provisions of the 1992 Proposed Regulations. They reverted, in a significant way, to a more accepted view of the arm's length principle¹⁴³ while significantly increasing the documentation that taxpayers are required to keep in order to justify their transfer pricing methodology.

It is interesting to note the convergence between the U.S. Treasury 1993 Temporary Regulations and the OECD's position on the transfer pricing question. The wide criticism of the 1992 Proposed Regulations prompted the OECD to release its views on the latter and its suggestions as to ways of making them more acceptable generally.¹⁴⁴ In its 1993 Temporary Regulations, the U.S. Treasury took into account some of the recommendations of the OECD and modified the radical approach adopted in the 1992 Proposed Regulations. In a second report, the OECD pursued the matter and highlighted the remaining differences.¹⁴⁵

¹³⁷ They were the so-called exact and inexact comparable methods, see *White Paper*, *supra* note 113, at 485-90.

¹³⁸ C. Chandler, 'Economic Issues in Intercompany Transfer Pricing', (October 20, 1993) 2 *Tax Management Transfer Pricing, Special Report* (No. 8) 27. See also E. Sunley et al., 'United States Section 482 White Paper' in F. C. de Hosson, ed., *Transfer Pricing for Intangibles: A Commentary on the White Paper*, (Kluwer 1989).

¹³⁹ OECD, *Intercompany Transfer Pricing Regulations Under Section 482 Temporary and Proposed Regulations* (Paris: OECD, 1993).

¹⁴⁰ See for example, Stoffregen et al., 'The BALRM Approach to Transfer Pricing: One Step Forward, Two Steps Back', (6 March 1989) 42 *Tax Notes* 1257.

¹⁴¹ OECD (1993), *supra* note 139, at 7 para. 1.25.

¹⁴² United States, Department of Treasury, Internal Revenue Service, *Report on the Application and Administration of Section 482* (Department of Treasury, 1992).

¹⁴³ 'New Pricing Rules Seen Offering Flexibility, Requiring Added Documentation', *Int'l Bus. & Fin. Daily (BNA)*, at 1 (19 January 1993), available in LEXIS, Nexis Library, Omni File.

¹⁴⁴ OECD (1993), *supra* note 139.

¹⁴⁵ *Supra* note 139, at viii para. 8.

The process of implementation of the provisions of the *Tax Reform Act of 1986* was concluded on 1 July 1994 with the release of the Final Regulations under section 482. These provide for extensive guidance: first as to the comparability of third-party data, and second as to the choice of a specific method to assess whether the results of inter-company transactions satisfy the arm's length standard.¹⁴⁶

The publication of the Final Regulations in July 1994 coincided with the release of the OECD Draft Guidelines on Transfer Pricing and Multinational Enterprises.¹⁴⁷ What is immediately apparent is that the reasonableness of many of the suggestions made by the OECD in its critique of the 1992 Proposed Regulations and the 1993 Temporary Regulations had been recognised. In fact, the OECD and United States officials had worked in close collaboration in their endeavour 'to reach internationally acceptable solutions to the problems addressed by these regulations.'¹⁴⁸

Yet, these regulations illustrate the difference of approach towards transfer pricing between European countries and the U.S. During the Coopers & Lybrand's European Tax Conference held in New York on 30 April 1996, Nick Raby, a director in the Coopers & Lybrand International Transfer Pricing practice based in Washington DC, surveyed some of these differences.¹⁴⁹ He claimed that there is a fundamental divergence between the OECD Guidelines and the U.S. regulations. The OECD Guidelines favour a subjective test that focuses on behaviour, given that it concentrates on how transfer prices are set. For its part, the U.S. Regulations require an arm's length result.¹⁵⁰ This is an objective test that focuses on taxable income. The IRS monitors the correctness of the tax base and focuses on the objective test for evidentiary reasons. The IRS also believes that only an objective test is consistent with the arm's length standard. The OECD, for its part, favours a more subjective approach in the determination of the arm's length standard. Therefore, the interaction of these two methods

¹⁴⁶ G. Carlson et al., 'The U.S. Final Transfer Pricing Regulations: The More Things Change, the More They Stay the Same', (2 August 1994) *Tax Notes Int'l* 333.

¹⁴⁷ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators: Discussion Draft* (Paris: OECD, 1994).

¹⁴⁸ OECD (1993), *supra* note 139, at 7 para. 1.28.

¹⁴⁹ S. Pope, 'Recent European Tax Developments - Coopers & Lybrand European Tax Forum', (24 June 1996) 12 *Tax Notes Int'l* 2006, at 2009.

¹⁵⁰ For many taxpayers, avoiding transfer pricing penalties has become more important than the double taxation risk. Indeed, the heavy penalties imposed by IRC section 6662 have arguably incited taxpayers to report an arm's length result notwithstanding that 'section 482 contains no such mandate and historically has been interpreted as allowing only IRS to disregard actual transaction prices'; see H.J. Birnkrant & J.E. Crocker, Jr., 'Transfer Pricing Final Regs. Increase Flexibility, but Not Certainty, in Choice of Methods', (1994) 81 *J. Tax'n* 268, at 269.

causes serious difficulties. The problem is compounded by the fact that in Western European systems the burden of proof for the arm's length standard rests with tax administrations, whereas in the U.S. it rests with the taxpayer.

To conclude, in spite of the new OECD Guidelines and the elaborate regulations in the U.S. and elsewhere, for example in Australia, it is doubtful whether the transfer pricing question can be satisfactorily solved within the parameters set by the arm's length principle.¹⁵¹ In view of the numerous difficulties of applying the arm's length principle, it is arguable that the U.S. Treasury has not closed the door to formulary apportionment. Indeed, in a press release dated 18 October 1995, Treasury noted that 'if in the future the arm's length principle becomes unworkable, then we will work with our trading partners to develop a cooperative multilateral solution.'¹⁵²

C The Australian Experience

As early as 1926 the Australian Taxation Office became aware of the problem of international profit shifting (IPS) in the oil industry.¹⁵³ There was, however, no substantial effort to stem the perceived loss of tax revenue until well into the 1980s. By that time, however, the problem had reached such proportions that in its 1987 report the Australian Auditor-General even proposed to apply formulary apportionment to share TNCs profits.¹⁵⁴

Various provisions applicable to international transactions are scattered throughout the *Income Tax Assessment Act 1936* (the ITAA 1936), for example, section 255 relative to persons in receipt or control of money from non-residents. Indeed, the general anti-avoidance provisions commonly referred to as Part IVA would seem to cover most transfer pricing situations.¹⁵⁵ Prior to 1982, section 136 of the ITAA 1936 purported to protect the Australian tax base from IPS. However, section 136, as it was then drafted, failed to achieve its purpose. Thus, since at least 1975, the Taxation Review Committee (the Asprey Committee) in its full report

¹⁵¹ Mazerov, *supra* note 100, at 28.

¹⁵² See C.E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', (7 April 1997) 75 *Tax Notes Int* 1 859, at 860.

¹⁵³ Australia, The Auditor-General, *Australian Taxation Office: International Profit Shifting*, Efficiency Audit Report (Canberra: AGPS, November 1987), at 18.

¹⁵⁴ *Ibid.*

¹⁵⁵ For a discussion on the application of Part IVA to international transactions, see Australia, The House of Representatives Standing Committee on Finance and Public Administration, *Tax Payers or Tax Players, A Further Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting* (Canberra: AGPS, 1989), at 92. See also *Spotless Services Ltd & Anor v FC of T* 77 ATC 4397, and *WD & HO Wills (Australia) Pty Ltd v FC of T* 96 ATC 4223.

noted that ‘the section does not give the Commissioner adequate power’.¹⁵⁶ Reform consisted in introducing, in 1982, a new set of measures, known as Division 13, to deal with IPS.

Under Division 13, the Commissioner is required to substitute arm’s length prices in lieu of the prices adopted if certain conditions are met. Any adjustment to taxable income arising from that substitution is then taxed at the appropriate rate. Division 13 applies both to separate entities and to head office and/or branches located in different jurisdictions. In addition, all of Australia’s DTAs are premised on the arm’s length principle.

Australia firmly believes in the adequacy of the arm’s length principle.¹⁵⁷ Division 13 of the ITAA 1936 enshrines the standard in Australian law, and a series of Rulings by the ATO aim at giving guidance to taxpayers for its correct application in different circumstances.¹⁵⁸ The ATO’s strategy at the present is to focus on compliance with the arm’s length standard through the application of three measures¹⁵⁹ which are:

- the Transfer Pricing Record Review program,
- the APA program, and
- section 25A disclosure statements.

Yet, Australia is not a stranger to formulary apportionment. As already mentioned, one of the country’s most important administrative authorities, the Auditor-General, has called for the implementation of a formulary type of apportionment in lieu of the arm’s length principle. Moreover, since 1938, the Commissioner of Taxation has applied a formula, the so-called Ewing Formula, to allocate interest expenses within the banking industry.¹⁶⁰ Finally, pursuant to

¹⁵⁶ Taxation Review Committee, *The Asprey Committee Full Report* (Canberra: AGPS, 1975), at 267, (*Asprey Report*).

¹⁵⁷ Australia, The House of Representatives Standing Committee on Finance and Public Administration, *Shifting the Tax Burden? An Interim Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting*, (Canberra: AGPS, 1988); The House of Representatives Standing Committee on Finance and Public Administration, *Tax Payers or Tax Players, A Further Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting*, (Canberra: AGPS, 1989); The House of Representatives Standing Committee on Finance and Public Administration, *Follow the Yellow Brick Road: The Final Report on an Efficiency Audit of the Australian Taxation Office: International Profit Shifting*, (Canberra: AGPS, 1991).

¹⁵⁸ To access these rulings see at <www.ato.gov.au>.

¹⁵⁹ For a brief description of these products, see D. Lewis and F. Putrino, ‘Transfer Pricing Update: Australia’, (24 April 2000) 20 *Tax Notes Int’l* 1884.

¹⁶⁰ J. Brookes & A. King, ‘The Allocation of Capital to Foreign Bank Branches’ (1998) ATO Staff Working Papers (DRAFT), at 3.

a higher portion of the world's Gross Domestic Product (GDP).¹⁶⁷ Clearly, the economic foundations on which Carroll based his conclusions are no longer applicable.

A. International Economic Integration

At the end of the Second World War a novel economic system was inaugurated. The Bretton Woods System was based on three new organizations:

- the General Agreement of Trade and Tariffs (GATT),¹⁶⁸
- the International Monetary Fund (IMF), and
- the International Bank for Reconstruction and Development (IBRD), commonly known as the World Bank.

In brief, the purpose of these organisations was to respectively implement a liberal free trade system, alleviate balance of payments problems, and to provide investment finance.¹⁶⁹

The foundation of the *Bretton Woods System* was the convertibility of the dollar into gold. The system prevailed with relative success until May 1973 when the dollar became non-convertible and was allowed to float with all other currencies in order to reach its natural exchange parity. The advent of floating currencies had dramatic consequences on exchange rates, shipping costs, and the general level of prices throughout the world. A revolution in the way international business is carried out was ignited.

Concurrently, the world experienced the dual oil price shock of 1974 and 1981 which inaugurated a period of macro-economic instability in most Western economies. Higher levels of unemployment and inflation became the norm. In addition, some of the gains achieved in multilateral negotiations through the GATT to reduce tariff protection were undermined by the rise of non-tariff protectionism. The ultimate result was a general slow-down in the growth of world output and trade.¹⁷⁰

¹⁶⁷ Avi-Yonah, *supra* note 7, at 1350. For the latest figures on foreign direct investments on a worldwide basis, see United Nations, DESA, *World Economic Situation And Prospects for 1999*, at <<http://www.un.org/desa>>.

¹⁶⁸ The GATT was not, strictly speaking, an international organisation. It was not created at Bretton Woods but was, however, a strong part of the system created there. It has now been supersede by the World Trade Organisation (WTO); see D. Wallace, Jr., *International Regulation of Multinational Corporations* (New York: Praeger Publishers, 1976), at 4.

¹⁶⁹ R.D. McKinlay & R. Little, *Global Problems and World Order* (London: Frances Pinter, 1986), at 91.

¹⁷⁰ H. Stretton, *Inefficiencies of Global Capital Markets*, (December 1998) United Nations, Department of Economic and Social Affairs, Discussion Paper No. 2 ST/ESA/1998/DP.2, see at <<http://www.un.org/desa>>.

A second significant change in the world economic map resulted from the relative decline of the U.S. role in the world economy.¹⁷¹ This loss in the U.S. share did not accrue to one nation in particular but to a certain number of nations in Europe and along the Pacific Rim. The relative decline of the U.S. was, however, counterbalanced by the gradual emergence of the European Union as a significant economic unit, consisting of a single market regrouping some of the world's highest purchasing powers. In addition, the conversion of the Eastern European economies from centrally planned to market economies will no doubt further expand European influence in world trade.¹⁷²

On the political front, there has been a dramatic increase in the number of sovereign governments due to decolonisation and, more recently, to the fragmentation of the former Soviet Union. The ultimate result of this change is that today the repositories of political power are more diverse. In 1944, only 44 nations attended the conference at Bretton Woods which gave birth to the International Monetary Fund. As at 5 September 1999, the member countries of the IMF totalled 182,¹⁷³ thus compounding the problem of coordinating the taxation system of such a vast number of countries. In addition, competition for scarce capital is now a pervasive feature of the international economy.¹⁷⁴

Most industrialised countries have rationalised their industries with the view to enhancing their competitive capabilities. Financial and exchange controls have been liberalised or even abolished, and many countries have eased restrictions on foreign ownership and the international movement of capital.¹⁷⁵ A general trend in taxation reform aimed at rationalising both domestic and international taxation has also been initiated.¹⁷⁶

¹⁷¹ P.R. Merrill & R.J. Patrick, 'U.S. International Tax Policy for a Global Economy', (Fall 1991) *NTA Forum*, at 1-2.

¹⁷² *Id.*, at 2. Other countries now wish to duplicate the positive results of establishing coherent free markets. Thus, for example, the creation of the North American Free Trade Agreement (NAFTA), the Asia-Pacific Economic Co-operation (APEC) and the Indian Ocean Rim Association for Regional Co-operation, have again created new opportunities.

¹⁷³ IMF Homepage, at <<http://www.imf.org>>.

¹⁷⁴ M. Gammie, 'Reforming Corporate Taxation: An Evaluation of the United States Treasury Integration Proposals and other Corporate Tax Systems in an International Context-Part I', [1992] 3 *BTR* 148, at 158.

¹⁷⁵ G. de Jonquiere, 'Des Réformes qui ne sont pas allées assez loin,' in *The Great Debate: Financial Times/Le Monde Diplomatique*, *supra* note 163, at 14-15.

¹⁷⁶ While it may be true that tax reform in major industrialised countries could have been ignited by the U.S. *Tax Reform Act of 1986*, there is evidence to show that major tax law changes which occurred in other countries such as in the U.K., for example, were made not as a reaction to the U.S. change, but were the necessary response to the same political and economic forces that led to the U.S. Tax Reform Act; see H. Grubert, W.C. Randolph & D.J. Rouslang, 'Country and Multinational Company Responses to the Tax Reform Act of 1986', (1996) 49 *National Tax Journal* 341, at 349. Australia is at this moment experiencing tax reform on a wide scale. Thus, for

Changes in technology have also been dramatic and fuelled the globalisation phenomenon.¹⁷⁷ New technologies, especially in the communication industries, have enabled TNCs to truly achieve their primary outcome, that is, the internationalisation of their business activities.¹⁷⁸ There is no doubt that this trend is accelerating with the explosive growth of electronic commerce through the Internet. These developments now require the full international cooperation as their effects permeate various spheres of activities as recognised by the finance ministers of the G-8 countries.¹⁷⁹

In short, on the politico-economic front, the world has moved from an aggregation of different national economies to interdependence and integration thereby uncovering the inherent weaknesses of the present taxation model which was established in the mid 1920s.

B The Proliferation of TNCs

TNCs have a long history. One of the earliest was the Dutch East India Company founded in 1602. What is obvious is that the economic paradigm inaugurated in the 1950s, and refined in the 1980s, created the ideal conditions for their expansion.¹⁸⁰ From the TNCs' viewpoint, globalisation primarily means 'the increased integration of resources and capabilities which may then be transferred anywhere within the multinational firm'¹⁸¹ Consequently, rather than blindly following known models, it comes as no surprise that these enterprises are constantly exploring new ways to engage in international business such as, for example, the emergence of strategic alliances. These are:

example, a Goods and Services Tax has been introduced with consequential reduction in corporate income tax and further in-depth business tax reform is being implemented; see Australia, *Review of Business Taxation: A Tax System Redesigned, (Ralph Report)* (Canberra: AGPS, 1999).

¹⁷⁷ J. Cantwell, 'Transnational Corporations and Innovative Activities', in *Transnational Corporations and World Development* (International Business Press, 1996), at 145.

¹⁷⁸ The dual effect of this evolution in communication can be summarised as follows: first, it lowered worldwide communications and transportation costs, thereby enabling TNCs to adopt global strategies; second, through mass advertising in the media, especially television, it encouraged the standardisation of products as people in different countries are driven to adopt the same style of living and use the same products; see M.E. Porter, 'Competition in Global Industries: A Conceptual Framework', in M.E. Porter, ed., *Competition in Global Industries* (Boston: Harvard Business School Press, 1986), at 54-55.

¹⁷⁹ See M. Kohiji, 'G-8 Finance Ministers Discuss World Economy and Tax Issues', Tax Analyst Document Number: Doc 2000-18789 (July 10, 2000).

¹⁸⁰ D. Wallace, Jr., *International Regulation of Multinational Corporations* (New York: Praeger Publishers, 1976), at 8.

¹⁸¹ A.K. Gupta & V. Govindarajan, 'Organizing for Knowledge Flows Within MNCs', (1994) 3 *International Business Review*, at 443-457.

agreements between firms in which each commits resources to achieve a common set of objectives. Companies may form Strategic Alliances with customers, suppliers or competitors. Through Strategic Alliances companies can improve competitive positioning, gain entry to new markets, supplement critical skills, and share the risk or cost of major development projects.¹⁸²

The introduction of new production processes has resulted in increased competition between producers.¹⁸³ The particular advantage now sought by TNCs is speed in the exploitation of new inventions and innovations with the view to increasing efficiency and thus gaining an appreciable competitive edge. Moreover, the most significant aspect of this change is that now there is a fundamental dislocation in manufacturing processes. In the past, the process in the creation of a product (or a service), from its conception to the finished good, was usually located in one jurisdiction. Today, these same processes are more widely distributed so that it is no longer possible to identify a purely national product.¹⁸⁴

These changing conditions have pushed TNCs to ‘focus more on exploiting their ownership advantages, in part by undertaking activities abroad in conjunction with specific factors (such as labour and government) of foreign countries.’¹⁸⁵ Concomitantly, some governments are endeavouring to protect local enterprises from intense global competition in order to enable these industries to become global companies and to compete with other governments for investment by TNCs,¹⁸⁶ while others favour a constant phasing out of protective measures in order to force their industries to submit to the rules of the free market.

In any event, the emergence of global economic models seriously hinders governments’ ability to impose national taxation systems based on traditional methods. In this new world order, familiar bearings are non-existent. What is required is a worldwide coordinated approach to the taxation of TNCs.

At this stage a brief study of the TNC is necessary to understand the significance of such an organisation on the present system which purports to tax the gains it derives from its various activities. The most recent theoretical study of TNCs may be divided into three phases. The

¹⁸² See Bain & Company, at <<http://www.bain.com/capabilities/t-strategicalliance.html>>. See also J.F. Moore, *The Death of Competition: Leadership & Strategy in the Age of Business Ecosystems*. (Harper Business, 1997).

¹⁸³ K. Ohmae, ‘Getting Back to Strategy’, in D.J. Lecraw & A.J. Morrison, eds., *The United Nations Library on Transnational Corporations, Transnational Corporations and Business Strategy*, (New York: Routledge, 1993), Vol. 4, at 194.

¹⁸⁴ R.B. Reich, ‘Multinational Corporation and the Myth of National Origin’, (Summer 1991) *Harvard International Review* 15.

¹⁸⁵ Australia, Bureau of Industry Economics, ‘Multinationals and Governments: Issues and Implications for Australia’, in *Bureau of Industry Economics Research Report 49* (Canberra: AGPS, 1993), at 13.

¹⁸⁶ M.E. Porter, ‘Competition in Global Industries: A Conceptual Framework’, in M.E. Porter, ed., *Competition in Global Industries* (Boston: Harvard Business School Press, 1986), at 6.

first phase starts from 1960 with a doctoral thesis authored by Stephen Hymer.¹⁸⁷ In his thesis, Hymer argued that the orthodox theory of international trade and capital movements did not explain the foreign operations of MNCs. In particular, it did not explain the two-way flows of FDI between countries, and still less between countries with similar factor proportions. His explanation of why firms move abroad and establish international production was based on a theory of the firm and industrialised organisation.¹⁸⁸ Three decades of further research have led to the conclusion that ‘a TNC must have some advantage to offset the additional costs of running its operation, compared with domestic rivals.’¹⁸⁹ Hymer believed that firms expand abroad because they possess firm-specific ‘ownership advantages’, for example, intangibles that do not show on a balance sheet and whose protection and exploitation required foreign expansion.¹⁹⁰

The second phase in the study of the TNC is characterised by the so-called internalisation theory advanced independently by a number of theorists.¹⁹¹ Internalisation theory is an extension of various theories, for example, the ‘transaction cost’ theory, which aimed at explaining the origin and nature of firms. To the first proponent of the theory, Ronald Coase,¹⁹² firms and markets were alternative forms of economic organisations and subject to a process of substitution, akin to the process by which classical microtheory conceives of producers selecting among substitutable factors of production, or consumers among products or services. According to Coase, the basis for substitution is transaction cost. Markets organise activities if the transaction costs of the market are less than those of the firm. In the converse situation the firm is able to cut back on transaction costs. From these principles, an attempt is made, not at explaining why firms expand overseas, but rather why, when firms do expand overseas, they tend to do so through integrated enterprises in lieu of, for example, licensing agreements or plain exports. According to the internalisation theory, multinational integration occurs to

¹⁸⁷ S.H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investments* (Cambridge, Mass: MIT Press, 1976).

¹⁸⁸ J. Cantwell, A Survey of Theories of International Production, in *The Nature of the Transnational Firm* C.M. Pitelis & R. Sugden, eds, (London: Routledge, 1991) 16, at 18.

¹⁸⁹ Y. Aharoni, ‘The Organization of Global Services MNEs’, *International Studies of Management and Organization* v 26 n 2, at 6-23, at <<http://dialog.krinfo.com>> item 01316098. For a critical view of the beneficial effects of the emergence of a global service industry, see J.R. Saul, *Voltaire’s Bastards* (Penguin Books, 1992).

¹⁹⁰ G.C. Hufbauer & J.M. Van Rooij, *U.S. Taxation of International Income: Blueprint for Reform* (Washington D.C.: Institute for International Economics, 1992), at 77.

¹⁹¹ See S.I. Langbein, ‘A Modified Fractional Apportionment Proposal for Tax Transfer Pricing’, (10 February 1992) *Tax Notes* 719, at 722 n 28 for a list of the major works of these authors.

¹⁹² R.H. Coase, ‘The Nature of the Firm’ (1937) 4 *Economica* 4.

obviate certain hazards.¹⁹³ Thus, for example, forward integration into distribution occurs to reduce the uncertainty inherent in the exploitation of valuable intangible property. First, internalisation reduces the risk of appropriation of the intangible property by competitors; and secondly, internalisation eliminates the hazard of reputation debasement, that is, an unrelated distributor might have an incentive to ‘free ride’ by lowering quality or reducing after-market service to control its own cost, thus damaging the reputation of the firm. Moreover, even if the firm does not possess valuable intangible property, it may still suffer if there is a certain debasement of what is termed its ‘assets specificity’ by unrelated firms. In other words, what is feared is that unrelated producers intervening at one of the production stage could, by holding up a vital stage in the production process, debase the value of the specific assets of the producer, thus holding to ransom large assets specific to the whole production process. Finally, there is a quality debasement hazard obviated by integration since the latter facilitates standardised quality control.

A third stage in the theory of the TNC is an attempt to synthesise these various theories. Dunning carried this out with his eclectic theory.¹⁹⁴ Other researchers, rather than focusing on economic factors, have studied the internal issues of firms’ operations.¹⁹⁵ Towards the end of the 1980s the search concentrated on management issues.¹⁹⁶ In short, these studies suggest that the primary success of the TNC may be explained by the fact that they are able to internalise the transfer of technology and of management skills across national boundaries in a kind of ‘coordinated federations’ or ‘centralized hubs’ where the overall result of the firm remains the key outcome.¹⁹⁷

The present phase in the evolution of TNC may be described as one based on strategic alliances between enterprises that are not under common control. For example, the emergence

¹⁹³ Langbein, *supra* note 191, at 723.

¹⁹⁴ J.H. Dunning, ‘Trade, Location of Economic Activity, and the Multinational Enterprise: A Search for the Eclectic Theory’, in B. Ohlin, P.O. Hesselborn & P.M. Wijkman eds, *The International Allocation of Economic Activity*, (London: Macmillan, 1977); J.H. Dunning, ‘The Eclectic Paradigm of International Production: An Update and Some Possible Extensions’, (1988) 19 *Journal of International Business Studies* 1; J.H. Dunning, *Multinational Enterprises and the Global Economy* (Workingham: Addison Wesley, 1993).

¹⁹⁵ A. Rugman, *Inside the Multinationals: The Economic of Internal Markets* (New York: Columbia University Press, 1981).

¹⁹⁶ See, for example, S. Ghoshal and N. Nohria, ‘Internal Differentiation Within Multinationals’, (1989) 9 *Strategic Management Journal* 9 and S. Ghoshal and E. Westney, *Organizational Theory and the Multinational Corporation* (New York: St. Martin Press, 1993).

¹⁹⁷ For an insight into the theory of clusters, see H. Stretton, ‘Inefficiencies of Global Capital Markets’, (December 1998) United Nations, Department of Economic and Social Affairs, Discussion Paper No. 2, ST/ESA/1998/DP.2, at <<http://www.un.org/desa>>, at 3, 9.

of joint ventures aimed at maximising profits as well as reducing costs. Thus, in the banking sector, operators are increasingly combining their back-office functions in order to achieve economies of scale and synergies. In certain circumstances, these strategies may be considered as a backdoor device to circumvent regulations preventing the creation of mega-banks. In short, while TNCs are jealous of their firm-specific 'ownership advantages', there is an increasing tendency to streamline operations which are remotely connected to their core strengths in order to either gain specific economic advantages or to circumvent national regulations.

What all these theories postulate is that TNCs aim at maximising global profits rather than maximising the profits of each of its individual units. The major tax policy implication of these findings is that a system designed to determine transnational profits on a separate accounting/arm's length standard is difficult if not impossible to apply and should be jettisoned in favour of some consistent formula applied on a worldwide basis. Thus, tax policy would match TNCs' own strategies.

2 The Separate Accounting/Arm's Length Standard and the TNC

In the increasingly integrated world economy it is likely that transactions between related entities will intensify. Such complex transactions involving intermediate goods and high-technology product will continue to undermine the theoretical rationale upon which the arm's length principle is constructed. In the words of Richard Cave:

[T]he transactional model of the MNE holds that international firms arise in order to evade failures of certain arm's length markets, especially those for intangible assets. Premier among those assets is the knowledge that represents new products, processes, proprietary technology, and the like. Thus theory implies and empirical evidence confirms that MNEs appear prominently in industries marked by high expenditures on R&D [Research and Development] and rapid rates of new product introduction and productivity advance...MNEs arise because of shortcomings of the arm's length markets for intangible assets and statistical evidence establishes the prominence of MNEs in high R&D industries.¹⁹⁸

After all, organisational theory holds that the profitability of a TNC is largely attributable to the organisational form itself. Indeed, because of its organisation, a TNC is able to reduce transaction costs, achieve integration economies and exploit intangible assets which often cannot be localised.¹⁹⁹ One of such costs is taxation. Since the very survival of TNCs is based

¹⁹⁸ R.E. Caves, 'Multinational Enterprises and Technology Transfer', in A. Rugman, ed., *New Theories of the Multinational Enterprises* (New York: St Martin's Press, 1982) 254, at 260.

¹⁹⁹ S.I. Langbein, 'Transaction Costs, Production Costs, and Tax Transfer Pricing', (1989) 44 *Tax Notes* 1391, at 1407ff. The OECD acknowledges the problem of applying the arm's length standard in these situations.

on their ability to reduce costs, and that taxation is one of such costs, it follows that whatever the response of governments to transfer pricing, TNCs will always seek to minimise taxation.

A The Response of TNCs: Financial Manoeuvring

In response to taxation authorities' focus on traditional transfer pricing issues, TNCs often respond by engaging in elaborate financial manoeuvring in order to minimise their global tax bill.²⁰⁰ Financial manoeuvring involves the use of inter-corporate financing techniques to achieve an optimum allocation of resources within a group of companies. If driven by tax considerations, financial manoeuvring aims at shifting taxable income from high tax to low tax countries.²⁰¹ It consists primarily of achieving a desired level of inter-company lending and/or the allocation of third party debt among affiliates.²⁰²

i Thin Capitalisation

Inter-company lending is a prime example of financial manoeuvring.²⁰³ It involves the manipulation of the debt-to-equity ratio of a TNC's subsidiaries as well as adjusting the rate of interest charged for inter-company loans. Thin capitalisation is a term describing companies with a high ratio of debt-to-equity or shareholder's funds.²⁰⁴ It occurs when subsidiaries are deliberately capitalised with a high debt ratio to strip out profits by interest deductions.²⁰⁵

However, its only answer is to reaffirm the soundness of the standard even in these situations. See OECD 1995 Guidelines, *supra* note 64, at para. 1.13.

²⁰⁰ See R.A. Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises', (1993) 79 *Cornell Law Review* 18, at 46ff.

²⁰¹ Hines, *supra* note 27, at 21.

²⁰² The result of such action is revenue loss to the order of \$740 billion over 20 years with an average of \$37 billion a year according to Dan Bucks, Executive Director of the Multistate Tax Commission; see C. Hubbard, 'Transfer Pricing Siphons billions in Revenues, MTC Official Charges', (1992) 56 *Tax Notes* 546. However, while TNCs may find it attractive from a taxation point of view to engage in financial manoeuvring, their actions may be inhibited by other non-tax considerations. For example, a TNC's affiliate may have access to cheap subsidised government loans, or it may require the affiliate to borrow locally in order to decrease political and foreign exchange risks. Indeed, by requiring the affiliate to borrow locally the TNC may even decrease its agency costs given that it may rely on the local lender to monitor the performance of the affiliate. Again, local borrowing may prove to be an adequate way of diversifying the group's source of funds. Notwithstanding all these considerations, TNCs would still have the ability to select whatever financial engineering technique that would enhance their global results. See also R. Gropp & K. Kostial, 'The Disappearing Tax Base: Is Foreign Direct Investment Eroding Corporate Income Taxes?', (September 2000) European Central Bank Working Papers Series, WP No. 31, at 8. This paper is available at <<http://www.ecb.int/>>.

²⁰³ Green, *supra* note 200, at 46.

²⁰⁴ Hines, *supra* note 27, at 21ff.

²⁰⁵ While tax treaties do not limit a country's power to tax business profits, a 10 per cent rate is generally imposed on interest income. Consequently, non-residents have an incentive to invest in corporate debt rather than in equity thereby creating a loss of revenue to the host country.

When a TNC manipulates the costs of inter-company funds it increases the risk of being targeted for a transfer pricing audit. However, the risk is bearable if it were to adjust the amount of equity it invests in its subsidiaries and optimise, on commercial grounds, its intercompany lending. Moreover, to minimise the risk of attack on the part of tax administrations, a TNC may interpose an arm's length third party between itself and its subsidiaries and utilise this intermediary in back-to-back loans bearing different tax rates.²⁰⁶

ii Innovative Financial Techniques

a. Foreign Exchange Issues

Foreign exchange questions arise in the context of gains and losses arising with the repayment of loans as well as in currency conversion necessary for the calculation of income and tax liability. The OECD as well as the accounting profession have sought to devise uniform practices acceptable in the international field for the treatment of foreign exchange gains and losses.²⁰⁷ However, the OECD considers the question outside the ambit of its double taxation model. In the absence of a coherent international practice for the taxation of exchange gains and losses on loans and the conversion of foreign currencies for the purpose of calculating tax liabilities, a potential for double taxation exists and must therefore be addressed.²⁰⁸

The problem of foreign exchange has ramifications beyond a mere revenue question. The globalisation of capital markets has resulted in a situation of extreme volatility. There is little doubt that major countries will develop closer consultation on macroeconomic policy leading to convergence as with Eurofed, that is, the European Central Bank.²⁰⁹ The same phenomenon is occurring in North America with the introduction of a mutual currency support mechanism with the North American Free Trade Agreement (NAFTA). The point is that foreign exchange problems cannot be regulated on a national basis.²¹⁰ Similarly, the taxation of cross-border

²⁰⁶ In this regard, it is worth noting that the trading of excess foreign tax credits may well be considered as an element of financial manoeuvring.

²⁰⁷ OECD, Report by the Working Group on Accounting Standards *Foreign Currency Transactions* (Paris: OECD, 1986).

²⁰⁸ R.J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region?' (March 1991) 45 *Bulletin for International Fiscal Documentation* 99, at 109. This situation has also a negative consequence as far as the tax base of certain countries is concerned. The Model completely ignores other financial issues. Therefore, schemes aimed at utilising every possible provision of the Model Treaty to characterise financial transactions proliferate. Thus cost of funds are made to appear as interest or hedging costs while more elaborate schemes aim at shifting costs within a TNC so as to generate a gain in the most favourable location having regard to the treaty network.

²⁰⁹ European Central Bank, at <<http://www.ecb.int/>>.

²¹⁰ OECD (1986) *supra* note 207, at 6.

income flows will necessarily be entrusted to an international organisation as they too cannot be resolved on a national basis as experience shows.

b Finance Leases

Leasing is an increasingly popular way of obtaining capital equipment. Both operating and finance leases have been strong growth areas. These techniques have also been used for purposes other than those intended originally. There are many instances where TNCs have entered into certain leases for the primary purpose of moving profits from one country to another.

Finance leases are the greatest source of concern for countries endeavouring to protect their tax base. Contrary to accounting practice, in many countries finance leases are not, for taxation purposes, regarded as loans. As a result, finance leases have been at the base of many tax avoidance schemes and the shifting of profits and losses in the international field.

The OECD has not comprehensively dealt with the tax problems arising from finance leases. Although it acknowledges the problem, its treatment of the matter is confined to operating leases and examines the question as to whether lease rentals should be characterised as royalties or business profits.²¹¹ There is therefore at the moment not even an embryonic proposition as to how this problem should be considered in the international field.

c. Treaty Abuse

Treaty abuse is achieved mainly through the use of conduit companies and base companies incorporated in low-taxation countries. A conduit company is one which exploits the fiscal advantages obtained in the country of the source of the income through treaty shopping as already defined. It has a brokerage function and channels income derived from a third country to the low-tax jurisdiction where it is incorporated. As for a base company, its function is to protect the global income of its group. It is also located in a low-tax country so as to reduce tax due in the country of residence.²¹²

The Commentaries on the OECD Model Tax Convention contain suggested anti-abuse provisions which aim at solving the problem of conduit companies. The transparency rule permits Contracting States to withhold the benefit of a convention to a company that is not owned directly or indirectly by residents of the jurisdiction in which the company is itself

²¹¹ G. Lindencrona & S. Tolstoy, 'General Report, XLIV Congress of the International Fiscal Association, Taxation of Cross Border Leasing', Stockholm 1990, (1990) *Cahiers de Droit Fiscal International* (Vol. 75a).

²¹² See OECD (1987), *supra* note 49, at 24. As will be explored in Chapter 5, Section III, 1, B, at 226 the issue of harmful tax competition through the use of such vehicles located in low tax jurisdictions is now under scrutiny by the OECD. See OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

resident.²¹³ The exclusion rule for its part operates to exclude certain companies from the benefits provided in a convention.²¹⁴ An example of such an anti-abuse mechanism is the incorporation in the Model of the theory of abuse of law.²¹⁵ Under this doctrine, if the sole or prevalent purpose of a transaction is to avoid tax, the form of the transaction may be ignored or disregarded on the grounds that the taxpayer has abused its rights by deliberately casting its transaction in a particular form.²¹⁶ In the context of treaty shopping, the consequence of the application of the theory of abuse of law results in the non-recognition, or the disregard of the form of certain payments, for example, interest, dividends, or royalties, flowing to and from companies involved in the arrangement. However, most treaties based on the OECD Model do not contain anti-abuse provisions.²¹⁷ In addition, there is no internationally accepted standard in the application of the disregard doctrine. Moreover, the 1992 OECD Model Convention does not even mention the need for internationally accepted provisions regarding the disregard doctrine, not even in the various indicative solutions contained in paragraphs 11 to 26 of the Commentary on Article 1.²¹⁸

Furthermore, the inadequacy of the OECD's proposed solutions is again apparent with the so-called stepping-stone strategy. In this situation, income from a country with favourable taxation rules is transferred first to a high-tax country before arriving at its final destination in such a way that tax authorities are forced to disregard the actual source of the income.²¹⁹ This strategy is used where direct transfer to the recipient is likely to attract a higher rate of tax under the Model Convention.²²⁰ An attempt to deal with the problem is the inclusion in some bilateral treaties, for example the double tax treaty between Switzerland and the United States, of a provision called a 'transit formula', which denies the exemptions and reliefs conferred by the treaty in cases where a conduit is being used.²²¹

²¹³ See OECD (1992), *supra* note 1, Commentary on Article 1, at C(1)-4 para. 13.

²¹⁴ *Supra* note 1, Commentary on Article 1, at C (1)-6 para. 16.

²¹⁵ *Supra* note 1, Commentary on Article 11, at C (11)-7 para. 21.1.

²¹⁶ D.A. Ward, 'Abuse of Tax Treaties', in H.H. Alpert & K.V. Raad, eds., *Essays on International Taxation to Sidney I. Roberts* (Kluwer 1993) 397. For a study of the principle of tax abuse and its consequences relative to EC law in general, see A.J. Rädler et al., 'Tax Abuse and EC Law', (1997-2) *EC Tax Review* 86.

²¹⁷ Russell, *supra* note 53, at 966.

²¹⁸ G. Palumbo, 'Anti-Avoidance and the 1992 OECD Model Convention', (September 1994) 21 *Tax Planning International Review* 3, at 5.

²¹⁹ See OECD, *International Tax Avoidance and Evasion*, (Paris: OECD, 1987), at 67.

²²⁰ Palumbo, *supra* note 218, at 6.

²²¹ See OECD (1992) *supra* note 1, Commentary on Article 1, para. 20.

B The Application of the Arm's Length Principle to Financial Manoeuvring

In this particular area, the arm's length principle behaves quite poorly. For example, tax authorities may always attempt an adjustment of inter-corporate interest rates. However, their chances of success is limited given that financial manoeuvring does not depend on non-arm's length charges. An adjustment of interest rates based on the arm's length standard is fraught with uncertainties. In order to deny an interest deduction on inter-company debt, tax authorities must recharacterise the loan as a contribution to equity on the argument that borrowings under such conditions do not occur as between unrelated parties. The difficulty is compounded if there is a third party interposed between the related parties, for example, an international bank. Thus, a TNC can lend to a branch of that bank and require another branch to lend to its affiliate in seemingly unrelated transactions.

Moreover, such arrangements would no doubt fall under protective legislation relative to bank secrecy and it is doubtful whether the OECD's efforts to curb abuses of bank secrecy laws in order to enable tax administrations to access bank information would be successful in this instance.²²² Indeed, the tax administrator must demonstrate that the lender would not have lent to an independent party on those conditions conceded to the affiliate. Evidence available in the context of closely held corporations shows that the rate of success is minimal.²²³ The reason for this is that, to date, financial theory has not conclusively established that an optimum debt-to-equity ratio exists. Even if that optimum ratio did exist, empirical studies have shown that the value of the firm is likely to remain constant over a wide range of debt-to-equity ratio.²²⁴ Moreover, since an extremely wide range of ratios is observed, the search for an arm's length debt-to-equity ratio may well remain a vain pursuit.²²⁵

In these circumstances, one may ask about the utility of the thin capitalisation rules that most developed nations are relying upon to deny a deduction for interest paid on excessive debt by non-resident related parties.²²⁶ Such provisions involve arbitrary line drawing particularly if the assets are valued at their adjusted basis.²²⁷ The arm's-length standard applied to the issue of

²²² See C. Gnaedinger, 'OECD Announces New Measures for Easing Tax Authorities' Access to Bank Information' (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1725.

²²³ See W.T. Plumb, Jr., 'The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal', (1971) 26 *Tax L. Rev.* 369.

²²⁴ A.C. Shapiro, *Multinational Financial Management* 3rd ed. (Boston: Allyn & Bacon, 1989), at 739.

²²⁵ See C.H. Berry et al., 'Arm's-Length Pricing: Some Economic Perspectives', (1992) 54 *Tax Notes* 731, at 732.

²²⁶ See T.R. Bretz & E.S. White, 'Cross-Border Placement/Movement of Indebtedness and Tax-Effective Use of Cash Accumulated Offshore', (1990) 68 *Taxes* 1103, at 1119-20.

²²⁷ Green, *supra* note 200, at 51.

thin capitalisation requires that the debt-to-equity ratio of a controlled corporation be comparable to that of an uncontrolled party. However, uncontrolled parties typically exhibit a wide range of debt-to-equity ratios. For instance, the Conference Committee Report on section 163(j)²²⁸ found that ratios far exceeding 1.5-1 were quite common. The Committee then rejected the contention that the arm's length would have been satisfied if related parties were to show the same thinness of capitalisation. Instead, it argued that thin capitalisation rules based on averages among firms and typical patterns satisfy the arm's length standard.

The OECD holds a contrary view. While conceding that there are some difficulties in applying the arm's length principle to thin capitalisation problems, it nevertheless holds that thin capitalisation rules are consistent with the arm's length principle when they are based on a facts-and-circumstances approach with reference to transactions between independent parties.²²⁹ This is hardly a workable standard but, as argued before, the OECD remains hostage to the traditional interpretation of the arm's length standard. As a result of such indetermination, TNCs are always a step ahead of tax authorities.²³⁰

The core of the problem is that, in a fully integrated TNC, an optimum debt-to-equity ratio makes no sense.²³¹ Indeed, in a world of increasing consumer power, a corporate parent, for the sake of preserving its reputational capital, will almost certainly indemnify its subsidiaries' lenders even if it has no legal obligation to do so.²³² Therefore, in setting up the interest rate to be charged to an affiliate, a lender is more likely to consider a TNC's consolidated debt-to-equity ratio rather than focus, as tax administrations do, on the separate debt-to-equity ratio of the affiliate.

Until the enactment of Controlled Foreign Corporations legislation (CFC rules)²³³ taxpayers, availing themselves of the separate entity principle, had been able to defer taxation on foreign

²²⁸ The thin capitalisation or earning stripping provisions of the U.S. Internal Revenue Code introduced in 1989. See Green, *supra* note 200, at 51.

²²⁹ OECD, *Issues in International Taxation No. 2, Thin Capitalisation and Taxation of Entertainers, Artists and Sportsmen* (Paris: OECD, 1987), at 29-32.

²³⁰ The OECD considers that Article 9 allows an adjustment where debt to equity ratios are too high. See OECD, *Issues in International Taxation No. 2, Thin Capitalisation* (Paris: OECD, 1987) paras. 48-49.

²³¹ R.A. Brealey & S.C. Myers, *Principles of Corporate Finance*, 4th ed. (New York: McGraw-Hill, 1991), at 447-50.

²³² Shapiro, *supra* note 224, at 746-48.

²³³ See E. Henson, 'Controlled Foreign Companies Legislation Around the World', (December 1995) 22 *Tax Planning International Review* 8, at 9. In 1996 the OECD published information of CFC legislation of 14 OECD Member countries as at June 1995. See OECD, *Controlled Foreign Company Legislation* (Paris: OECD, 1996).

sourced income.²³⁴ CFC legislation disregards one of the fundamental principles of international taxation whereby income accumulated in a foreign company is not taxed to the resident shareholder until it is distributed. This concept is based on the principle that the foreign company is a legal entity separate from its resident shareholders. The CFC rules enable the shareholders of controlled foreign companies to be taxed on their pro rata share of certain categories of the companies' income.

CFC rules emerged because the attribution principles of double tax treaties have not fully achieved their purpose. The practice prevailing, when there is a tax treaty between Country A and Country B, is that business profits derived by an enterprise resident in A may only be taxed in B to the extent that they are attributable to a permanent establishment situated in B. If Country A introduces legislation of the CFC type, a resident of A may be required to pay his or her proportionate share of Country B's company's income. In other words, CFC legislation operates as a consolidation of TNCs tax accounts in line with modern accounting treatment but against the principles of tax treaties.²³⁵ CFC legislation is by no means the only instance when 'the basic assumptions and primary objects of tax treaties are being subverted by major members of the OECD'²³⁶.

What is certain is that these often convoluted, solitary, and uncoordinated attempts by governments to protect an ever-shrinking tax base are doomed to failure. Evidence has shown that at the present the revenue loss resulting from the incapacity of the present system to work is staggering.²³⁷ TNCs consider tax as a cost which should be minimised as any other cost in

²³⁴ 'Domestic source income can be transferred to a foreign company free of domestic tax, for example, where it constitutes a deductible expense paid by a domestic company to a foreign company for services rendered by the foreign company, and where the service fee is technically not domestic source income. Domestic source income may also be transferred to a foreign company at a lower rate of domestic tax where it is extracted from the source country as interest or a royalty, and only bears source country tax at the reduced withholding tax rate that applies to this income when derived by non-residents.' See Rigby, *supra* note 26, at 312.

²³⁵ For an analysis of the compatibility of CFC rules and tax treaties, see D.Sandler, *Pushing the Boundaries: The Interaction Between Tax Treaties and Controlled Foreign Company Legislation* (London: The Institute of Taxation, 1994). For judicial pronouncements in the British context, see *Bricom Holdings LTD v Inland Revenue Commissioners* [1997] STC 1179; and in the French context, P. Douvier & D. Bouzora, 'Compatibility of CFC Rules With Tax Treaties: Lower Courts Reach Conflicting Conclusions', (March 1997) *European Taxation* 103.

²³⁶ Vann, *supra* note 208, at 108.

²³⁷ For example, according to the U.S.'s government figures, in 1991 the use of Netherlands companies enabled the latter to receive from the U.S. Dfl 10,000 million in interest, Dfl 2,000 million of dividends and Dfl 15,000 million of royalties. U.S. withholding tax on such payments should have been Dfl 13,500 million, rather than the Dfl 150 million collected pursuant to the 1948 Netherlands-United States double tax treaty; see Saunders, *supra* note 46, at 21. The new treaty signed in 1993 between the Netherlands and the U.S. tries to limit treaty shopping manoeuvres by the inclusion of a 50 per cent-or-more stock-ownership test, and a less-than-50 percent base-erosion test. Other derivative tests seeking to extend the treaty to other residents of the EU are: a

calculating their profits. Sophisticated minimisation and/or avoidance techniques prevent the present OECD Model to fulfil one of its major objectives: the prevention of tax avoidance. As a result, many countries simply ignore their treaty obligations. As mentioned earlier, the U.S. has regularly introduced legislation that overrides the provisions of treaties which they have signed and ratified.²³⁸ New Zealand has also circumvented its treaty obligations when its new rules for dividend withholding payment were introduced.²³⁹ The same can be said of Australia with regard to its thin capitalisation legislation. More recently, Germany added section 50d in its tax code. This provision requires payments subject to German withholding tax to be made without regard to any treaty or provisions implementing the European Union (EU) parent-subsidiary directive.²⁴⁰ In the U.K. the question of treaty override has not been settled in view of the doctrine of the sovereignty of Parliament.²⁴¹ A well-publicised threat of treaty override by the British Government occurred in its dispute with California over the latter's use of worldwide unitary combination. Although the matter appears to have been settled, the British Government may still reactivate the threat to override the U.S. - U.K. tax treaty in relation to certain California-based TNCs by invoking the so-called Grylls Clause inserted in the 1985 Finance Act, as the U.K. Chancellor of the Exchequer warned in an interview after the Barclays decision²⁴². In this particular example, though, it may well be that in order to justify an eventual decision along these lines, the U.K. Government would maintain that its action cannot be assimilated to treaty override, but rather, arises following material breach by the U.S. In the end, the blunt question is whether the very concept of tax treaties still remains an adequate method of dealing with contemporary international tax problems.

In the emerging global economy the arm's length principle is an act of faith rather than a scientifically orientated method for the allocation of the income and expenses of TNCs. It requires tax administrators to form an opinion on what an arm's length price ought to be on the

publicly -quoted test, a bona fide business-purposes test, and a headquarters-company test, see P. Lier & T.P. North, 'The New U.S.-Netherlands Treaty', (February 1993) *Tax Planning International Review* 3, at 21. See also Anonymous, 'U.S.-Netherlands Tax Treaty Takes Effect', (January 1994) *Tax Planning International Review*, at 3-16.

²³⁸ For a critique of various congressional tax enactments that have expressly overridden tax-treaty obligations of the U.S., see D. Sachs, 'Is the 19th Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?', (Summer 1994) 47 *Tax Lawyer*, at 867-83.

²³⁹ Vann, *supra* note 208, at 119.

²⁴⁰ H.M. Pott, 'Germany: Treaty Override', (January 1996) 21 *World Tax Report*, at 7-8.

²⁴¹ See P. Baker, *Double Tax Conventions and International Tax Law*, 2nd ed. (London: Sweet & Maxwell, 1994), at 52-54.

²⁴² G. Graham & A. Jack, 'U.S. Judges Dismiss Barclay's Challenge on Unitary Tax Law', *Fin Times* (London), 21 November 1994, at 1.

basis of figures supplied by the TNC itself. In the words of Professor Bird, the arm's length principle which expects 'tax administrators to construct such a mythical world out of the figures for which they must depend entirely on the firms they are trying to tax is to expect too much.'²⁴³ This 'act of faith' is so inappropriate in the present context that a wider meaning is surreptitiously being ascribed to the system.

Jill Pagan's sums up the situation when she wrote '[N]o arm's length comparable? Then try the cost-plus or resale method, or even a more complex functional analysis of due reward for economic contribution and commercial risk'.²⁴⁴

However, in reality, as will be shown in later chapters, all these techniques are no more than covert forms of formulary apportionment.

²⁴³ Bird, *supra* note 73, at 294.

²⁴⁴ J.C. Pagan, 'An Open Letter to Jeffrey Owens, Fiscal Affairs Division, OECD, From Jill C. Pagan' (17 January 1994) *Tax Notes Int'l* 161, at 164.

The Reform of the Present System of International Taxation

This chapter is concerned with tax reform.¹ Several scenarios may be envisaged when tax reform is contemplated.² Broadly, though, reform may be undertaken through:

- the maintenance of the existing system based on the separate accounting/arm's length standard coupled with innovative solutions such as the harmonisation of the dominant systems; and
- radical reform through either an abandonment of the prevailing income tax systems for a consumption-based one³, or the adoption of some form of unitary method in lieu of the separate accounting/arm's length standard.

Some of these variants are studied in the following sections. Section I examines the avenues for the harmonisation of the dominant taxation systems. Section II explores the emergence of profit-based methodologies. Finally, Section III argues that the ultimate result of the evolution process that characterises international taxation could well be an indirect reshaping of the conventional principles on which the whole system is premised.

¹ Australia is now in the grips of a major tax reform process including international taxation as a result of the publication of the *Ralph Report*. See *Review of Business Taxation, A Tax System Redesigned*, (Canberra: AGPS, 1999), more especially Sections 20-23, 'Responding to Globalisation', at 623-688. For an outline of the proposal for reform, see R. Vann & G. Cooper, Report of Australia's Business Tax Review and the Government's Response, Tax Analysts Document Number: Doc 1999-31999, (9 September 1999). See also A. McCleary, 'An Overview of the Review of Business Tax', (August 2000) 35 *Taxation in Australia* (No. 2) 76.

² A.J. Easson, 'A New International Tax Order - Responding to the Challenge' (October 1991) 45 *Bull Int'l Fiscal Documentation* 10, at 465.

³ C.E. McLure, Jr., et al., *The Taxation of Income from Business and Capital In Columbia* (1990) chap. 4. The proponents of a direct consumption-based tax believe that it has a definite superiority over income-based taxation. This superiority is seen in the field of economic efficiency and simplicity. The consumption tax alternative has always been considered as a domestic tax issue. In the international context, consideration has only been given to the external constraints that a country wishing to adopt such a system would have to face. The consumption-tax alternative has been studied in J.E. Meade, *The Structure and Reform of Direct Taxation*, Report of a committee of the Institute for Fiscal Studies (London: Allen & Unwin, 1978).

More radical proposals for reform have been made, for example, the Hufbauer-van Rooij business cash flow tax. See G.C. Hufbauer & J. M. Van Rooij, 'Reforming Business Taxes', in A.C. Warren, Jr., & R.J. Shapiro, eds, *Enterprise Economics and Tax Reform: Promoting U.S. Growth in the Global Economy*, at <<http://www.dlcppi.org/text/economics/eecon1.TXT>>. See also R Krever, ed., *Tax Conversations; A Guide to Key Issues in the Tax Reform Debate* (Kluwer Law International, 1997). One of the core proposals of the *Ralph Report* (*supra* note 1) is the so-called cash flow/tax value method for determining taxable income in Australia. For an analysis of this proposal, see D. Boccabella, 'Australia's Tax Reform Rejects or Modifies Fundamental Principles', (June 2000) *Australian Tax Review* (No. 29) 81.

Section I Improving The Existing Rules

The coexistence of different tax systems and their interaction often creates uncertainty for both taxpayers and tax administrators. This encourages costly disputes in the transfer pricing area that are counterproductive to both tax administrators and transnational corporations (TNCs). One method of solving these potential conflicts is to harmonise the various dominant systems of international business taxation in order to better mesh the various national systems, thus closing off any potential arbitrage opportunities.

1 The Process of Harmonisation in the European Union

Tax harmonisation is generally defined as the process of planning how to approximate the tax systems of various nations in order to better achieve certain objectives.⁴ This is the focus of tax harmonisation in the European Union (EU) given that a lack of harmonisation results in ‘loss of government revenue, distortion to real economic behaviour, and increased administrative and compliance costs.’⁵

A The Initial Strategy of Harmonisation in the European Commission

In the EU the ‘tax harmonisation exercise is generally defined as the process of planning how to approximate the tax systems of the 15 Member States in order to better achieve the objectives of the European Community.’⁶ The ultimate aim of the Treaty of Rome which gave birth to the European Economic Community (EEC), now the European Union, is to create a single market comprising all Member States. Ideally, a single market requires a coherent system of taxation in order to prevent the perpetuation of inefficiencies that could threaten its viability. The need to harmonise both indirect and direct taxes in the EU is of critical importance if Member States are to fully benefit from the advantages created by the single market. One of the essential objectives of harmonisation is to achieve tax neutrality. Neutrality is achieved when taxes do not impede the free movement of goods and services, persons or

⁴ R.J. Vann, ‘Improving Tax Law Improvement: An International Perspective’, (1995) 12 *Australian Tax Forum* (No. 2) 193, at 206. For an explanation as to the meaning of ‘tax harmonisation’, ‘tax convergence’ and ‘tax approximation’, see K. Messere, ‘20th Century Taxes and their Future’, (January 2000) 54 *Bulletin For International Fiscal Documentation* (No. 3) 2, at 21.

⁵ See comments of Lucy Chennells, senior research economist at the Institute for Fiscal Studies, London, as reported by J. Weiner, ‘News Analysis: Institute for Fiscal Studies Reports on EU Corporate Tax Harmonization’, Tax Analysts Document Number: Doc 2000-14053 (15 May 2000).

⁶ L. Hinnekens, ‘The Monti Report: The Uphill Task of Harmonizing Direct Tax systems of EC Member States’, (1997) 6 *EC Tax Review* (No. 1) 31, at 33. See also S. James, ‘Can We Harmonise Our Views on European Tax Harmonisation?’, (June 2000) 54 *Bulletin for International Fiscal Documentation* (No. 6) 263.

capital within a common internal market. Nor should tax operate as trade barriers. When these conditions are satisfied one may speak of a meaningful regime of free competition.⁷

The European Commission has sought to initiate the harmonisation process in three different areas:

- First, efforts were made to harmonise import duties;⁸
- Second, the harmonisation attempt was pursued with the general consumption tax, the Value Added Tax (VAT) with a fully harmonised taxable base;⁹ and
- Third, the Commission has sought to harmonise certain direct taxes, for example, the rates of corporate taxes.

In the first two instances the success of the harmonisation effort cannot be denied. However, the history of the harmonisation of direct taxes in Europe remains fraught with hesitations, volte-faces, and sudden successes. When it comes to harmonisation, there seems to be a constant bickering between the various organs of the EU. For example, facing strong opposition from the European Parliament,¹⁰ the European Commission has unsuccessfully attempted to harmonise the structure and rates of corporate taxes in the EU.¹¹ Until recently, in spite of certain efforts in this direction, little was accomplished in the field of direct tax harmonisation.¹²

Finally, in 1990 the European Commission announced that it had, for the immediate future, abandoned the idea of a comprehensive corporate tax harmonisation. However, it is fair to say that while tax harmonisation is not explicitly on the Commission's agenda, it is 'perennially an issue among Member States governments, EU multinationals, and small and medium-sized

⁷ See S. Cnossen, preface to K. Vogel, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality Under European Community Law: an Institutional Approach* (Kluwer: 1994), at 7. For a thorough examination of the issues relevant to the harmonisation of company tax systems in the EU, see S Cnossen, 'Reform and Harmonisation of Company Tax Systems in the European Union', in R. Krever, ed., *Tax Conversations; A Guide to Key Issues in the Tax Reform Debate* (Kluwer Law International, 1997), at 365ff.

⁸ J. Westerburgen, 'Tax Harmonisation in the EC -- Where are We and What are the Prospects?', (1990) 10 *Intertax* 483.

⁹ *Ibid.*

¹⁰ Report from the Commission to the Council, *Scope for Convergence of Tax Systems in the Community* (27 March 1980, Doc. Com (80) 139 final).

¹¹ Proposal for a Directive on the Harmonisation of Systems of Company Taxation and of Withholding Taxes on Dividends (1 August 1975, OJ 1975 C 253/2) in A. Easson, 'Harmonisation of Direct Taxation in the EEC', (1992) 40 *Canadian Tax Journal* 3, at 606.

¹² See Hinnekens, *supra* note 6, at 34, where the author notes that 'the strategy for the Commissioner in charge of direct taxes, when it comes to dealing and playing the cards of direct tax harmonization inevitably becomes that of Cervantes: Patience, and shuffle the cards!'

enterprises'.¹³ Instead, the Commission directed its attention to the seemingly less daunting task of harmonising specific elements of the various company tax systems of the EU. It was felt that the interaction of those disparate elements were the main cause of double taxation and constituted, therefore, an obstacle to cross-border expansion of companies within the EU. The European Commission further published a list of priorities at the top of which was a package of three measures which it regarded as essential to achieving a certain level of tax coherence within the EU. These were as follows:

- The Parent-Subsidiary Directive, which applies to the 'distribution of profits' paid by a subsidiary in one Member State to its parent in another Member State. The aim of the parent-subsidiary directive is to eliminate double taxation and to facilitate the operation of a foreign subsidiary or affiliate.
- The Merger Directive, which eliminates fiscal obstacles to cross-border mergers. This second element of the package aimed at achieving a coherent fiscal treatment of cross-border mergers within the EU. Its objective was to eliminate any fiscal obstacles to cross-border mergers by postponing the realisation of capital gains on assets or shares involved in a merger until their actual disposal by the newly merged company.
- The Arbitration Convention, which introduced an arbitration procedure in case Member States fail to agree on adjustments in transfer pricing cases.

The process of harmonisation, along with new policy lines defined by the European Commission, continued with the publication in November 1990 of two additional proposed directives. The first is the Proposed Directive on Interest and Royalties, which may be regarded as an extension of the parent-subsidiary directive exempting from withholding tax dividends paid by a subsidiary to its parent in another state. It exempts payments of interest and royalties from a subsidiary to its parent. However, and this is the innovative feature of this proposed directive, an exemption is likewise proposed in case of interest or royalty payments made by the parent to a subsidiary.

The Proposed Directive on Intra-group Losses was the second proposal submitted to the Council on the 28 November 1990. If adopted, enterprises would be allowed to take into account losses incurred by all their permanent establishments or subsidiaries operating in various Member States provided these permanent establishments or subsidiaries have been subject to such corporate income taxes as listed in the directive. As for permanent establishments, relief would be granted by either the 'credit method' or the 'deduction method

¹³ Weiner, *supra* note 5.

with reincorporation of subsequent profits', while subsidiaries would be required to use the latter method only.¹⁴

The goal of harmonisation was pursued by the publication in April 1990 of the European Commission's *Guidelines on Company Taxation*.¹⁵ This document defined what the European Commission thought was necessary for the completion of the internal market by the end of 1992. However, the most important aspect of the document is that it developed a new strategy for the harmonisation of direct taxation.

i The Ruding Report

The Commission then entrusted a further study to a committee of eight experts headed by Dr Onno Ruding, the former finance minister of the Netherlands. The committee was directed to study three different questions relative to the tax systems prevailing in the Community, namely, their interaction, the prospects of harmonising these systems, and the actions required to achieve that outcome. The committee of experts, (henceforth the Ruding Committee), submitted its report¹⁶ to the Commission in February 1992.

The *Ruding Report* does not mark a significant change in direction from the policy of the previous 30 years.¹⁷ In general, the European Commission had already considered most of its main proposals. Nevertheless, the *Ruding Report* does contain recommendations which, had they been adopted, would have tested the Community's real desire for harmonisation.

ii The Ruding Report and the Arm's Length Principle

The main objective of the Ruding Committee was to investigate the question of harmonising direct taxation in the EU. The Committee did not therefore fully examine the question of the equitable allocation of revenue raised from corporate tax among the Member States.¹⁸ However, the Committee did express its attitude to the arm's length principle. The Ruding Committee unquestionably adhered to the doctrine of the primacy and adequacy of the arm's length principle without even questioning its basic tenets. The Report remained indisputably in favour of the status quo. It fully supported the use of the separate accounting/ arm's length principle to divide the income of TNCs.

¹⁴ Easson, *supra* note 11, at 623.

¹⁵ European Community, *Guidelines on Company Taxation* Commission Communication to Parliament and the Council (20 April 1990, Doc COM (90) 601 final).

¹⁶ The European Communities, *Report of the Committee of Independent Experts on Company Taxation* (Luxembourg: Office for Official Publications of the European Communities, 1992), at 19 (*Ruding Report*).

¹⁷ Easson, *supra* note 11, at 632.

¹⁸ *Ruding Report*, *supra* note 16, at 129-130.

However, the recommendations of the *Ruding Report* have been largely ignored.¹⁹ Undaunted by this attitude, Dr Onno Ruding, in a speech at a meeting of the Bankers' Taxation Circle in London, still held the view that 'the committee's conclusions and recommendations are as up-to-date today as they were when they were first published in 1992, since the Member States have failed to coordinate their corporate tax policies systematically.'²⁰

B The Latest Initiative

Subsequent to the *Ruding Report*, the Commission announced in its July 1992 Communication that it intended to launch a comprehensive process of consultation of the tax authorities and other interested parties before formulating proposals for Community legislation in the second half of 1992. Nothing substantial occurred until the 20 March 1996 when Commissioner Monti made certain propositions in a Discussion Paper to the Informal Meeting of the European Council of Economic Finance Ministers (ECOFIN) to be held in Verona on 13 April 1996.²¹ This communication, the Verona Memorandum became the Commission Report on Taxation in the European Union, or the *Monti Report*.²² The ECOFIN Ministers did not endorse the Commission's views on the harmonisation process. Discussions that followed were carried out through a High Level Group appointed by the finance ministers. All this showed that both the Commission and Member States were still not ready for an open debate on the question of harmonisation of the company taxation throughout the EU.²³

i The Principle of Subsidiarity

A new approach based on the principle of subsidiarity is now being explored with the view to achieving some degree of harmonisation of direct taxes in the EU. The principle of subsidiarity, as defined in the Maastricht Treaty, takes a decentralisation approach to EU issues. It empowers the European Commission to intervene only in specific rather than in every field of economic life, and as 'for the rest, market forces play'.²⁴ In the taxation field, the principle of

¹⁹ European Union, Communication SEC (92) 118 of 27 July 1992 in Hinnekens, *supra* note 6, at 34.

²⁰ J. Blumenberg, 'Ruding Comments on the Future of Corporate Taxation in the European Union', (22 July 1996) 13 *Tax Notes Int'l* 245.

²¹ Hinnekens, *supra* note 6, at 34.

²² European Commission, Report on the Development of Tax Systems, *Taxation in the European Union* (Brussels, 22 October 1996), Com (96) 546 final, in Hinnekens, *supra* note 6, at 34.

²³ Hinnekens, *supra* note 6, at 39.

²⁴ C. Scrivener, 'Corporate Taxation in Europe and the Single Market', (1990) 4 *Intertax* 207. In regard to the principle of subsidiarity, it is interesting to note how the 'sovereign pretensions of the individual states receive strong reinforcement from the conviction of mainstream economics today that markets can be counted on to provide appropriate incentives as long as monetary stability is assured.' See M.J. Frankman, 'Global Taxation: A Search for Generalizable Precedents', (June 1997) 31 *Journal of Economic Issues* 641.

subsidiarity is taken to mean that each Member State must retain its tax sovereignty in so far as it does not interfere with the EU's broad tax objectives.²⁵

It is difficult to see how this new strategy is going to promote the idea of harmonisation given that neutrality and subsidiarity are quite difficult to reconcile under the corporation tax.²⁶ Progress in the field of harmonisation has been achieved only when Member States have felt that the proposed changes did not impact negatively on their competitive positions especially in terms of their ability to attract foreign direct investments.²⁷ The European Commission has never been able to achieve its objectives by convincing Member States to adopt measures that they considered are contrary to their national interests. Therefore, the Commission's new strategy may reasonably be construed as the recognition that it cannot achieve its harmonisation objectives. These have consistently been viewed as being 'overambitious' and have thus been rejected by Member States.

ii *The European Court of Justice*

While on the political level progress towards the internal market is being made laboriously, the decisions of the European Court of Justice (ECJ) are achieving an equivalent result, in a less spectacular way. For instance, the articulation of the doctrine of non-discrimination by the ECJ is quietly achieving fiscal neutrality throughout Europe.²⁸ Again, in the area of tax accounting, the ECJ has had to consider, for example, two German cases submitted by two German courts acting independently.²⁹ Both cases related to the question of compliance with the Directive's mandate by the German implementation law for the Fourth Company Law Directive and involved a tax accounting problem.³⁰ Basically, the Court was called upon to decide indirectly on a question of tax accounting, an eminently political issue. In seizing

²⁵ The real meaning of the subsidiarity principle when applied to taxation is not clear. In general, the term relates to the idea of decentralisation of government functions and thus is linked to the theory of fiscal federalism. It connotes therefore the idea of fiscal decentralisation, that is, tax diversity, with coordination and cooperation to achieve the EU's overall objective. See J. Brands, 'Comments: Trade-Off Between Subsidiarity and Neutrality', in K. Vogel, *Taxation of Cross-Border Income, Harmonization, and Tax Neutrality Under Community Law* (Kluwer, 1994) 35, at 39.

²⁶ Cnossen, *supra* note 7, at 8.

²⁷ Research by the European Central Bank shows that 'EU tax harmonization would affect primarily three countries: Germany, Italy and Ireland. Germany and Italy would experience a significant improvement in their net FDI position and gain revenue, while Ireland would experience the opposite.; See R Gropp & K. Kostial, 'The Disappearing Tax Base: Is Foreign Direct Investment Eroding Corporate Income Taxes?', (September 2000) European Central Bank Working Papers Series, WP No. 31, at 8. This paper is available at <<http://www.ecb.int/>>.

²⁸ P. Nias, 'Harmonization by the Backdoor?', (October 1995) *International Tax Review* 29.

²⁹ See O. Thömmes, 'EC Tax Scene', [1996] 5 *Intertax*, 218-9, at 218.

³⁰ European Community, Fourth Council Directive of 25 July 1978, [1978] O.J. L222/11.

competence in such matters, the ECJ is likely to 'become a key player not only in tax but also in accounting matters'³¹ in so far as it addresses the thorny question of compliance between tax and commercial accounting. As will be studied in Chapter 6, the conformity problem has a direct consequence on the fiscal sovereignty of Member States.

Currently, therefore, it is fair to say that a certain restriction of the sovereign powers of Member States is being achieved by the judiciary rather than by the legislative structures of the EU.³² It may well be that this method of achieving harmonisation is actually favoured by the politicians in so far as it deflects attention from their role in this process.

On another front, changes in the way business is carried out are also influencing the tax debate within the Union. Business integration arising from competitive pressures, the single market and, since the beginning of 1999, a single currency in 11 Member States are also important elements which are contributing to render obsolete the traditional methods of profit allocation between different states. In such an environment, proposals for reform abound. Thus, recently a strong case has been put forward for the acceleration of the creation of the European Company (*Societas Europaea*) which would act within Europe as if the internal market was a real single market with one legal system.³³ Other possible solutions range from the adoption of a branch basis for taxation to a European income tax.³⁴

One of the major institutional impediments to tax harmonisation in the EU is the requirement for unanimous agreement for any proposals for corporate tax reform. To remedy the problem, at least partially, the European Commission's President, Romano Prodi, and Commissioner Michel Barnier, have authored a report proposing greater use of qualified majority voting

³¹ Thömmes, *supra* note 29, at 219. See also *Finanzamt Köln-Altstadt v. Roland Schumacker* (14 February 1995 C-279/93). For an analysis of the case see A.J. Rädler, 'An Analysis of the European Court of Justice's *Schumacker Decision*', (15 May 1995) 10 *Tax Notes Int'l*, 1683. For a critique of the *Schumacker* decision, see P.J. Wattel, 'Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax allowances: Why *Schumacker*, *Asscher*, *Gilly* and *Gschwind* Do Not Suffice', (June 2000) *European Taxation* (No. 6) 210.. See also D.M. Weber, 'The First Steps of the ECJ Concerning an Abuse Doctrine in the Field of Harmonized Direct Taxes', (1997) 6 *EC Tax Review* (No. 1) 22 for an analysis of the more recent case of *Denkavit-VITIC-Voormeer* (17 October 1996) where the ECJ has interpreted for the first time certain clauses of the Parent-Subsidiary Directive, (90/435/EEC), 23 July 1990, OJ, L 225 of 20 August 1990, and D. Schelpe, 'The *Denkavit-Vitic-Voormeer* case', (1997) 6 *EC Tax Review* (No. 2) 17.

³² Dr A.J. Radler, one of the eight independent experts on the Ruding Committee 'is a strong believer in using the ECJ to achieve results that may not be available from other governing bodies, see J. Weiner 'Consortium of EU - Based Law Firms Discusses EC Law's Direct Impact on Direct Taxation' (10 April 2000) 20 *Tax Notes Int'l* (No. 15) 1629.

³³ Sven-Olof Lodin & M. Gammie, 'The Taxation of the European Company', (1999) 39 *European Taxation* (No. 8) 286.

³⁴ *Id.*, at 287. It is interesting to note that if the Ruding proposals had been implemented, then income tax systems would have converged to a point which, according to Professor Sven-Olof Lodin and Malcolm Gammie, would have created the environment for the emergence of a European corporate income tax.

(QMV) as a mechanism to increase the efficiency of EU institutions. The report recommends ‘that QMV be extended to allow for coordination of national tax and social security laws.’³⁵ However, in a speech in Hoevelaken, the Netherlands, the current EU commissioner for fiscal policy, Frits Bolkestein, while commenting on these proposed changes emphasised that QMV would not apply to laws harmonising corporate taxes.³⁶ In other words, one should not expect spectacular developments in the area of corporate harmonisation in the short term. Yet, with the adoption of the single European monetary unit (the Euro) by 11 EU Member States in 1999, which meant that a serious nontax barrier to cross-border activity within the EU has been effectively dismantled, tax obstacles such as the disparate national tax systems still have to be addressed.³⁷

2 A New Approach to Tax Administration

Harmonisation, as demonstrated in the EU, takes a long time to achieve. In the short term, it is important to explore other avenues for reform with the view to solving some of the most critical problems with the present system of international taxation.

A Improving Exchange of Information Procedures

One of the major problems with the administration of the separate accounting standard is the difficulty of determining the parameters of a comparable transaction because of the absence of relevant information.³⁸ TNCs operate in a certain number of jurisdictions and it is often difficult for tax authorities to obtain information on specific operations carried out by a particular entity of the group. Such information is often held offshore and its strategic significance may even be unknown to the TNC’s local managers. Obtaining information from foreign jurisdictions is often fraught with uncertainties especially if held by third parties such as financial institutions benefiting from the protection of bank secrecy laws.

The OECD is well aware of the problems that tax authorities face in gaining access to all necessary information for assessment purposes. Indeed, financial information is often subject to bank secrecy laws and abuse of such legislation is well documented through its 1985 report on the question.³⁹ The report, however, had limited success.⁴⁰ Recently, the OECD has issued

³⁵ Anonymous, ‘EU Report Recommends Qualified-Majority Voting for More Tax, Social Securities Areas’, (3 April 2000) 20 *Tax Notes Int’l* (No. 14), at 1529.

³⁶ N. Tutt, ‘EU Commissioner Discusses Ways to Promote EU Tax Harmonisation’, (3 April 2000) 20 *Tax Notes Int’l* (No. 14), at 1528.

³⁷ Weiner, *supra* note 5.

³⁸ S. Picciotto, *International Business Taxation* (London: Weidenfeld and Nicholson, 1992), at 280.

³⁹ See OECD, *Taxation and Abuse of Bank Secrecy* (Paris: OECD, 1985).

a new report on the question,⁴¹ and it is now confident that ‘this new report will be more successful because all 29 member countries—including Switzerland—approved it.’⁴²

i Exchange of Information

One method of achieving cooperation between different tax administrators is through the exchange of information between relevant tax authorities. This involves an exchange of information already held by tax administrations as opposed to information held by third parties that have first to be accessed before being exchanged. In engaging in an information exchange procedure, each participant state surrenders part of its sovereignty since it is agreeing to do something, which under international law, it is not required to do. The gain to participants is that access to information held offshore enhances their ability to enforce compliance with their tax laws. Improving the exchange of information procedures is regarded as one of the most appropriate methods of reforming to a certain extent the present system of international taxation without going through any radical change.

There are broadly three methods of obtaining information for taxation purposes:⁴³

⁴⁰ C. Gnaedinger, ‘OECD Announces New Measures for Easing Tax Authorities’ Access to Bank Information’ (17 April 2000) 20 *Tax Notes Int’l* (No. 16) 1725.

⁴¹ See OECD, *Improving Access to Bank Information for Tax Purposes*, (Paris: OECD, 2000).

⁴² See C. Gnaedinger, ‘OECD Announces New Measures for Easing Tax Authorities’ Access to Bank Information’ (17 April 2000) 20 *Tax Notes Int’l* (No. 16) 1725.

⁴³ There are other instruments or mechanisms for exchanging information for tax purposes outside the tax treaty network. Thus, for example, Member States of the EU, pursuant to three Directives, (77/799/EEC, 79/1070/EEC and 92/12/EEC (Article 30)), are able to exchange information within the Union on direct and indirect tax matters. Many OECD members have also ratified the European Convention on Mutual Assistance in Criminal Matters of 20 April 1959. This convention extends assistance in tax matters through an Additional Protocol. In addition, the EC Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering also provides Member States with the possibility of using information thus obtained for taxation purposes. In spite of all these mechanisms, there is a definite link between money laundering and tax evasion as suggested by a recent report of the United Nations Office for Drug Control and Crime Prevention. See United Nations, *Financial Havens, Banking Secrecy and Money Laundering*, (8 June 1998) in OECD, *Improving Access to Bank Information for Tax Purposes*, (Paris: OECD, 2000), para. 48, at 25 n 14. Indeed, the problem of access to financial information, identified in the recent OECD report, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998) is so crucial for the purposes of a fair and neutral tax system that it has been the main subject of discussion at a round table discussion between business and government officials held in Rome on 6-8 September 1999. What transpires from all these initiatives is the relative impotence of national governments acting on a unilateral basis or on uncoordinated and unpooled multilateral instruments. However, a first step has been taken to enhance cooperation in this area, more especially between the G-7, the Financial Action Task Force (FATF) a group made up of 24 OECD Member countries, Hong Kong, Singapore, the European Commission and the Gulf Co-operation Council, and the Committee on Fiscal Affairs of the OECD. Thus, the Committee on Fiscal Affairs will ‘initially review progress in this area at the end of 2002 and thereafter periodically.’ See OECD (2000), *supra* note 41, at 15 para. 21.

- first, and on a bilateral basis, most double tax treaties provide for an exchange of information procedure. Since there are in excess of 1500 treaties concluded on a bilateral basis, the potential for enhanced information flows is formidable;⁴⁴
- second, on a multilateral basis, the Convention on Mutual Administrative Assistance in Tax Matters sponsored by the OECD and the Council of Europe contains a procedure for information exchanges; and
- finally, the U.S. has pioneered the concept of stand-alone tax information exchange agreements and has signed a number of these, mainly with countries of the Caribbean Basin.

According to the OECD, the exchange of information is an essential tool for combating sophisticated ‘methods of tax avoidance and evasion’.⁴⁵ Exchanges of information are provided for in Article 26 of the OECD Model Convention.⁴⁶ This provision, according to the Commentary, is to be construed ‘to the widest possible extent’.⁴⁷ Article 26 of the OECD Model permits the exchange of information which is necessary for carrying out the provisions of a double tax agreement (DTA).⁴⁸ The application of these provisions by different countries has been widely documented.⁴⁹ It is now agreed that, following the 1977 revision of the 1963 Draft Model Convention, much of the ambiguity that originally plagued Article 26 has been removed. However, some difficulties remain, for example, the prescription that the information to be exchanged must relate to a tax which is covered by the DTA, as is the rule that ‘the application thereunder is not contrary to the Convention.’⁵⁰ Therefore, since the Model Convention applies to taxes on income and capital exclusively, exchange of information are limited to such taxes, and do not apply, for example, to sale taxes.

There are two basic principles underlying the information exchange obligations in most DTAs. First, no information can be disclosed unless this type of information is specifically treated as capable of disclosure in the DTA. The reason for this limitation is that, in most instances, the

⁴⁴ R.J. Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’, (1991) 45 *Bull Int’l Fiscal Documentation* 99.

⁴⁵ OECD, Report by the Committee on Fiscal Affairs, *Tax Information Exchange Between OECD Member Countries: A Survey of Current Practice* (Paris: OECD, 1994), at 11 & 17.

⁴⁶ OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris: OECD 1992), looseleaf (1997 update), at M-49. (Note: A 2000 update is now available.)

⁴⁷ *Id.*, at Commentaries on Article 26, Preliminary Remarks, at C-(26)-1 para. 2.

⁴⁸ *Id.*, at M-49 para. 1.

⁴⁹ See, for example, V. Morgan, ‘Mutual Administrative Assistance in Tax Matters’, (1988) 36 *Can. Tax. J.* 974; C Brodersen, ‘Limits on the International exchange of Tax Information’, (1987) 27 *Eur. Tax’n* 171; and P. Dekker, ‘Cross Border Information Under Tax Law: A Dutch Perspective’, (1987) 27 *Eur. Tax’n* 107.

⁵⁰ OECD (1992), *supra* note 46, at M-49 para. 1.

secrecy provisions of a country's domestic tax law require that legislative authority sanctions any disclosure of information to third parties. Second, although an agreement may exist enabling the disclosure of information, signatories to a DTA will invariably interpret strictly their obligation to disclose. This restraint may be traced to the sovereignty principle which in a sense is given away each time a country furnishes information to another.

Yet another limiting factor in the present system of information exchange arises from the principle that an information exchange must apply to such information that is 'necessary' for the purposes of the DTA. This provision is construed to mean information essential for:

- the carrying out of the provisions of the DTA,
- the prevention of fraud, or
- the administration of statutory provisions concerning taxes covered by the DTA.

If any improvement of the exchange of information provisions is to be achieved, then the term 'necessary' needs to be construed widely. For the moment, the construction of the word 'necessary' is left to the individual appreciation of the revenue authorities concerned. The logic of this rule is difficult to defend. One would have thought that if information has been specifically requested, that information is necessary for the authority in order to enable it to properly assess. The restrictive character of the information exchange provisions of DTAs is a serious limiting factor to their effectiveness and requires revision. If this reform is achieved, then it is arguable that information flows between different tax administrations would be enhanced. Indeed, the potential for meaningful exchanges is formidable if revenue authorities were to make better use of the developments in information technology. Computerised databases are, at the moment, being created in major countries.⁵¹ The administration of taxation laws worldwide would be greatly facilitated if information contained in these databases were to become accessible between countries.

ii Tax Information Exchange Agreements

The concept of tax information exchange agreements (TIEAs) was pioneered by the U.S. in the 1980s. In an attempt to gain the cooperation of countries with which it does not have a comprehensive bilateral or multilateral tax treaty, the U.S. is prepared to enter into TIEAs with those countries. Pursuant to section 274(h)(6)(C)(i) of the Internal Revenue Code, the Treasury Department is authorised to negotiate and conclude TIEAs with Caribbean Basin countries, although such agreements may also be entered into with other non-Caribbean

⁵¹ See R. Avi-Yonah 'The Structure of International Taxation', (1996) 74 *Texas Law Review* 1301, at 1337.

countries also.⁵² The U.S. generally considers countries in that region as tax havens.⁵³ In order to entice these countries into entering into TIEAs, the U.S. is prepared to concede to them certain advantages listed in the *Caribbean Basin Economic Recovery Act* which is the legislative implementation of the Caribbean Basin Initiative unveiled by President Ronald Reagan at the Organisation of American States (OAS) meeting in February 1982.⁵⁴ Subject to section 423 of the *Tax Reform Act of 1986*, the main advantage is the duty-free treatment of agricultural and manufacturing products if ‘that article is imported directly from a beneficiary country into the customs territory of the United States’.⁵⁵ While this method may give positive results in the short run, it is submitted that the notion that countries may be induced to provide information on tax matters in exchange for economic aid may not be the most appropriate method to promote tax cooperation.

iii The Convention on Mutual Administrative Assistance in Tax Matters

The *Convention on Mutual Administrative Assistance in Tax Matters* (MAATM),⁵⁶ a multilateral convention promoted by the OECD and the Council of Europe, came into force on 1 April 1995.⁵⁷ The concept of MAATM is borrowed from certain regional agreements of this kind⁵⁸ and is a tool that would ‘allow the tax administrators of signatory states to “organise” their enforcement activities in the same way as multi-nationals organise their tax affairs.’⁵⁹

The purpose of the MAATM is twofold. It provides for:

- the multilateral exchange of information; and

⁵² E.R. Larkins, ‘U.S. International Agreements: Understanding the Process’, (1 July 1996) 13 *Tax Notes Int’l* 59, at 64.

⁵³ For a draft of these agreements, see ‘United States and Caribbean Basin Initiative’, in W.H. Diamond & D.B. Diamond, eds, *International Tax Treaties of All Nations* (Dobbs Ferry: Oceana Publications, 1985) Vol. 17 series B, at 381-409.

⁵⁴ R. Gordon et al, ‘An Analysis of Tax Information Exchange Agreements Concluded by the U.S.’, (10 May 1991) 20 *Tax Management International Journal* 187, at 189.

⁵⁵ United States, *The Caribbean Basin Economic Recovery Act*, at <shelden@www.law.cornell.edu>.

⁵⁶ For a reprint of the Convention, see W.H. Diamond & D.B. Diamond, eds., *International Tax Treaties of All Nations*, (Dobbs Ferry: Oceana Publications, 1988) Vol. 20 series B, at 393-410.

⁵⁷ OECD (1992), *supra* note 46, Commentaries on Article 26, ‘Preliminary Remarks’ at p C-(26)-1 para 3. The MAATM has been ratified by Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden and the United States, see OECD (1994), *supra* note 45, at 27 para. 83.

⁵⁸ The Nordic Mutual Assistance Treaty that was originally signed in 1972 inspired the multilateral convention. A new Nordic Convention on Mutual Assistance in Tax Matters signed in 1989 and in force since 7 December 1991 is in harmony with the MAATM. See OECD (1994), *supra* note 45, at 12-13 para. 11.

⁵⁹ L. Burns & R. Woellner, ‘Bilateral and Multilateral Exchanges of Information’, (May 1989) 23 *Taxation in Australia* 656, at 656.

- the mutual administrative assistance in recovering tax claims in participating countries.⁶⁰

In MAATM, the scope of the exchange of information provisions may be considered as being slightly broader than the requirements in the current bilateral DTAs. This is because of the adoption of a different gateway test to determine what kind of information is to be shared. MAATM provides that information is to be shared if it is ‘foreseeably relevant’ to the assessment collection or recovery of taxes. While an important development in the field of tax information exchanges, the concept of what is foreseeably relevant is relatively flexible and may perhaps open the gate to different interpretations which may, in the end, thwart the very purpose of the Convention.⁶¹

B Improving Dispute Resolution Mechanisms

There are three peaceful mechanisms to resolve international conflicts:

- negotiation between the countries concerned,
- decision by an international court, and
- international arbitration.⁶²

At the present time, although there have been several calls for a World Tax Court⁶³, adjudication of tax matters by an international court is unavailable except to a limited extent within the EU.⁶⁴ The only two available dispute resolution mechanisms are, therefore, negotiation and arbitration.

In recent years a novel method for dealing with such disputes has evolved. The Advance Pricing Agreement (APA) is an attempt to prevent transfer pricing disputes in lieu of the traditional method of trying to solve such disputes after they have arisen.

⁶⁰ These two functions of the MAATM as well as its multilateral character has caused ‘some schizophrenia as to whether MAAT’s importance [in this thesis the acronym MAATM is used] is in its multilateral nature or in its provisions for administrative assistance. In four years the Committee [Committee on Fiscal Affairs] went from talking about a multilateral information exchange treaty to a model convention on administrative assistance. The final product is a combination of both, a point that is often missed. The provisions for reservation in the treaty (Article 30) allow for the severance of the administrative assistance aspects.’ See A. Fletcher, ‘International Agreements-The Convention on Mutual Administrative Assistance on Tax Matters’, (1989) 30 *Harv Int’l LJ*, at 514-23.

⁶¹ Burns & Woellner, *supra* note 59, at 656.

⁶² L. Hinnekens, ‘The European Tax Arbitration Convention and its Legal Framework-I’ [1996] *BTR* 132, at 138.

⁶³ J. Azzi, ‘Tackling Tax Treaty Tensions: Time to Think About an International Tax Court’, (August/September 1998) 52 *Bulletin for International Fiscal Documentation* (No. 8/9), at 344.

⁶⁴ The 1978 Conference of World Peace Through Law Centre commissioned a paper, *A Study on the Feasibility of a World Tax Court*, and a paper by the ICC entitled *Resolution of International Conflicts* dated 16 June 1984, both concluded that ‘in the long run, it should be possible to set up an International Tax Court.’ See also Hinnekens, *supra* note 62, at 139; and G. Lindencrona & N. Matterson, *Arbitration in Taxation* (Kluwer, 1981).

i The Mutual Agreement Procedure

Under the OECD Model, the mutual agreement procedure (MAP) is the primary mechanism available to resolve a bilateral tax dispute. It is essentially an administrative procedure whereby the Contracting States authorise their revenue authorities to negotiate the settlement of disputes arising from the application of a common double tax convention without going through diplomatic channels.⁶⁵ Article 25 of the OECD Model Convention provides that the competent authorities of Contracting States shall endeavour, by mutual agreement, to resolve double taxation issues when there is a risk of double taxation, or whenever disputes arise from conflicting interpretations of the provisions of a treaty.

The MAP and its executive instrument, the competent authority (CA), have, at times, been considered an 'ineffective mechanism(s) to resolve international tax disputes'.⁶⁶ The enduring problems of the MAP are its time limits, the length of the procedure, inadequate taxpayer participation, uncertainty about the details of the procedure, and the collection of tax and payment of interest pending the resolution of the issue. All these problems have now been addressed and recommendations to Member States have been made.⁶⁷ It would appear that at this time certain tax administrations believe that the MAP, if modified along these lines, could adequately serve its intended purpose.⁶⁸ The U.S. Internal Revenue Service (IRS) acknowledges the growing number of cases involving the MAP⁶⁹ while the German government holds the view that the process 'works well' and 'to a large extent protects taxpayers' against double taxation.⁷⁰ In addition, if in the past there were some constraints on the proper exercise of the MAP because of the budgetary limits on the travelling of CAs, this is likely to change given that technological solutions are being experimented with in order to

⁶⁵ See OECD (1992), *supra* note 46, Commentary on Article 25, at C-(25)-14 para. 39.

⁶⁶ S.A. Reece, 'Arbitration in Income Tax Treaties: To Be or Not To Be', (Summer 1992) 7 *Florida Journal of International Law* 277, at 283. See also Picciotto *supra* note 38, at 289-90 for an example of the failure to resolve a double taxation issue through the use of the MAP with the dispute ending in Court. The case (*Boulez v. Commissioner* (1984) 83 T.C. 584) relates to the orchestra conductor Pierre Boulez, a German resident whose fees for conducting orchestral performances in the U.S. for recording purposes were characterised as royalties and taxed both in Germany and in the U.S. without any relief for the conductor through the MAP.

⁶⁷ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995), (1995 OECD Guidelines), at IV-13-IV-21, paras. 4.40-66.

⁶⁸ J. Killaly, 'International Tax Into the Future: An ATO Perspective', *Paper delivered at the Taxation Institute of Australia, International Tax Intensive Retreat* (14-15 June 1996, Mount Eliza Business School) 5.

⁶⁹ On 12 December 1995 the IRS issued Revenue Procedure 96-13 revising the procedural rules to be followed by taxpayers seeking assistance of the U.S. Competent Authority under the mutual agreement article of U.S. tax treaties. For an analysis of the new rules, see J.R. Mogle, 'New Competent Authority Procedures Examined', (14 February 1996) 4 *Tax Management Transfer Pricing Report* 677.

⁷⁰ A. Fernandez et al., 'Federal Bar Association Hones In on International Tax Issues', (18 March 1996) 12 *Tax Notes Int'l* 875, at 876.

enable video conferencing of treaty partners' competent authorities.⁷¹ The MAP operating through the CA is an important procedure to solve double taxation as acknowledged by the former U.S. CA, John Lyons, in a recent interview.⁷² However, this success, according to Lyons, may be short-lived and could lead to a worldwide meltdown of the system. The basis for this conclusion is the following:

- First, there is a belief among 'people in the government in position of authority' that the U.S. CA must strictly adhere to section 482 regulations when negotiating transfer pricing cases. Lyons believes that this tends to entertain the perception that 'the U.S. legislative and regulatory system for determining transfer prices is infallible.'⁷³
- Second, the MAP is meant primarily, to eliminate double taxation. To do so it relies on the application of the arm's length standard. However, the promotion of the arm's length standard as perceived by the U.S. Treasury is gaining ascendance over the primary object of the MAP. This may, according to Lyons, antagonise U.S. treaty partners.
- Third, there is a flurry of requests for CA materials, Field Service Advices, Pacific Area Tax Administrative materials, Group-of-Four materials as well as other treaty-related material going back as far as 1990 pursuant to the Freedom of Information Act (FOIA). This 'raises significant issues of sovereignty and extraterritorial reach of U.S. law.'⁷⁴ This assault on confidentiality of information may 'have a chilling effect on the U.S. CA's ability to conduct its traditional treaty business [and would translate] into a mark drop in the flow of information which could have the impact of paralyzing the entire mutual agreement process.'⁷⁵

⁷¹ Anonymous, 'ACI Researching Competent Authority Use of Teleconferencing, Lyons Says', (31 January 1996) 4 *Tax Management Transfer Pricing Report* 571.

⁷² Thus, the procedure has been responsible for resolving double taxation completely in almost 90 per cent of cases while granting partial relief in the remaining 10 per cent. See Anonymous, 'U.S. Competent Authority Into the New Millennium: A Look Back and Ahead', (17 July 2000) 21 *Tax Notes Int'l* 184.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* It is to be noted that that while Congress declared that APA material as falling outside an FOIA discovery, it did not do so in relation to treaty material.

*ii Advance Pricing Arrangements*⁷⁶

Advance Pricing Arrangements (APAs) may have, in the short term, the potential to solve the problem of income allocation between the various components of TNCs. The first country to adopt a unilateral APA procedure was Japan through its 1987 Pre-Confirmation System (PCS).⁷⁷ Under the PCS, the National Tax Administration of Japan must accept a taxpayer's transfer pricing methodology once it has been 'confirmed'.⁷⁸ The U.S. readily endorsed the concept and has, through Revenue Procedure 91-22, initiated a substantial APA program.

An APA is simply an effort to eliminate the uncertainties and controversies in the taxation of cross-border transactions. It is not a procedure designed to determine specific prices for the transfer of goods and services between the various components of a TNC. Rather, an APA is an agreement between the revenue authorities and the taxpayer as to acceptable transfer pricing methodologies (TPMs).

In general APAs have been welcomed by TNCs⁷⁹ and by small business alike.⁸⁰ An APA may be appropriate in many circumstances, for example, where a TNC is not involved in any deliberate transfer pricing manipulation, an APA is desirable if only to avoid costly disputes with tax authorities where units of the TNC operate. An APA is particularly desirable if it is impossible to find evidence of comparable third party arrangements in order to test the inter-company transfer price. Indeed, an APA is regarded as a positive innovation if the risk of

⁷⁶ The OECD and Australia use the term Advance Pricing Arrangement while the U.S. uses the term Advance Pricing Agreement. The APA procedure is not restricted to the international income tax area. There is evidence of the increasing encroachment of international trade concerns on purely national income taxation matters. The IRS, for example, 'has concluded at least one APA where Customs reviewed the proposed APA terms and signed off on the imported merchandise valuation.' (1995) 4 *Tax Management Transfer Pricing Report* 356. The conclusion of such an APA was made necessary because of the conflict that taxpayers could be faced with in trying to satisfy transfer pricing requirements concurrently with custom regulations as is the case, for example, in the U.S. pursuant to section 1959A of the Internal Revenue Code.

⁷⁷ K. Okawara, 'Japan's National Tax Administration Plans to Issue New PCS (APA) Procedures' (24 May 1999) 18 *Tax Notes Int'l* (No. 21) 2097.

⁷⁸ A. Miyamoto, D. Yoost & G. Noble, 'Japanese APAs hit their stride, (April 1999) 10 *International Tax Review* 9 (No. 4) 39.

⁷⁹ Ernst & Young, 'Transfer Pricing: Risk Reduction and Advance Pricing Agreements', (31 July 1995) *Tax Notes International* 293, at 295. In reality, it would appear that TNCs are using the APA process 'to deal with a few strategic problems and are leaving their serious business for Appeals.' Indeed, TNCs have now two a choice: they either 'cut a deal at 30 cents on the dollar or get an APA.' See Anonymous, 'McIntyre on APA Report and More', (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1775, at 1776.

⁸⁰ In order to extend the APA process to more taxpayers, 'the IRS has implemented an expedited small business taxpayer program and an early referral program.' See A.M. Fernandez & K.A. Bell, 'U.S. APA Program Drawing Foreign Tax Administrators' Attention' (8 June 1998) 16 *Tax Notes Int'l* (No. 23) 1786.

dispute between the taxpayer and the tax authority over subjective ‘guesstimating’ is important.⁸¹

In spite of its acceptance by several countries, some major industrial nations, such as France, have expressed ‘serious reservations about the compatibility of the APA process with the arm’s length principle.’⁸² In April 1996 new regulations on transfer pricing rules were introduced in France.⁸³ These recognise the benefits of APAs, although at that time it would appear that the practice was not popular given the absence of any tradition of dialogue between taxpayers and French tax authorities.⁸⁴ However, it would appear that such reluctance has been put aside and APAs, at least bilateral, APAs, are now available to French taxpayers.⁸⁵ In fact, it would appear that the French authorities ‘are negotiating the first multilateral agreement.’⁸⁶

The British attitude to APAs, after an initial reticence, is such that Steven Harris, one of the IRS’s APA chiefs, has described it as akin to ‘jump[ing] into the pool 100 per cent’.⁸⁷ A new statutory procedure for APAs was introduced in the *Finance Act 1999*⁸⁸ and in September 1999 the ‘U.K. Inland Revenue issued advance pricing procedures, revising a 1998 draft

⁸¹ *Id.*, at 295.

⁸² B. Arnold & T. McDonnell, ‘The Allocation of Income And Expenses Among Countries: Report on the Invitational Conference on Transfer Pricing’, (1993) 10 *Australian Tax Forum* 545, at 565.

⁸³ S. Pope, ‘Recent European Tax Developments - Coopers & Lybrands European Tax Forum’, (24 June 1996) 12 *Tax Notes Int’l* 2006, at 2008.

⁸⁴ P-J Douvier, *Droit Fiscal Dans les Relations Internationales* (Edition A. Pedone, 1996), at 581 para 1569, where the author states: ‘La France est réticente à appliquer une telle pratique; tradition bien culturelle de notre pays, puisque le dialogue institutionnalisé avec l’administration n’existe pas encore en France. Les Etats membres de l’OCDE qui ont expérimenté l’APP sont en nombre limité, mais il semble que ces expériences soient positives.’

⁸⁵ For an analysis of the French APA procedures, see B. Gouthière, ‘Advance Pricing Agreements Introduced’ (March 2000) 40 *European Taxation* (No. 3) 118.

⁸⁶ *Id.*, at 805. Moreover, legislation has been introduced in the French Parliament which if enacted would establish a formal APA program. See comments by Stephane Pellet in Anonymous, ‘Lawyer Says Telecoms Face Problems Due to Changing Industry, Few Comparable’, (19 May 1999) 8 *Transfer Pricing Report* (No. 2) 54, at 55. On 17 September 1999, the French tax authorities issued procedures in the form of a new tax circular for obtaining APAs (Instruction 4 A-8-99 dated 17 September 1999). These new APA guidelines will make bilateral (not unilateral) APAs more accessible to French taxpayers. See Tax Analysts Document Number: Doc 1999-31945 (29 September 1999).

⁸⁷ Fernandez & Bell, *supra* note 80, at 1786.

⁸⁸ See F. Baylis, ‘Advance Pricing Agreements-What will They Offer?’ (March 2000) 40 *European Taxation* (No. 6) 229.

document to allow more time for applying for an APA and to place less emphasis on requiring that APAs be bilateral.⁸⁹

The success of APAs is such that, as least in the U.S., many companies have joined in the race to conclude APAs.⁹⁰ It seems that there is a growing concern among companies that if one of their competitors obtains an APA from the IRS this could result in that company obtaining a competitive edge in the market.⁹¹ In addition, given the headway that the U.S. has in the transfer pricing area⁹² as a result of the relative popularity of its APA program, several countries are responding in the belief that the U.S. policies 'are causing income transfers from their jurisdictions to the United States and reducing tax revenue.'⁹³

The question that arises is whether the APA process could be generalised so as to eventually reach a multilateral level. In October 1994, at a meeting of the Pacific Association of Tax Administrators (PATA), agreement was reached between the U.S., Canada, Australia and Japan for common procedures for bilateral advance pricing arrangements.⁹⁴ At a meeting of the International Fiscal Association (IFA), U.S. Branch, held on 1 December 1994, Michael Durst, Director of the U.S. Internal Revenue Service's APA program, expressed the opinion that 'the next generation of APAs will meet the needs of multinationals operations and go beyond the current trend of bilateral cooperation to the multilateral level'.⁹⁵ In any event, 'the IRS's tour de force, the advance pricing agreement program, continues to flourish...'⁹⁶ By 1997, the IRS had completed more than 170 APAs,⁹⁷ with the process seen as continuously improving.⁹⁸ Since the program started in 1991 and up to the second quarter of 1999, the IRS

⁸⁹ Moreover, taxpayers may also ask the Revenue to address permanent establishment issues as part of an APA; see Anonymous, 'Revised APA Guidance Provides More Time To Seek Accords, Less Emphasis on Bilaterals', (15 September 1999) 8 *Transfer Pricing Report* (No. 10) 428.

⁹⁰ K.W. Gideon et al., 'Advance Pricing Agreements', (June 1996) *International Tax Review Supplement* 9, at 13.

⁹¹ See 'Competitive Interests Snag APA Program Guidance', (8 January 1996) 70 *Tax Notes*, at 138-40.

⁹² S. Harris, 'U.S. programme sets the standard', (April 1999) 10 *International Tax Review* (No. 4) 35.

⁹³ H. Gode, 'France and United Kingdom Respond to Transfer Pricing Challenge', (9 April 1997) 5 *Tax Management Transfer Pricing Report* 803.

⁹⁴ J. MacKinnon, 'IFA's U.S. Branch Considers Recent Worldwide APA Developments, U.S. Conduit Regs', (12 December 1994) 9 *Tax Notes Int'l* 24.

⁹⁵ *Ibid.* In addition, according to S. Claude Lemelin, former chief of the transfer pricing section of Revenue Canada's International Tax Programs Directorate, Revenue Canada is working on an APA which involves up to five nations, (8 May 1996) 5 *Tax Management Transfer Pricing Report* 12.

⁹⁶ S. M. Lyons, U.S. Government Officials Address International Tax Issues, (5 February 1996) 12 *Tax Notes Inter'l* (No. 6) 389, at 390.

⁹⁷ M. Durst, 'APAs: A Personal View', (April 1999) 26 *Tax Planning International Review* (No. 4), at 9-11.

⁹⁸ Advance Pricing Agreements, 'Practitioners Say Field Is Slowing Process, Refusing To Agree to Some Rollbacks of APAs', (30 July 1997) 6 *Tax Management Transfer Pricing Report* 203, at 204.

has finalised 190 APAs⁹⁹ with 196 pending at various stages of development.¹⁰⁰ As of 31 December 1999, 231 APAs had been concluded with another 187 pending.¹⁰¹

At one stage, however, the growth of the APA program had been momentarily slowed down following a lawsuit filed by the Bureau of National Affairs, Inc. (BNA) for the release of information pertaining to APAs.¹⁰² Initially, the IRS argued that these were protected 'return information' documents falling within the secrecy provisions of the income tax legislation given that these documents contain confidential commercial or financial information, attorney-client privileged materials, or are documents protected by the deliberative process privilege granted to government agencies.¹⁰³ However, faced with the prospect of disclosure by order of the Court, the IRS stated in January 1999 its intention to disclose APA information under section 6110 of the U.S. IRC. Nevertheless, to preempt any loss in confidence in the confidentiality of the process, Public Law 106-170 amended section 6103 to provide that advance pricing agreements and related background information are confidential return information. Moreover, the law provides that 'APAs and related background information are not "written determinations"' as that term is defined in section 6110. Therefore, the public inspection requirements of section 6110 do not apply to APAs and related background information.¹⁰⁴

Another incidental advantage arising from the success of the APA program proceeds from the growing experience of tax administration with the CA process. Bilateral APAs are taking less time to negotiate as tax authorities now make use of technology and bypass the normal channels to negotiate the arrangement.¹⁰⁵ Progress is also being achieved towards the

⁹⁹ Anonymous, 'Known Completed U.S. Advance Pricing Agreements', (11 August 1999) 8 *Transfer Pricing Report* (No. 8) 275.

¹⁰⁰ Anonymous, 'IRS Reports 14 APAs Completed, Sixteen Requests Received in 2nd Quarter', (28 July 1999) 8 *Transfer Pricing Report* (No. 7) 267.

¹⁰¹ Anonymous, 'IRS First Annual Report on Advance Pricing Agreements', [Announcement 2000-35, released 3/30/00], (2000) 8 *Tax Management Transfer Pricing Report* (No. 24) 1020. For an assessment of the usefulness of information presented in the report, see P.B. Burns, 'The APA Program's Ninth-Birthday Snapshot: One Practitioner's Perspective on the First Annual Report', (1 May 2000) 20 *Tax Notes Int'l* (No. 18) 1931.

¹⁰² See S. Grodnitzky, 'U.S. APAs Should Be Kept Confidential, Says Canada's National Revenue Minister and Competent Authority', (26 July 1999) 19 *Tax Notes Int'l* (No. 4) 323.

¹⁰³ 'IRS Issues Final Denial of Tax Analysts Request for APAs under FOIA', (17 June 1996) 12 *Tax Notes Int'l* 25.

¹⁰⁴ See U.S. *Joint Committee on Taxation Reports on Confidentiality and Disclosure Provisions* JCS-1-00, Volume 1 (28 January 2000), at <<http://taxbase.tax.org/taxbase>>. For an analysis of this legislation which resulted from the so-called Archer-Roth proposal as well as the U.S. Treasury legislative proposals, see Anonymous, 'Practitioners Raising Questions About Archer-Roth Annual APA Report', (28 July 1999) 8 *Transfer Pricing Report* (No. 7) 275.

¹⁰⁵ Anonymous, (22 May 1996) 5 *Tax Management Transfer Pricing Report* (No. 2), at 28-29.

conclusion of multilateral APAs. For example, a representative of Revenue Canada revealed in an interview that his country is in the process of negotiating an APA involving up to five nations.¹⁰⁶ The success of APAs is likely to continue in the short and medium term now that the confidentiality question has been resolved at least in the U.S. As for the OECD, after having looked into 'whether it should establish some type of international APA standards' in order to promote consistency in practice among nations that use this method has, in October 1999, published its guidelines for conducting Mutual Agreement APAs.¹⁰⁷

iii Arbitration in Tax Disputes

Arbitration as a means of resolving international commercial disputes has long been considered as an alternative to judicial adjudication in international commerce.¹⁰⁸ In recent years, the issue of arbitration to resolve international tax disputes, especially in the area of transfer pricing, has been at the forefront of the debate.¹⁰⁹ This is by no means a new idea. As early as 1895 in Germany, L von Bar and, in 1899 in Italy, A Garelli were advocating arbitration in taxation matters.¹¹⁰ One of the first double tax conventions to include an arbitration provision was signed on 14 April 1926 between the U.K. and Ireland.¹¹¹ The Institute of Fiscal Association explored arbitration at its Congresses held in Zurich in 1951 and later in Florence in 1993. Business is also quite favourable to the idea as evidenced by the BIAC 1971 Position Paper on the proposed amendment to Article 25 of the 1963 OECD Draft Model Convention and

¹⁰⁶ See interview with S.C. Lemelin, former chief of the transfer pricing section of Revenue Canada, 'Canada Working on APA to Involve Five Nations', (8 May 1996) 5 *Tax Management Transfer Pricing Report* 12.

¹⁰⁷ See statement made by Jeffery Owens, Head of the OECD's Fiscal Affairs Division in 'More Nations Accepting APAs, Adopting Formal APA Programs', (14 August 1996) 5 *Tax Management Transfer Pricing, Special Report*, Report No. 22, at 5. See also, OECD, Committee on Fiscal Affairs, *Guidelines for Conducting Advance Pricing Arrangements Under the Mutual Agreement Procedure*, DAF/CFE/WP6(99)1 (Paris: OECD, 1999) and J. Neighbour, 'OECD Issues Guidance on Mutual Agreement APAs', (22 November 1999) *Tax Notes Int'l* 1954. For a comparison between the U.S. and the OECD APA procedures, see S.C. Wrappe & B.J. Mantegani, 'Side-by-Side Comparison of Advance Pricing Agreement Procedures for the U.S. and the OECD' (6 March 2000) 20 *Tax Notes Int'l* (No. 10) 1133.

¹⁰⁸ W.W. Park, 'Finality and Fairness in Tax Arbitration', (June 1994) 11 *Journal of International Arbitration* 19, at 20.

¹⁰⁹ See, for example, D.R. Tillinghast, 'The Choice of Issues to be Submitted to Arbitration Under Income Tax Conventions', in H. Alpert and K. van Raad eds., *Essays on International Taxation in Honour of Sidney I. Roberts* (Kluwer, 1993) 349; J-P LeGall, 'Fiscalité et arbitrage', (1994) *Revue de l'Arbitrage* 3.

¹¹⁰ Hinnekens, *supra* note 62, at 141.

¹¹¹ Article 7, 'Any question that may arise between the parties to this Agreement...shall be terminated by such tribunal as may be agreed between them, and the determination of such tribunal shall, as between them, be final.' In Hinnekens, *supra* note 62, at 141.

the 1984 ICC's Resolution of International Conflicts.¹¹² While the idea of arbitration seems to be popular in various quarters, there is some difficulty in putting this option into practice.

There have been numerous calls for the establishment of 'an independent arbitral institute to address international tax matters.'¹¹³ Within the EU, the Ruding Committee, like the Neumark Committee in 1962, recognised the need to resolve double taxation arising from transfer pricing disputes in order for the single internal market to operate efficiently.¹¹⁴ On 23 July 1990, the 12 original EU Member States signed the Convention on the Elimination of Double Taxation in connection with Adjustment of Profits of Associated Enterprises (90/326/EEC) in Brussels. It became effective for an initial period of five years as from 1 January 1995.¹¹⁵

The OECD is well aware of the need for a proper arbitration process in its model treaties to complement the mutual agreement procedure. In this regard, it is significant that its 1995 Report contains a short section on arbitration.¹¹⁶ The Report concedes that relief is not guaranteed under the MAP if tax administrations cannot reach an agreement. The OECD agrees that in such circumstances a certain form of arbitration could prove to be an adequate tiebreaker. Consequently, the Report will be supplemented with the conclusions of a study of the question to be undertaken as a matter of urgency by the Committee on Fiscal Affairs.

Interest in arbitration as a method of resolving international tax disputes originated with certain dissatisfaction with the MAP. With the renewed interest in the MAP, as already discussed, perhaps what is needed is simply the availability of an arbitration procedure rather than arbitration itself. In other words, if the parties have at their disposal the possibility of arbitration outside the usual tax administrative machinery, then it is arguable that tax administrators may be keener to resolve the dispute on their own terms rather than submit to an external body. Furthermore, the availability of arbitration may act as an incentive for the parties involved to resolve the dispute. Indeed, any party refusing to submit to arbitration, if available, may be viewed as bearing the responsibility for the failure to reach a satisfactory conclusion. In any event:

¹¹² International Chamber of Commerce, 'The Resolution of International Tax Disputes', (1984) 24 *European Taxation* 337.

¹¹³ Reece, *supra* note 66, at 286. See also J.N. Covington, 'Dispute Resolution Under Tax Treaties: Current and Proposed Methods', (1989) 24 *Texas International Law Journal* 367.

¹¹⁴ *Ruding Report*, *supra* note 16, at 205.

¹¹⁵ For a thorough analysis of the Convention, see Hinnekens, *supra* note 62.

¹¹⁶ OECD (1995), *supra* note 67, Ch. IV, section G, at IV-53 paras 4.167-171.

[I]f one of the contracting states expresses a willingness to go to arbitration when a mutual agreement procedure is unresolved there is a feeling amongst tax administrations that this will place heavy pressure on the other party to agree..¹¹⁷

Under the current MAP, as provided for in the OECD Model, it is impossible to establish who is accountable if there is no resolution of the conflict. Clearly, the non-resolution of tax conflicts has the potential to hamper the expansion of cross-border business. It is urgent, therefore, to find an acceptable form of arbitration procedure in taxation matters to ease the pressures that are being brought to bear on the tax treaty system as a result of the constant expansion in international trade. Arbitration has been a feature of international commerce for decades and it has worked well. There is no reason why this success could not be duplicated in the taxation area. Thus, the constant osmosis between international trade and international taxation is again confirmed, as is the relentless evolution in international tax rules.

Section II The Evolution of Existing Rules

The latest illustration of the evolution of international tax rules is the emergence of profit-based methodologies for the apportionment of cross-border income. These have appeared as a result of the weaknesses of the traditional transaction-based methodologies as already studied. A transactional profit-based methodology is described by the OECD as one which ‘examines the profits that arise from particular controlled transactions’.¹¹⁸ It may well be that these methodologies are the precursors of some form of global formulary apportionment notwithstanding the OECD’s aversion of the latter.

1 The Emergence of Profit-Based Methodologies

The U.S. pioneered the use of profit-based methodologies after the relative failure of the traditional methods to achieve their objective.¹¹⁹ Profit-based methodologies:

no longer attempt to derive an arm’s length *price* from comparable individual transactions, but an arm’s length *return* by focussing on returns on investment in comparable firms or dividing between

¹¹⁷ R.J. Vann, *The Future of International Tax Treaty or Institution? Small Step or Great Leap?* (1996), unpublished paper.

¹¹⁸ OECD (1995), *supra* note 67, at III-1 para. 3.2.

¹¹⁹ See, for example, the address of U.S. Treasury Assistant Secretary Leslie B Samuels to the Seventh Annual International Tax Institute held on 16 & 17 December 1994 sponsored by the Internal Revenue Service and George Washington University in which he observed that ‘the reality is that the traditional methods are often inadequate to deal with many transfer pricing cases’, (26 December 1996) 8 *Tax Notes Int’l* 1951. See also OECD, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations* (Paris: OECD, 1993); Committee on Fiscal Affairs, ‘The U.S. Proposed Regulations Dealing with Tax Aspects of Transfer Pricing Within Multinational Enterprises’, (January 1993) 47 *Bulletin For International Fiscal Documentation* 21.

them the combined profits in two interrelated members of the same MNE [Multinational Enterprises].¹²⁰

Thus the introduction of the comparable profit method and the profit split method. The emergence of these methods has caused some concern for the OECD.¹²¹ However, the U.S. Treasury and the OECD have managed to shape a compromise which will be further examined below.¹²²

A The Comparable Profit Method

One of the first profit-based methodologies is the comparable profit method (CPM) which appeared in the U.S. 1993 Temporary Regulations. It is a revised version of the 1992 Comparable Profit Interval Method.¹²³ The CPM determines the arm's length consideration¹²⁴ for a controlled transfer of property by referring to objective measures of profitability called 'profit level indicators' derived from uncontrolled taxpayers engaged in comparable business activities with other uncontrolled taxpayers in similar circumstances.¹²⁵ Profit indicators are 'ratios that measure the relationships between the profits and costs incurred or resources employed,'¹²⁶ for example, the location, size and line of business. In determining such profit level indicators, any differences between the companies being compared need to be taken into account when applying the CPM. While several profit level indicators may be used, those most likely to be favoured would be the rate of return on assets and financial ratios, such as operating profits to sales, or gross profit to operating expenses.¹²⁷ The profit level of the tested party is then compared to those of an uncontrolled party with adjustments made if there are important differences between them. Significantly, the tested party does not have to be the

¹²⁰ S. Plasschaert, 'Transfer Pricing for Managerial Purposes in Relation to Fiscal Parameters', (1997) 4 *International Transfer Pricing Journal* (No. 5) 198, at 201.

¹²¹ OECD, *Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations* (Paris: OECD, 1993); OECD, *Intercompany Transfer Pricing Regulations Under Section 482 Temporary and Proposed Regulations*, (Paris: OECD, 1993) (OECD/GD (93) 131).

¹²² See P. Blackwood, 'Transfer Pricing', *Paper presented at the First Trans-Tasman Tax Conference held under the aegis of the Taxation Institute of Australia and NZ Society of Accountants* (1-5 May 1996, Auckland) 2.

¹²³ United States, Department of Treasury, Internal Revenue Service, TD 8552, *Intercompany Transfer Pricing Regulations Under Section 482* (1994 Final Regulations) in LEXIS/NEXIS File TXLAW5 42, at 44.

¹²⁴ Whether the CPM satisfies the arm's length standard is still debateable. See J. VanderWolk, 'Direct Taxation in the Internet Age: A Fundamental Approach', (April 2000) 54 *Bulletin for International Fiscal Documentation* (No. 4) 173, at 174.

¹²⁵ J.E. McDermott et al., *Transfer Pricing Under U.S. Law - The New Regime: 1994 Final Regulations* (IBC Financial Publishing Ltd, 1995) 45.

¹²⁶ United States, Section 1.482-5(b)(4).

¹²⁷ United States, Department of Treasury, Internal Revenue Service, *supra* note 123, at 72.

taxpayer, but may instead be another member of the controlled taxpayer's group, for example, its parent corporation.

If taxpayers in the same business and subjected to the same circumstances tend to earn similar returns over a reasonable period of time, then in order to determine an adequate return for a particular enterprise it makes sense to examine the level of profits earned by another enterprise of roughly the same size, engaged in a similar business, and operating under similar conditions. This exercise should demonstrate that profits earned by the controlled enterprise and that earned by the uncontrolled one are comparable.¹²⁸ In broad terms this is what the CPM intends to achieve.¹²⁹ However, in doing so, it 'deviates from the historical approach for transfer pricing methodologies, since it does not look at prices and attempt to adjust those prices to a value similar to a price which would be determined by the free play of market forces.'¹³⁰

B The Transactional Net Margin Method

The 1995 OECD Guidelines state that the 'Transactional Net Margin Method (TNMM) examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction.'¹³¹

The TNMM is applicable as a method of last resort in situations where:

- it is not possible to identify gross margins or mark-ups, but net margins are available;
- differences in functions make the use of gross margins unreliable; or
- differences in expense structures have a material effect on gross margins and prevent reliable adjustments.

The theoretical justification of the TNMM is that returns earned by firms in a particular industry tend to be the same over a reasonably long period of time if they operate under similar conditions.¹³² It follows that the profits earned by a taxpayer in a controlled transaction may be compared to those earned by an uncontrolled party in order to determine an arm's length profitability result. The TNMM seeks to make such a comparison. Net profit margins are

¹²⁸ *Supra* note 123, at 164.

¹²⁹ J.P. Fuller, 'International Tax Development', (July/August 1995) 49 *Bulletin for International Fiscal Documentation* 302, at 304.

¹³⁰ McDermott et al., *supra* note 125, at 46.

¹³¹ OECD 1995 Guidelines, *supra* note 67, at III-9 para. 3.26. It is arguable that the TNMM is in reality the resurfacing of Carroll's empirical methods; see McDermott et al., *supra* note 125, at 25.

¹³² D.R. Wright et al., 'TNMM - The OECD's Response to CPM: Are they Really Different?', (1995) 35 *European Taxation* 306.

compared rather than gross profit margins as in the resale and cost-plus methods.¹³³ This means that the TNMM is designed to operate in a manner similar to the cost plus and resale price methods, except that it relies more on indirect data. It is perhaps because of this indirectness of the data used that the OECD maintains the TNMM be applied only as a matter of last resort. With the TNMM net profit is 'expressed relative to sales, costs, or assets; the most commonly employed measures are return on sales and return on assets.'¹³⁴

Finally, it is convenient to note that the language used to describe the TNMM is very similar to that used in relation to the U.S. CPM. This tends to strengthen the view that TNMM and CPM are broadly similar, as will be examined later. Moreover, after comparing the CPM with the Australian Profit Comparison Method (PCM), a method tentatively explored in Australia's Draft Ruling TR95/D22, the Australian Taxation Office (ATO) concluded that the latter is equivalent to the TNMM.¹³⁵

C Profit-Split Methods

The profit-split method is normally employed in situations where transactions are so interrelated that it is impossible to evaluate them on a separate basis.¹³⁶ The 1995 OECD Guidelines define profit split as a method which:

seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction... by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.¹³⁷

In the first place this method identifies the profit (or losses) to be split between the associated enterprises by examining the transactions in which the associated enterprises are engaged while seeking 'to achieve the division of profit that independent enterprises would have realised'.¹³⁸ It then divides the total profit earned between the two related parties using a formula, for example, the ratio between earned profit to capital employed, or any other 'economically valid' method. The profit-split method may be applied to the whole of the profit (or losses) generated by the transactions¹³⁹ or to a residue of the latter that cannot be allocated to the

¹³³ Around the World, OECD, 'Draft's Call for Net Margin-Based Method Raises Questions About CPM's Global Role', (7 June 1995) 4 *Tax Management Transfer Pricing Report* 74.

¹³⁴ Wright et al., *supra* note 132, at 311.

¹³⁵ See P. Blackwood, 'Australia's Draft Transfer Pricing Rulings,' (15 November 1995) 4 *Tax Management Transfer Pricing Special Report*, Report No. 20 at 5. See also Australian Draft Ruling TR95/D22 para. 470.

¹³⁶ United States, Section 1.482-6, in LEXIS/NEXIS, *supra* note 123, at 174.

¹³⁷ OECD 1995 Guidelines, *supra* note 67, at III-2 para. 3.5.

¹³⁸ *Supra* note 67, at III-2 para. 3.5.

¹³⁹ The so-called contribution analysis, see OECD 1995 Guidelines, *supra* note 67, at III-6 para. 3.16.

parties because they arise from the use of high-value and unique intangibles.¹⁴⁰ Finally, in order to determine their relative contributions, a functional analysis of each of the participating enterprises needs to be carried out.

One crucial issue is whether the OECD's profit-based methodologies and those of the U.S. 1994 Final Regulations are compatible. In case of incompatibility, the risk of double taxation arises if the U.S. applies its own version of the profit-based methodologies while the other OECD Member countries apply the OECD's recommendations, or worse opt for their own methodologies in a free-for-all stampede. Nonetheless, in spite of the seemingly opposing views, and in an effort to reach comparable solutions, there has been much cooperation between the U.S. and the OECD regarding this question of compatibility.¹⁴¹ The comments regarding the convergence of the U.S. and the OECD position are favourable.¹⁴² Indeed, these indicate that there is a real convergence between the two profit-based methodologies.¹⁴³ Nevertheless, there are two major differences between the two sets of measures which, if not addressed, are likely to cause double taxation. The first of these differences relates to the use of ranges.¹⁴⁴ The second important difference is in the use of the inter-quartile range by the U.S. Regulations.¹⁴⁵ This entails the exclusion of the top and bottom 25 per cent of the range. While the IRS permits taxpayers to use comparable data without adjustments for differences in functions and risks, a limit for the determination and evaluation of transfer prices by the CPM is nevertheless imposed by the prescription relative to the inter-quartile range. Therefore, the most serious problem that this may likely cause is a dispute between one jurisdiction applying the OECD Guidelines and finding that the appropriate transfer price is precisely within either the lower or the upper 25 per cent of the range, while the IRS would be forced to find that the appropriate transfer price is within the inter-quartile range. Such a variance would then need to be solved through the MAP if double taxation is to be avoided. As for the Australian Taxation

¹⁴⁰ This method is termed the residual analysis, see OECD 1995 Guidelines, *supra* note 67, at III-7 para. 3.19.

¹⁴¹ See *Around the World*, *supra* note 133, at 75 where it is claimed that 'TNMM is an attempt by the OECD and the United States to adjust the language of the July 1994 version of Part I (the Draft Guidelines) to accommodate concerns and the varying regulations of different European countries.' See also A. Fernandez & SM Lyons, 'The Transatlantic Tax Outlook: European and U.S. Tax Relations', (17 June 1996) 12 *Tax Notes Int'l* 1923, at 1924.

¹⁴² Wright et al., *supra* note 132, at 311-13. See also D. Cheng, 'General Comments and Comparison Chart on the 1994 Final Section 482 Regulations and the 1995 OECD Guidelines', (30 October 1995) *Tax Notes Int'l* 1184, at 1185; R. Culberston, 'A Rose by any Other Name: 'Smelling the Flowers of the OECD's (last) Resort' (7 August 1995) *Tax Notes Int'l* 370; C.S. Triplett et al., 'Extensive Similarity, Fundamental Accord Found In Comparison of Revised OECD Guidelines, 482 Rules', (5 July 1995) 4 *Tax Management Transfer Pricing Report* 140.

¹⁴³ Wright et al., *supra* note 132, at 313.

¹⁴⁴ OECD 1995 Guidelines, *supra* note 67, at III-15 para. 3.45.

¹⁴⁵ M. Schwartz, 'OECD Issues Latest Guidelines', (September 1995) *International Tax Review* 11, at 12.

Office, its view on this particular point is that ‘the excision of the upper and lower quartiles from the sample used to calculate the comparable profit tends to produce average outcomes.’¹⁴⁶

The emergence of profit-based methodologies is the latest answer to the limitations of transaction-based methodologies to arrive at acceptable transfer prices in the context of TNC operations. Notwithstanding this, 1995 OECD Guidelines maintain the superiority of transaction-based methodologies over profit-based ones. Pursuant to the Guidelines, the latter should be used only in the last resort. On the other hand, while it proclaims the same policy, the general conviction is that the IRS is likely to favour profit-based methodologies as a method of first rather than last resort.¹⁴⁷ This is because the use of transaction-based methodologies is premised on the availability of ‘sufficient good quality data’. The determination of ‘sufficient good quality data’ is a highly subjective exercise. The IRS, pursuant to the 1994 Final Regulations, is required to follow ‘the most reliable’ method in order to determine appropriate transfer prices. This means that if data is unavailable, then the IRS will have to fall back on the CPM in order to achieve its outcome. In addition, while pledging its preference for transaction-based methodologies, the U.S. regulations have at the same time expanded the circumstances in which profit-based methodologies should be applied, notably to the transfer of valuable intangible property.¹⁴⁸

In any event, over the years there has been an evolution of the arm’s length principle and the official recognition of that evolution is acknowledged in the 1995 OECD Guidelines.¹⁴⁹ The 1995 OECD Guidelines reaffirmed the organisation’s commitment to the arm’s length principle as the most appropriate method for the taxation of TNCs. Nevertheless, it is submitted that there has been a subtle shift in OECD Member countries’ perception of what the arm’s length principle stands for.

A significant illustration of this is found in the language used, for example, by the Australian authorities in their interpretation of Division 13, the anti-profit-shifting provisions of the Australian *Income Tax Assessment Act 1936*. While these provisions use the expression ‘arm’s length price’ the Commissioner of Taxation refers more readily to an ‘arm’s length

¹⁴⁶ Blackwood, *supra* note 135, at 5.

¹⁴⁷ S.P. Hannes, ‘Commentary on U.S. Final Regulations’, in T. Cooper, ‘A Comparison of the Profit-based Pricing Methodologies under the Transfer Pricing Rules of Australia and the United States: Are They a Voluntary Compliance Option For the Taxpayer?’, (1995) 12 *Australian Tax Forum* 91, at 105.

¹⁴⁸ For the ascendance of profit-based methodologies, see A. Fernandez & T.F. Field, ‘Canadian Tax Foundation Holds First World Tax Conference’, (6 March 2000) 20 *Tax Notes Int’l* (No. 10) 1056, at 1060.

¹⁴⁹ OECD 1995 Guidelines, *supra* note 67.

consideration’, an ‘arm’s length outcome’ or an ‘arm’s length range.’¹⁵⁰ Clearly, the ATO, like many other revenue authorities around the world, is coming to the conclusion that the traditional approach in the application of the arm’s length principle is unsatisfactory and is exploring new approaches for its application.

In addition, it is reasonable to conclude that although both the OECD and the U.S. regulations claims to the contrary, the reality is that both the TNMM and the CPM purport to set a benchmark as to the level of profitability that is expected for an enterprise in a given industry. Indeed, profit-based methodologies seek ‘to determine the nature of the audited business and its functions for the purposes of comparing and, if necessary, adjusting its *overall* profitability with that of comparable uncontrolled businesses.’¹⁵¹ Therefore, through a backdoor device, tax authorities are given the opportunity to ‘dictate to taxpayers in what business they shall engage or how to run their businesses profitably or economically.’¹⁵²

Profit-based methodologies may thus be viewed as a transition from the well-known transactional methodologies to the lesser-known world of profit apportionment methodologies. Profit-based pricing methodologies have certain definite practical advantages over the traditional methods. There is thus a serious possibility that they ‘will become the preferred methodologies of tax auditors’ in certain jurisdictions.¹⁵³ If this is to be the case, then it is important that a certain uniformity be achieved in their application. Uniformity, or at least a certain concerted effort towards uniform application, has been achieved in the case of transactional methodologies through a rather strict adherence to OECD recommendations. The same result must be replicated in respect of profit-based pricing methodologies.

2 A Refined Application of the Existing Rules

In 1991 Professor Vann published a paper criticising tax treaties in general and the OECD Model in particular.¹⁵⁴ In 1996, in a series of unpublished papers, he reviewed that critique and tentatively identified the major evolutionary trends in international taxation.¹⁵⁵ An

¹⁵⁰ Australia, Taxation Ruling TR 97/20, *Income Tax: Arm’s Length Transfer Pricing Methodologies for International Dealings*. See also, Taxation Ruling TR 94/14, *Income Tax: Application of Division 13 of Part III (International Profit Shifting) – Some Basic Concepts Underlying the Operation of Division 13 and Some Circumstances in Which Section 136 AD Will Apply*, for example, at para. 367.

¹⁵¹ Cooper, *supra* note 147, at 99.

¹⁵² Per Deane & Fischer JJ in *Magna Alloys & Research Pty Ltd v FCT* (1981) 11 ATR276, at 293. The Court of course disapproved this attitude.

¹⁵³ Cooper, *supra* note 147, at 107.

¹⁵⁴ R.J. Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’, (1991) 45 *Bull for International Fiscal Documentation* Part I, 99-111 & Part II, 151-63.

¹⁵⁵ Vann, *supra* note 117.

examination of these ideas discloses two main themes that are likely to dominate international taxation in the short and medium term, that is, a refined application of existing ideas and the emergence of institutional models.

A An Innovative Application of Existing Treaty Rules

One of the most salient characteristics of the emerging global economy is the growing importance of trade in high-value services. Goods now incorporate such high value services, for example, computer hardware where value is not in the hardware per se but rather in the patent and know-how on which the machine is built.

Double Tax Agreements (DTAs) do not deal effectively with the concept of high-value services. The construction of old concepts such as the permanent establishment (PE), royalties, or the provision of dependent or independent services have been stretched to accommodate these new developments. Thus, for example, following the 2000 update of the OECD Model Convention, Article 14 governing the taxation of income from independent services has been removed. This is justified:

on the assumption that there were no intended differences between the concepts of “permanent establishment” and “fixed base” and, moreover, between the computation of profits under Arts. 7 and 14.¹⁵⁶

i The Treatment of High-Value Services

Traditionally, firms engaged in international commerce carry out their activities either through branches or subsidiaries. The PE of a TNC still constitutes the minimum nexus that allows a particular jurisdiction to tax profits derived in its territory. The question that arises is whether the PE concept fits the model used by TNCs to provide high value services. In addition, with high value services, the immediate issue is whether the traditional views pertaining to revenue characterisation are still workable.¹⁵⁷

Most of the value of such services rests in their intellectual property and copyright components rather than with their physical attributes as, for example, with an on-line tax advice service. A purely orthodox application of the concept is likely to cause serious problems for source countries attempting to tax the activities of TNCs engaged in the provision of such services.

Services may be associated with highly expensive equipment which is often very mobile, unattended, or even located beyond the jurisdiction of any state, for example,

¹⁵⁶ See K. Vogel, ‘Tax Treaty News’, (March 2000) 54 *Bulletin for International Fiscal Documentation* (No. 3) 98.

¹⁵⁷ D. Osborne, ‘Revising Royalties in the Age of Electronic Commerce’, (1999) 47 *Canadian Tax Review* (No. 2) 410.

telecommunication facilities in space, or a Web site in a tax haven.¹⁵⁸ With electronic commerce, therefore, the traditional conditions for the existence of a PE may not be satisfied.¹⁵⁹ Even if a PE is found to exist, the problem of calculating and collecting the resulting tax liabilities from enterprises operating under these novel conditions remains unsolved. Clearly, electronic commerce raises a certain number of tax issues that need to be addressed in a comprehensive way.¹⁶⁰ For example:

- Does an enterprise of country A, which engages in electronic commerce in country B, have a sufficient presence in B (the PE concept) to justify the revenue authorities of B exercising its taxing authority?¹⁶¹
- How is income generated by electronic commerce to be characterised?
- Is it sales income, royalties, rental income, or income from services?
- What should be considered as appropriate tests to determine where such income has been derived?
- How should income and deductions be allocated among various parts of a TNC engaged in electronic commerce?

To deal with such questions a novel approach to tax administration is required.

ii The Necessary Evolution in Tax Administration

If national tax administration is to adapt to the significant changes in the way business is being conducted, cooperation between national tax administrations is absolutely critical.¹⁶² Therefore, a fresh approach seeking to manage the system as a whole needs to be pursued as

¹⁵⁸ See A. Hamilton, 'Electronic Commerce: Task Forces Take Shape in the U.S.', (12 May 1997) 14 *Tax Notes Int'l* 1539.

¹⁵⁹ OECD, *A Borderless World: Realising the Potential of Global Electronic Commerce; Report on International and Regional Bodies: Activities and Initiatives in Electronic Commerce*, (Paris: OECD, 1998) SG/EC(98)10/REV2. See also OECD, *Electronic Commerce – Overview of Online Delivery of Digitised Products and Other trade Policy Issues* (Paris: OECD, 1999) TD/TC/WP(98)30/REV1.

¹⁶⁰ See H.E. Abrams & R.L. Doernberg, 'How Electronic Commerce Works', (12 May 1997) 14 *Tax Notes Int'l* 1573.

¹⁶¹ In October 1999, Working Party No. 1 on Tax Conventions and Related Questions released, for comments, a proposal for the clarification of the Commentary on Article 5 dealing with the application of the permanent establishment definition in the context of electronic commerce. This document is available at <<http://www.oecd.org>>. For a review of the comments received, see OECD, 'The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Proposed Clarification of the Commentary on Article 5 of the OECD Model Tax Convention', (May 2000) 40 *European Taxation* (No. 5) 190.

¹⁶² See U.S. Treasury Department, 'U.S. Treasury Secretary Summers Speaks to Inter-American Center of Tax Administrators General Assembly, Tax Analysts Document Number: Doc 2000-18649 (10 July 2000).

is proposed in this thesis. Tax administration in an increasingly internationalised environment will probably rest on three major instruments and these are:

- the exchange of information and the mutual agreement procedures,
- advance pricing arrangements, and
- arbitration.

These instruments as well as the Convention on Mutual Administrative Assistance in Tax Matters (MAATM) have already been analysed. What is also clear is that tax administration is moving from the national to the international level. Thus, the OECD has instituted a monitoring procedure to examine whether Member countries' legislation, regulations, and administrative practices are consistent with its 1995 Guidelines. This monitoring is carried out through a peer review, which may be construed as an innovative tax administration method.

This evolution in tax administration is apparent when one considers the recent proposal of the European Commission in the field of tax administration. In international law one state will not assist in the enforcement of a tax debt due to another state. This practice is known in the U.K. as the *Government of India* principle as recognised in *Government of India v Taylor*.¹⁶³ This principle is followed by other members of the EU and is indeed upheld throughout the world. However, breaking away with tradition, the European Council Directive 76/308/EEC of 15 March 1976 restricted the application of the principle and instead provided that certain debts for unpaid taxes and duties pertaining to agricultural levies and custom duties and owed to a Member State could be recovered within the EU. In 1979, the Directive was extended to VAT and excise duties on tobacco, alcohol, and mineral oils. The new proposal from the European Commission would extend the provision for mutual assistance in the recovery of unpaid taxes to 'taxes on income and capital', for example, income tax, corporation tax and capital gains tax. If this proposal is adopted, then the principle of non-assistance in the direct enforcement of foreign tax debts will disappear within the EU. Therefore, those governments within the EU that have not signed the OECD-Council of Europe multilateral agreement for mutual assistance in tax matters may find themselves in a position as if they had done so.¹⁶⁴

B Beyond Existing Tax Treaties

There are two main factors which are progressively remodelling the principles of international business taxation. On a general level, the influence of international economic law is growing in

¹⁶³ [1955] A.C. 491.

¹⁶⁴ P. Baker, 'Mutual Assistance in The Recovery of Tax Claims: No *Government of India* in the European Union?' [1999] *B.T.R.* (No. 1) 14.

this area, while the interaction between two specific principles of economic law and international taxation is increasingly being felt as international trade expands.

The effect of the ongoing internationalisation of world economies is a steady expansion of international trade in both the traditional goods sector and in the services sector.¹⁶⁵ In the latter case, growth has been such that a General Agreement on Trade in Services (GATS) has had to be conceived in order to facilitate exchanges. The GATS aims at achieving benefits similar to those of the General Agreement on Tariffs and Trade (GATT).¹⁶⁶

The continuing expansion of international trade requires the concurrent promotion of certain broad principles of international economic law which, if applied on a worldwide basis, would create the conditions of stability and security in which trade flourishes resulting in a sustainable growth in world welfare.¹⁶⁷

Taxation is an important element of international economic principles. It is viewed by TNCs as a cost and its relative control through optimum transfer pricing strategies enhances their returns. Since TNCs consider taxation as a cost of engaging in trade, it must necessarily affect to a certain degree the qualitative as well as quantitative aspects of international trade. Moreover, the higher the trade volume of one country, the higher is that country's expected revenue. Therefore, to maximise international trade is a direct way of maximising revenue, provided correct taxation methods are in place.

A certain evolution towards the economic, rather than a narrow legal view, is now permeating the development of international tax law. TNCs require a standardisation of broad economic principles in order to operate efficiently. They also require comparable tax administration systems if not an international tax organisation that would guarantee equality of treatment to allow truly global competition. There is, however, a fundamental cleavage between the principles of international taxation and the world of international economics. The first is premised on bilateralism whereas the second operates more on a multilateral basis. Will these international trade law principles keep their multilateral character upon incorporation in the present international taxation model? Bilateralism will need to give way to multilateralism even

¹⁶⁵ OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalisation*, (Paris: OECD, 1998) C/MIN(98)15.

¹⁶⁶ M.G. Eckert, 'The GATS: A 'Glimmer of Hope' for a Multilateral Liberalization of Financial Services Markets', (Spring 1997) Accounting and Tax Database Dialog File 485 Document 00603194. Moreover, pursuant to the provisions of Article XIX of the GATS, WTO Members have committed themselves to resume negotiations no later than 5 years from the date of entry of the GATS agreement. Therefore, GATS 2000 negotiations are now about to be launched.

¹⁶⁷ On the theory of welfare and free trade see J. Bhagwati, 'Challenges to the Doctrine of Free Trade', (1993) 25 *NYU J. Int'l L. & Pol.* 219.

in the field of international business taxation. International trade and international business taxation have a symbiotic character in so far as each one depends on the other. What is crucial is that wealth created by international trade be taxed in a rational way. In an increasingly globalised world such a rational taxation system could be achieved if there were to be a gradual surrender of national tax jurisdiction to an international tax organisation. This is not only desirable but is, arguably, inevitable as it would no doubt facilitate further growth in the world economy.

Section III The Reshaping of International Taxation

The study of the principles that are reshaping the international taxation scene may be restricted to examining the measures that are being imported into the area. It may also focus on a bigger picture, that is, it may look beyond the relatively uncontroversial aspect of change and examine new ways of dealing with the whole problem. In any event, the impact on trade liberalisation measures is likely to continue influencing tax policy.¹⁶⁸

1 The Importation of the Non-discrimination Principle in the Taxation Area

One of the most important concepts of international economic law is the non-discrimination principle. In the taxation field non-discrimination is achieved when the most favoured nation (MFN) provision and the national treatment concepts are incorporated in DTAs.

A The Non-discrimination Principle

The origins and the differences between the principle of non-discrimination and its adjunct, the 'most favoured nation', as well as the principle of national treatment have already been examined. What remains to be achieved is the enhancement of these principles so that they become an integral part of the international taxation environment.

The concept of non-discrimination permeates several spheres of human activity ranging from the social to the economic, including human rights. It was developed in order to facilitate the

¹⁶⁸ In this respect, the Millennium Round was held in Seattle on 30 November 1999 to 3 December 1999. The failure of the Seattle Round has been widely publicised. For an analysis of the reasons for this failure, see D.G. Mike Moore, 'Reflections on the Global Trading System', speech made at the Symposium on Global Economic Integration held at Jackson Hole, USA, 25 August 2000, at <<http://www.wto.org/english/news>>. For a critique of the WTO's position, see S. George, 'Le commerce avant les libertés', *Le Monde Diplomatique*, Novembre 1999, at 1.

operation of market economies.¹⁶⁹ Today, it is mainly concerned with the creation of conditions conducive to the expansion of business activities as carried out by corporations. The principle of non-discrimination is closely related to the concept of economic efficiency whereby welfare is increased if markets are allowed to operate across borders without undue constraints and without discrimination based on nationality or place of operation.¹⁷⁰ In general, therefore, the principle of non-discrimination is construed as requiring a degree of fairness and reasonableness such as to satisfy the common public interest standard. In other words, the principle will not be regarded as prohibiting all distinctions within the field in question, but only those that cannot be justified by reference to such standards.¹⁷¹

Most modern DTAs contain the standard non-discrimination provision which provides that each treaty country agrees not to discriminate against nationals of the other country resident in its territory by taxing them more severely than its own nationals. Arguably, the attractiveness of tax treaties would be significantly enhanced if the non-discrimination principle were to be refined and made to apply in a uniform fashion in all bilateral tax treaties. In a multilateral setting as proposed in this thesis, the non-discrimination principle must, for equity purposes, be accorded special attention.

B Non-discrimination in Tax Treaties

Article 24 is the current non-discrimination article in the OECD Model.¹⁷² Article 24(1) focuses on the term 'national', which refers to individuals as well as all legal persons including partnerships and associations. The Commentary on Article 24 mentions the 'nationals' rather than the 'residents' of treaty partners as provided for in the League of Nations and the Mexico and London Drafts.¹⁷³ A nationality non-discrimination provision first appeared in the OEEC Model Tax Treaty of 1958.¹⁷⁴ As for the operation of the non-discrimination principle, Article 24 of the OECD Model proscribes tax discrimination based on nationality rather than on residence. One explanation for this is that the Model proceeds on the basis of different

¹⁶⁹ J.G. O'Brien, 'The Non-Discrimination Article in Tax Treaties', (1978) 10 *Law and Policy in International Business* 545, at 546.

¹⁷⁰ Vann, *supra* note 117, at 41.

¹⁷¹ *Supra* note 117, at 42.

¹⁷² OECD (1992) *supra* note 46, at M -43. The Commentaries are at C-(24)-1.

¹⁷³ Fiscal Committee, *London and Mexico Model Tax Conventions, Commentary and Texts*, League of Nations Document C. 88. M. 88. 1946. II.A., (November, 1946) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*, (Washington D.C.: U.S. Government Printing Office, 1962), at 4388-89.

¹⁷⁴ OEEC, *Report of the Fiscal Committee of the OEEC, The Elimination of Double Taxation*, 1958 in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*, (Washington D.C.: U.S. Government Printing Office, 1962) 4445, at 4481.

treatment of residents and non-residents. A general provision prohibiting discrimination against residents of a treaty partner would have been too wide.¹⁷⁵ Further, in three specific cases, the permanent establishment of non-resident enterprises (Article 24(4)), deductible payments to non-residents by resident enterprises (Article 24(5)), and foreign-owned resident enterprises (Article 24(6)), it is required that the tax treatment of non-residents be equivalent to that of residents.

Quite apart from these innovative trends within the traditional framework of international taxation, unitary taxation has for some years been regarded as a plausible alternative to the current system of international taxation.

2 The Unitary Tax Question

The difficulties inherent in applying the arm's length principle to TNCs operating in global markets have, in the 1980s, prompted the examination of the so-called worldwide unitary tax method (WUT) as an alternative to the arm's length principle. Most governments and TNCs have not welcomed the prospect of WUT with its formulary apportionment methodology as a possible solution to the problem of allocating the tax base of TNCs. The latter have peremptorily decreed that WUT, or more specifically the formula therein used to allocate to various jurisdictions the profits of a TNC, is intrinsically arbitrary and unworkable.

A The Growing Debate On Unitary Taxation

Interest in unitary taxation as a credible alternative to the separate accounting method is gaining momentum. Recently, the President of the U.K. Institute of Taxation said:

[T]here is no guiding principle that tells us how to divide the profits earned by increasingly integrated companies in a world economy. The use of formula apportionment within the U.S. demonstrates this point. The adoption of advance pricing agreements is merely a variation on the formula apportionment theme which takes the arm's length principle as its starting point.¹⁷⁶

Various organisations, both governmental and non-governmental, as well as individuals, politicians, and academics, have called for the application of worldwide unitary combination on the basis of its superiority when compared to the arm's length standard.

The Ruding Committee examined the suggestion that a scaled-down version of WUT applied along the water's-edge principle¹⁷⁷ should be used in the EU if the arm's length principle failed

¹⁷⁵ J.F. Avery-Jones et al., 'The Non-Discrimination Article in Tax Treaties,' [1991] *BTR* 359, at 360.

¹⁷⁶ M. Gammie, 'Is Rational Reform a Prospect for International Tax?' (October 1993) *International Tax Review* 10, at 12.

¹⁷⁷ For an examination of the water's-edge principle, see Chapter 4, Section II, 2, C, at 161.

to fulfil its objective. Its conclusion on the question is deceptively simple. In the Committee's view, 'there is no case for introducing a system of formula allocation within the community in the foreseeable future.'¹⁷⁸ The Committee believed that an arm's length price is unavailable only in rare cases. Similarly it held the view, contrary to the finding of several studies that, in general, a comparable price can be arrived at by traditional methods. Moreover, the Committee admitted that in the case of intangibles and global trading arrangements, a formulary apportionment method could be justified.¹⁷⁹

B Specific Actions to Promote Unitary Taxation

The possible adoption of a certain form of unitary taxation to replace the arm's length standard at the U.S. federal level was contemplated by the American Congress as far back as 1962 when legislation to adopt a formula for income apportionment was introduced. However, during the Congressional debates leading to the *Revenue Act* of 1962, the formulary alternative was rejected.¹⁸⁰ In 1971 Congress enacted a limited formulary apportionment method in the form of profit splits for the so-called Domestic International Sales Corporations (DISCs) and their successors, the Foreign Sales Corporations (FSCs), and 'section 936' corporations.¹⁸¹

In the 1980s California's use of the so-called worldwide unitary combination reopened the debate on formula apportionment. In spite of the controversy of the Californian practice, in 1995 the General Accounting Office issued a report exploring the use of a formulary system at the federal level.¹⁸² A staunch advocate of the use of formulary apportionment at the federal level is Senator Byron Dorgan (D-ND). Senator Dorgan's position is at odds with that of the U.S. Treasury whom the senator criticised for its interpretation of Article 9 of the U.S. DTAs in the following words:

[T]reasury Department officials interpret one article in each of these treaties as preventing the United States from scrapping its outdated arm's length enforcement approach on corporate income

¹⁷⁸ European Communities -Commission, *Report of the Committee of Independent Experts on Company Taxation*, (Luxembourg: European Communities Commission, 1992) 130.

¹⁷⁹ See C.E. McLure, Jr., 'U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles', (7 April 1997) 75 *Tax Notes* 109, for a critical review of the issues that would arise if formula apportionment were to replace separate accounting based on arm's length pricing as the international norm in dividing income from intangibles among related multinational enterprises.

¹⁸⁰ R.M. Hammer, 'Will the Arm's Length Standard Stand the Test of Time? The Specter of Apportionment', (January 1996) 24 *Intertax* 2.

¹⁸¹ *Id.*, at 4. As will be examined in Chapter 5, Section II, 2, B, i, at 218, in October 1999 the World Trade Organization declared the U.S. foreign sales corporation tax regime to be an illegal export subsidy.

¹⁸² United States, General Accounting Office, *Tax Policy and Administration: California Taxes on Multinational Corporations and Related Federal Issues* GAO/GGD-95-171 (11 July 1995).

tax and replace it with the simple and time-proven formula method, which is now the norm between the states. In my judgment, this interpretation by the Treasury Department is wrong-headed and is ill advised.¹⁸³

Senator Dorgan, a former North Dakota tax commissioner, believes that foreign multinationals based in the U.S. are not paying their fair share of taxes as evidenced by the General Accounting Office study that he instigated. His position in the Senate is such that in 1995 he managed to slow the process of ratification of six double tax treaties.¹⁸⁴ He even advocated a cut in U.S. funding for the OECD 'in retribution for the Treasury Department's refusal to release OECD work papers related to its adoption of the arm's length standard for transfer pricing and its rejection of formulary apportionment.'¹⁸⁵ As a result of these activities the Treasury Department announced on 18 October 1995 that it was launching a study destined to identify the issues that would arise if the U.S. used formulary apportionment in lieu of the arm's length standard.¹⁸⁶ The U.S. Treasury was, however, quick to reaffirm that its decision to conduct the study should not be interpreted as indicating any weakening of [the agency's] support for the arm's length principle.'¹⁸⁷

Currently, in spite of the reaffirmation of the primacy of the arm's length principle by the OECD in its 1995 report on transfer pricing, it is arguable that there is a slow movement towards the adoption of some sort of formulary apportionment methodology which would, for an interim period, be compliant with the arm's length principle. Transfer pricing is a vitally important tax issue for TNCs throughout the world.¹⁸⁸ These enterprises are in general dissatisfied with the methods now in place to resolve transfer pricing disputes.¹⁸⁹ The APA alternative may provide momentary satisfaction to both TNCs and revenue authorities. However, it is suggested that a new international tax order more suited to the conditions prevailing in an integrated world must be found in order to encourage broader investment and a more equitable sharing of the tax pie. In fact, as Senator Dorgan claims, the APA is only a secret method of applying formulary apportionment on a business-by-business basis.¹⁹⁰ Therefore, it is proper to examine the whole question of formulary apportionment and propose

¹⁸³ See In Congress, (16 August 1995) 4 *Tax Management Transfer Pricing Report* 240.

¹⁸⁴ See *International Tax Review*, September 1995, at 3.

¹⁸⁵ See In Congress, *supra* note 183, at 240.

¹⁸⁶ See Anonymous, (13 November 1995) 4 *Tax Management Transfer Pricing Report* 356.

¹⁸⁷ *Ibid* at 357.

¹⁸⁸ Ernst & Young, 'Transfer Pricing: Risk Reduction and Advance Pricing Agreements', (31 July 1995) *Tax Notes Int'l* 293, at 294.

¹⁸⁹ *Id.*, at 295.

¹⁹⁰ See In Congress, *supra* note 183, at 240.

a model for the application of an acceptable version of the method on a worldwide basis. This is the purpose of the second part of this thesis.

PART II
A NEW INTERNATIONAL TAX ORDER

INTRODUCTION

Formulary apportionment is a method by which an income base 'is apportioned between various jurisdictions by means of an allocation formula consisting of various factors which are thought to be relevant in the production of (such) income.'¹ It may be applied to both a single entity or to a multiple entity viewed on a consolidated basis.

Unitary taxation, Worldwide Combined Reporting (WWCR), or formulary taxation of the unitary enterprise (FTUE)² are 'based on different economic premises, [have] different economic effects and [present] different technical issues, although the problems of applying the arm's length method to a given unitary enterprise are not among them.'³ In essence, unitary taxation refers to the process of combining the operational results of a group of corporations engaged in a unitary business prior to allocating a fair share of this combined result to the various components of the business.⁴ The unitary method involves, therefore, the calculation of an enterprise's total income base (the total income of the entire business minus deductions), and apportioning to the various constituents part of the enterprise the remaining net income by way of a formula.⁵

Unitary taxation may be regarded as the alternative to the separate accounting method. Whereas the separate accounting method is based on the assumption that each member of a group acts independently, the unitary method considers a group of enterprises as a single business which, for purely formal reasons, is divided into separately incorporated subsidiaries.⁶ Consequently, for taxation purposes, the operational performance of each of the members of the group cannot be viewed in isolation. This theoretical construction fits well with the way

¹ F.M. Keesling & J.S. Warren, 'The Unitary Concept In the Allocation of Income', (1960) 12 *Hastings LJ* 42, at 43.

² P.R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', (1994) 49 *Tax Law Review* 691, at 702.

³ *Id.*, at 703.

⁴ Consolidation differs from unitary combination given that it is based on ownership and does not consider whether companies are part of an economic unit which is the essence of the unitary concept. See J.M. Weiner, 'Using the Experience in the U.S. States to Evaluate issues in Implementing Formula Apportionment at the International Level', (23 December 1996) *Tax Notes Int'l* 2113, at 2118 n 16.

⁵ B.F. Miller, 'Worldwide Unitary Combination: The Californian Practice', in C.E. McLure, Jr., ed., *The State Corporation Income Tax, Issues in Worldwide Unitary Combination* (Stanford: Hoover Institution Press, 1984), at 132. See also Weiner, *supra* note 4 at 2117, where the author states that '[A]pportionment refers to the process of using a formula to assign a portion of the total income of a company and its branches that operate in several locations to each individual location. Unitary taxation refers to the process of combining the functionally integrated operations of a multiple entity affiliated corporate group that operate as a single economic enterprise into a single unit for purposes of determining the taxable unit.'

⁶ See Note, 'Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code', (1976) 89 *Harv L.R.* 1202, at 1203.

TNCs operate. In general, within TNCs, operational control is exercised from the centre, that is, the head office or parent, towards the periphery, which comprises the members of the group. The whole dynamic of control is, undoubtedly, to ensure that the aggregate result of the group is optimised.

One of the main objectives of a TNC is to achieve maximum efficiency in the conduct of its global operations. To measure its overall performance, a TNC must be capable of measuring the performance of each and every member of the group against the group's overall plan. In order to determine the contribution of each of its constituents parts, a TNC has two alternatives:⁷

- First, it may require that the worldwide consolidated profits be distributed in such a way that each of group's operating units' performance is capable of being assessed independently.
- Second, it may directly apportion to each subsidiary or branch the consolidated result of the group according to an index that would reflect the real economic contribution of each to that aggregate result.

In simple terms, the unitary system replicates this second approach for taxation purposes. It assumes that operative interdependence is axiomatic to the very existence of any TNC. Unitary taxation starts with the determination of the overall result of a unitary business. The individual contribution of each component of the business to that overall result is then resolved by means of an allocation formula which attributes to specific firms in the group its share of that overall result. The formula used is designed to reflect the economic weight of each firm in the unitary business operation as well as the economic conditions in which they operate.

The hypothesis in this thesis is that global formulary apportionment is a plausible alternative to the separate accounting/arm's length method. In fact, it is argued that the present international tax system of the dominant economic power, which is the U.S., already contains significant formulary components.⁸ For instance, a U.S. corporation must use a formulary method to apportion interest expenses between its U.S. source income and its foreign source income in order to determine the level of its allowable foreign tax credits.⁹ Moreover, pursuant to Notice

⁷ P.B. Musgrave, 'International Tax Base Division and the Multinational Corporation', (1972) 27 *Pub Finance* 394, at 398-99.

⁸ McDaniel, *supra* note 2, at 703. The Australian system also contains a significant number of apportionment formulas, as with the so-called interest paid adjustments noted earlier.

⁹ IRC 864(e); Temp. Reg 1.861-9T to 13T.

94-40,¹⁰ the U.S. tax authorities have routinely used a formulary apportionment methodology to determine the income of enterprises engaged in the global trading of financial instruments. In addition, other countries, for example, Canada and Switzerland, also have domestic systems based on the formulary apportionment method. These are working perfectly well and, arguably, they may be regarded as having the potential to replace those countries' international system.

In essence, what this thesis demonstrates is that, in evolutionary terms, formulary apportionment is likely to supplant the arm's length standard. It therefore proposes a certain refinement of the system in order for it to be suitably applied on a worldwide basis. In addition, it argues for a multilateral adoption of the formulary method rather than wait for the system to be applied by stealth by major economies.

¹⁰ 1994-1 C.B. 351.

A Historical Account of the Alternative Method

The purpose of this chapter is to examine the historical origins of the formulary apportionment methodology. Its diverse European variants are considered in Section I and its characteristics as applied in the North American context are reviewed in Section II. Finally, Section III analyses its theoretical rationale in order to determine its strengths and weaknesses as an alternative method for the taxation of transnational corporations (TNCs).

Section I The Alternative Method In Europe

The formulary apportionment methodology, or fractional apportionment to use Mitchell Carroll's terminology, evolved in Central Europe as a means of allocating the taxable income of a group of companies operating in several jurisdictions. In the 1920s the system was adopted by the Swiss Confederation and by Spain.¹

1 The Central European Experience

A The Historical Context

Fractional apportionment first came to be used to apportion the income of enterprises whose activities straddled two or more sovereign states born out of the disintegration of the Austro-Hungarian Empire.² According to Mitchell Carroll, fractional apportionment refers to 'the determination of the income of one establishment of an enterprise by dividing total net income in the ratio of certain factors—for example, assets, turnover, pay-roll, or a fixed percentage.'³ In other words, fractional apportionment is a method of determining an entity's local taxable net income as a percentage of its entire net income.

Fractional apportionment emerged in countries where businesses were required to pay a *patente* tax, that is, a type of franchise tax for the privilege of doing business in that particular jurisdiction. Significantly, instead of relying on traditional accounting principles, the *patente* tax was calculated on an empirical or *forfaitaire* basis, that is, by reference to outward indicia,

¹ M.B. Carroll, *Taxation of Foreign and National Enterprises, Volume IV - Methods of Allocating Taxable Income* League of Nations Document No. C. 425. (b) M. 217. (b) 1933. II. A. (30 September 1933), at 70 (*Carroll Report*).

² *Id.*, at 67-70.

³ *Id.*, at 46.

which were regarded as adequate for the evaluation of business income.⁴ This tradition of calculating the tax potential of a business probably predisposed the tax administrations in those countries to adopt fractional apportionment as an alternative to separate accounting.

Mitchell Carroll's Report to the League of Nations states that fractional apportionment was used mainly although not exclusively, in two circumstances: It became prominent as a method for the proper allocation of an enterprise's profits across national frontiers, as with the successors of the Austro-Hungarian Empire, or across cantonal borders as in Switzerland; and secondly, it was adopted by Spain as a convenient anti-avoidance method.⁵

B Fractional Apportionment By International Agreement

The earliest systematic use of fractional apportionment as a method for the apportionment of business income occurred between Austria, Czechoslovakia and Hungary.⁶ Austria had in fact two regimes for the apportionment of income. The first regime based on domestic law provided that 'a certain fraction of the profits derived from the joint activities of establishments within and without Austria be taxable in Austria.'⁷ The second regime arose from treaties Austria had signed with Czechoslovakia and Hungary.

The breakdown of the Austro-Hungarian Empire after World War I meant that Austria, Czechoslovakia and Hungary emerged as sovereign states. Notwithstanding this new political environment, a certain number of enterprises found the various components that comprised their operations were now scattered in three taxing jurisdictions. Therefore, each entity forming part of such highly integrated enterprises was nevertheless required to source a portion of the enterprise's total income in the different jurisdictions where they were operating. The complications which arose from this situation were such that the three countries resorted to the mechanism of tax treaties to share the available revenue. Fractional apportionment was found to be the most practical solution to the allocation problem. The treaties provided that the profits of the targeted enterprise, mostly manufacturing and selling concerns as well as banking and insurance corporations, were to be first determined by each administration in accordance with its own fiscal regulations. Then, these profits were to be aggregated and apportioned to each of the establishments in each country according to specified ratios.⁸

⁴ *Id.*, at 46-47.

⁵ *Id.*, at 61.

⁶ *Id.*, at 67-70.

⁷ *Id.*, at 73.

⁸ *Id.*, at 75.

2 The Western European Practice

A Fractional Apportionment through Judicial Adjudication

Switzerland offers an example of fractional apportionment achieved through decisional law. In the 1920s the Swiss Federation consisted of 25 sovereign cantons and ‘demi-cantons’ bound under a federal constitution.⁹ Although Article 46(II) of the Constitution prohibited double taxation between the cantons, it did not prescribe any rule as to how this prohibition was to be achieved.¹⁰ It merely provided that in case of perceived double taxation taxpayers would have the right to refer the matter to the Swiss Supreme Court competent for resolving problems of intercantonal taxation.¹¹ The tax laws of the cantons contained little guidance on the apportionment of income derived by multicantonal or multinational enterprises. Certain general principles were clearly advocated, for example, the principle that foreign enterprises were to be taxed on the profits attributable to their establishments within the canton. In this environment, a formula apportionment methodology slowly evolved with the decisions of the Swiss Supreme Court for the prevention of double taxation and the settlement of inevitable disputes achieving prominence. Consequently, as far as the taxation of multi-cantonal or multinational enterprises was concerned, a uniform practice came to be applied by the various cantons.

The Swiss Supreme Court was not too concerned with the profits or loss incurred by a particular unit of an enterprise. Instead, it adopted a global approach and directed that the total profits of an enterprise be apportioned between those cantons with a legitimate claim to tax such profits. The principle that evolved was that a canton was allowed to tax that part of an enterprise income that ‘corresponds to the proportion between the productive factors in the canton and all the productive factors of the enterprise.’¹² In this model, apportionment is effected on the basis of such criteria as the ratio of the manufacturing costs, the turnover, or other elements that are suitable in each particular case. Thus, for industrial enterprises, the suitable factors were considered to be assets and labour. For the purpose of the Swiss system, assets comprised, inter alia, land and buildings, machinery, tools, furniture, trading stocks, cash, bills of exchange, and accounts receivable. Labour was represented by salaries and wages capitalised at the rate of 10 per cent and attributed to the establishment which paid

⁹ S. Langbein, ‘The Unitary Method and the Myth of Arm’s Length’, (1986) 30 *Tax Notes* 625, at 630.

¹⁰ I. Houriet, ‘Law of Taxation’, in F. Dessemontet & T. Ansay, eds, *Introduction to Swiss Law* (The Hague: Kluwer Law International, 1995) 189, at 201.

¹¹ X. Oberson & H.R. Hull, *Switzerland in International Tax Law*, (IBFD Publications, 1996), at 85 n 2.

¹² *Carroll Report*, *supra* note 1, at 68.

them. Factors that could be allocated without controversy were readily attributed with residual profits apportioned proportionately on the basis of an economic rather than juridical rationale. In other words, the Swiss system was based on practical economic realities. It did not seek to satisfy legal theories based on assumed behaviour or theoretical models. In the apportionment formula, the numerator consisted of the sum of productive factors attributed to a particular canton while the denominator represented the sum of all productive factors of the enterprise. This operation yielded a fraction of the income of the enterprise which the canton could tax.

In general, the Swiss system, as documented by Carroll, applied in a widely diverse context. There were at that time, and indeed there still is, wide differences between the 26 Swiss cantons consisting of about 3000 communes each with a certain degree of fiscal sovereignty as delegated by the canton to which it is attached.¹³ They share four major languages, two different religions, as well as other substantial differences in economic development or cultural vision. Yet, in spite of this diversity, fractional apportionment as a method of apportioning the income of firms operating in Switzerland is not questioned. Basically, under the control of the Swiss Supreme Court, the present system operates along the following lines:¹⁴

- A firm operating in a number of cantons is required to file a tax form in each canton of activity. It must report its total worldwide income. Thus, because of a difference in cantonal tax rules, a firm's taxable income may not be identical in all the cantons concerned.
- The tax rate in each canton is determined with regard to the worldwide income of the firm. Pursuant to this principle, and in order to satisfy those cantons which apply progressive tax rates to corporate income, two firms showing the same total profit pay the same tax whether they operate in one canton alone or in several others or even in different countries.
- Each canton is allowed to tax a share of the firm's total taxable income as defined by the canton's law.
- The calculation of the shares is made on the principle that the firm is taxed in the canton where it maintains its seat, while its 'permanent establishments' are taxed in the canton where they are located.

¹³ For an overview of the fragmentation of the Swiss fiscal system, see R. Duss & R. Bird, 'Switzerland's "Tax Jungle"', (January-February 1979) 27 *Canadian Tax Journal* 46.

¹⁴ P. Thalmann, 'Tax Coordination and Competition in Switzerland, European Communities -Commission', in *Report of the Committee of Independent Experts on Company Taxation* (Luxembourg: European Communities - Commission, 1992) 397, at 402. (*Ruding Report*).

The criteria for apportioning the income of other firms depend on the nature of the activities of these firms. For commercial enterprises, the criterion for apportionment is turnover; for insurance companies it is premiums earned and capitalised assets; and payroll for industrial enterprises. In order to compensate for cases where the selected criterion gives too little weight to the activities of the headquarters, an initial share of profits of 10 to 20 per cent may be attributed to the canton of situs. This measure which Carroll identified as a *préciput* or *praecipuum* was already in place in the 1920s.¹⁵ A notable exception, however, required banks to use the separate accounting method. This rule arises because, pursuant to federal legislation, banks are required to keep separate accounts for their branches.¹⁶

The Swiss system, with different formulas, thus refutes the argument that formulary apportionment consists simply of ‘a formula that is predetermined for all taxpayers’,¹⁷ and applied mechanistically across the whole spectrum of taxpayer regardless of their particular situation. It still survives to this day as confirmed by Thalmann in a submission to the Ruding Committee.¹⁸

B Fractional Apportionment By Legislation

Until the 1920s Spain taxed the branches of foreign enterprises on the basis of the income shown in the branches’ books. However, the levels of profit derived by these branches as shown by their accounts were, in the view of the Spanish Government, grossly inadequate. Therefore, the Spanish authorities did not attach much importance to branch accounts. They argued that if these branch accounts existed, and this was not always the case, they could not be relied upon to determine the branch’s profits. They held the view that, for taxation purposes, one needed to refer to the profits of the enterprise as a whole in order to determine the share of the profits that could realistically be attributed to the branch operating on Spanish territory. Basically, Spain considered that reliance on a notional profit as evidenced by the accounts of the branch was inherently arbitrary since these carried no real economic significance.

The Spanish authorities, therefore, abandoned assessment on the basis that separate accounting facilitated income shifting by TNCs. Spain then embraced fractional apportionment

¹⁵ Carroll Report, *supra* note 1, at 70.

¹⁶ Oberson & Hull, *supra* note 11, at 88.

¹⁷ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995) (OECD 1995 Guidelines), at III-20 para. 3.60.

¹⁸ Thalmann, *supra* note 14. See also Oberson & Hull, *supra* note 11, at 83ff for an example illustrating the Swiss system for the allocation of taxable profits.

in order to determine the income derived by foreign branches operating within its borders. To Mitchell Carroll, inquiring about the rationale for their practices, the Spanish authorities argued that fractional apportionment was the only method that was fair and practical because it guaranteed that no enterprise was taxed at more than 100 per cent of its profits.

The Spanish authorities employed the following steps for apportioning business income of foreign enterprises. First, the real profit of the enterprise on a worldwide basis was ascertained. That figure was then apportioned according to principles which reflected the economic significance of the branch relative to the whole enterprise.

The Spanish system also dealt with foreign subsidiaries operating in Spain. The rule was that the tax administration could override the juridical independence of subsidiaries and declare that the subsidiary was in fact 'only a branch of another company or enterprise'.¹⁹ Indeed the conditions imposed for casting aside the juridical concept of the independence of group companies is an expression of the unitary concept which was contemporaneously being articulated by the American courts.²⁰

The Spanish system did not contain any concrete rule for the apportionment of the profits of an enterprise. A committee of experts called the *jurado de utilidades* carried out this exercise. This jury was required to determine the quantum of profits to be attributed to Spain on the basis of the importance of the Spanish operations relative to the enterprise as a whole. The composition of the jury also reflected the desire of the Spanish legislators to abide by the rules of equity. Apart from high-ranking fiscal officials, it also included two representatives of banking institutions, as well as 'an expert of recognised authority'.

The methods used by the jury were far from being arbitrary. The jury agreed on a formula which was then put to the taxpayer who had the right to refuse to abide by it. If the taxpayer rejected the formula, discussions would follow and eventually modifications to the formula would be made. If no agreement was reached, the matter was put to independent experts for an opinion. Care was taken in order to safeguard sensitive information concerning the enterprise in question. If there appeared to be difficulties in the valuation of the contribution of the company's business operations, the jury resorted to 'mathematical statistics' or, in contemporary language, a sampling method was used.

In general, therefore, both the Swiss and the Spanish methods of fractional apportionment were a reasoned attempt to reach a method of apportionment that would satisfy all the

¹⁹ *Carroll Report*, *supra* note 1, at 62.

²⁰ *Supra* note 1, at 70.

America Act 1867 (now the *Canada Act*), Canadian provinces may levy and collect direct taxes to fund their activities. Federal government, for its part, finds in section 91(3) of the Act the power to engage in ‘the raising of money by any mode or system of taxation.’²⁵ Thus, Federal Government is granted the right to levy both direct and indirect taxes as well as the power to regulate interprovincial trade and commerce. In Canada, therefore, there is devolution of direct taxing power between two layers of government. The whole history of the Canadian federal/provincial tax relation is based on the search for a suitable arrangement to accommodate these two sovereign-taxing powers.

A The Evolution of the System

Both the provinces and Federal Government over a period starting from 1894 to 1941 introduced corporation income tax and personal income tax.²⁶ In the absence of any coordinating mechanism between the federal and provincial practices, the system became ‘complex beyond belief’ and produced a ‘competitive scramble for revenue’ more especially in the depression period of the 1930s. To find a suitable solution to the problem a Royal Commission on Dominion–Provincial Relations (the Rowell-Sirois Commission) was formed. In its report presented in 1940,²⁷ the Commission described the Canadian system as ‘inequitable, inefficient, uncoordinated, incredibly complex and, in a word chaotic.’²⁸ The Commission recommended that, in return for compensatory grants from the Federal Government, provincial governments were to surrender to the federal government their jurisdiction to tax personal and corporate income. The latter would then be required to impose uniform bases and tax structures throughout Canada.

The provinces rejected the recommendations of the Royal Commission. Nevertheless, many of its propositions were eventually implemented, albeit in an indirect way. Indeed, as a consequence of the Second World War, and in order to facilitate the financing of the war effort, the provincial governments surrendered their right to levy corporate and personal income tax in return for federal grants described as tax rentals calculated pursuant to certain formulas. After the war, seven provinces remained committed to the arrangement, which

²⁵ W.R. Thirsk, ‘Tax Assignment and Revenue Sharing in Canada’, in C.E. McLure, Jr., ed., *Tax Assignment in Federal Countries*, (Canberra: ANU Press, 1983), at 236.

²⁶ Daly, *supra* note 22 in the *Ruding Report*, *supra* note 14, at 384. Two provinces chose not to introduce personal income tax.

²⁷ Canada, *Report of the Royal Commission on Dominion-Provincial Relations*, (Rowell-Sirois Commission) (Ottawa: Kings’s Printer, 1940) Book I 36-46 in GV La Forest, *supra* note 24.

²⁸ E.H. Smith, ‘Allocating to Provinces the Taxable Income of Corporations: How the Federal-Provincial Allocation Rules Evolved’, (1976) 24 *Canadian Tax. J.* 545, at 547

provided for a compulsory five per cent provincial corporation income tax together with rules for allocating taxable income to provinces. A residual role was provided for a two-factor apportionment formula (sales and wages) if the separate accounting method could not be readily applied, or if the taxpayer agreed. In 1952, a reversal of roles occurred with formula apportionment being granted the first rank in the apportionment methodology and separate accounting being relegated to a residual role. In 1962, the residual right to allocate profits on the basis of a company's separate accounts was withdrawn, given that only a few companies used it as it proved to be difficult to administer.²⁹

The tax rental system was abandoned in 1962 in favour of a new approach in tax sharing called tax abatement together with a series of tax collection agreements. Under this system, the Federal Government returned to the province of origin ten per cent of federal personal income collections, nine per cent of corporate income tax yield and half of the federal estate tax collections.³⁰ The tax collection agreements created an obligation for the federal government to collect income taxes for any province or territory provided the income tax legislation of the province met certain conditions regarding the definition of the tax base, the allocation rules, and, in the case of the personal income tax, the rate structure.³¹ Furthermore, originally provincial income tax legislation had to strictly adhere to federal directions. However, since 1972 the provinces have had more leeway in altering their tax system provided they adhere to the federal definition of the tax base. Thus, the provinces have been able to pursue their own social and economic objectives at their level of government, while evolving within an overall tax system that is both highly decentralised and harmonised.

B An Analysis of the Canadian System

All Canadian provinces and territories levy tax on corporate income. To compensate corporations for provincial taxes paid, a provincial tax credit is provided. Pursuant to section 124(1) of the Canadian Tax Code, corporations are allowed to deduct from their federal taxable income an amount equal to ten per cent of the corporation's 'taxable income earned in the year in a province'. This deduction is available to corporations independently of any taxes actually payable by it to the province.³²

Regulations under Part IV of Canada's *Income Tax Act: Regulations and Rulings* define the corporation's 'taxable income earned in the year in a province' and prescribe methods for

²⁹ *Id.*, at 560.

³⁰ Thirsk, *supra* note 25, at 238.

³¹ Daly, *supra* note 22 in the *Ruding Report*, *supra* note 14, at 385.

³² CCH Canadian Limited, *Canadian Master Tax Guide*, 53rd ed., (New York, 1998), at ¶ 8630.

determining the quantum of taxable income that is earned in a province.³³ Corporations are therein classified as being in the category of ordinary companies or in the category of special companies, such as insurance corporations, chartered banks, or grain elevator operators. For ordinary corporations, Regulation 402 provides that a corporation's taxable income earned in a particular province is the taxable income attributable to a permanent establishment (PE) in the province.

The primary nexus for the attribution of taxable profits is thus the PE. Regulation 400(2) defines the PE concept. Interpretation Bulletin IT-177R2³⁴ shows that Regulation 400 enlarges the standard definition of a PE as contemplated, for example, by Article 5 of the OECD Model. First, the requirement for a fixed place of business is not critical to the existence of a PE. Regulation 400(2)(a) allows for the substitution of the principal place in which the corporation's business is conducted in lieu of the habitual fixed place of business criterion. In addition, timberlands are considered as PEs as is the use by a corporation of substantial machinery or equipment in a particular place at any time in a taxation year.

Often a corporation will have several PEs both within and outside of the province, or even outside Canada. In that case, pursuant to Regulation 403(3), taxable income is apportioned between the provinces and between Canada and the foreign country by a two-factor formula based on gross revenue and salaries and wages.

Leaving aside the mathematical operation for the determination of the gross revenue that is reasonably attributable to each of a corporation's PEs, it is convenient to consider the policy decisions at the base of these regulations. The Canadian system is based on the premise that each participating province should be treated fairly. In this context what is often looked for is 'not the exactitude by which income is allocated but the achievement of an equitable result.'³⁵ If a corporation has several PEs in different provinces the gross revenue that is reasonably attributable to each of the PEs must be computed. Gross revenue may be attributed to the place of production (the origin rule), or to the place where the good is consumed, that is, the place where the sale was negotiated which, normally, would be the province of residence of the buyer (the destination rule). Regulation 402(4) adopts the following rule: If the destination of a shipment is in a particular province, the gross revenue derived from the sale of the shipment is attributable to the PE of the supplier in that province. However, if the supplier

³³ CCH Canadian Limited, *Canada Income Tax Guide-Income Tax Act Regulations and Rulings*, Vol. 4, at 65,911ff.

³⁴ *Id.*, Vol. 2, at 9-95.

³⁵ G.G. Richardson, *Report of the Eleventh Annual Tax Conference*, (Toronto: Canadian Tax Foundation, 1957), at 52.

making a shipment to a province does not have a PE in that province, then the gross revenue from the sale of the goods is to be allocated to the PE to which the person negotiating the sale might reasonably be regarded as being attached. Moreover, if the destination of a shipment is another country in which the supplier does not have a PE, then the gross revenue derived from the sale of the shipment is attributable to the province of manufacture. In other words, for export purposes the rule reverts back to the principle of origin. The effect of these measures is to divide a TNC's income into foreign-source income and Canadian-source income. The latter is then again divided into smaller portions of provincial income. Since only the Canadian-source income is subject to provincial tax, and since provinces use the same allocation formula, double taxation of foreign-source income at provincial level is eliminated.

Apart from delineating precise attribution rules, the Canadian system establishes a full harmonisation of the tax base. As mentioned, the federal government agreed to collect corporate (and personal) income taxes on behalf of the provinces or territories party to a tax collection agreement on the condition that their tax base and the allocation rules are in conformity with the federal tax base.³⁶ It is true that the convergence sought between the federal and provincial tax bases has been achieved and been facilitated by the existence of common accounting practices. As a result, double taxation does not arise in Canada.

The prospect of double taxation not occurring in this system is further assured with the use of a two-factor formula to apportion a common tax base among jurisdictions. As a result, each participating province taxes a fraction of the nationwide income of the corporation equal to the average of the fractions of sales and wages arising in a province compared with the total for the country as a whole.³⁷ The choice of the factors, more especially the inclusion of sales therein, has been the subject of debate. The rationale for maintaining sales in the apportionment factor will be explored in Chapter 7. However, it is important to realise that the guiding principle in the choice of factors has been the desire to achieve consistency between provinces. Finally, the adoption of a common apportionment formula reduces the opportunities for tax arbitrage and therefore goes a long way to satisfying the neutrality principle.

It is evident that the Canadian system, which requires that provincial tax credit be administered centrally, contributes to reduce the costs incurred to administer the system and inhibits tax avoidance. In addition, it frees provincial resources. For example, provinces may use their corporation tax to pursue whatever social and economic policies they deem fit for their

³⁶ *Ruding Report*, *supra* note 14, at 186.

³⁷ *Daly*, *supra* note 22, in the *Ruding Report*, *supra* note 14, at 386.

constituents while disputes over allocation of the corporate tax base are determined in federal courts.

Finally, an interesting aspect of the Canadian system is that in order to enable each provincial government to supply an average standard of service throughout Canada, grants are transferred from the federal government to the provincial governments through a tax equalisation system. It would be utopian to consider the duplication of such a system on a worldwide basis although one needs to admit that, as applicable in Canada, it goes a long way to achieving an equitable allocation of the country's tax yield among its citizens.

Many aspects of the Canadian system and, to a lesser extent, the Swiss system have inspired the construction of the proposed model in this thesis. This model is based on the creation of an international tax organisation to administer a system of global formulary apportionment. Basically, therefore, the proposed system would replicate some of characteristics of the Canadian system. Thus, the international tax organisation would ensure that the calculation of the commercial profits of the TNCs is carried out in a uniform fashion, a function carried out by the federal tax authorities in Canada. Furthermore, as in the Canadian system, the power to modify the allocation formula is not vested with the participating jurisdictions. Such a measure prevents the manipulation of the factors within the formula for short-term gains and is, therefore, inherently more equitable.

2 The American States' Approach

An examination of the American states' approach to the taxation of corporate income is a complex exercise. This section attempts to segregate the historical evolution of the states' apportionment method, the so-called unit rule, from its legal tests and constitutional justifications. However, since the development of unitary taxation occurred as a result of several judicial decisions determining concurrently the constitutionality of the method and defining its conditions of application, there is bound to be a certain overlap in the following discussion.³⁸

³⁸ P.J. Hartman, 'State Taxation of Interstate Commerce: A Survey and an Appraisal', (1960) 46 *Virginia Law Review* 1051, at 1059.

A The Domestic Application of the Unit Rule

i The Initial Application of the Unit Rule

In the U.S., when doing business within a state's jurisdiction, a corporation is subject to either an annual franchise tax or a privilege tax. The present system of state corporate franchise taxation has its roots in an earlier general property tax. Indeed, it has been said that the current method for the taxation of business income is merely 'the latest arrival in the family of corporate tax measures.'³⁹ Allocation fractions have always been used in connection with capital stock taxes, receipt taxes, or as a method of valuing movable or unit property.⁴⁰ Whether the tax involves property, receipts or income, one of the fundamental questions of U.S. state taxation hinges on the problem of apportioning such bases among different states which may claim a right to tax.⁴¹ The preferred method of achieving this objective is apportionment by formula.⁴² The 'theory of apportionment by formula is that certain factors or elements of a business will fairly reflect the portion of the measure of the tax allocable to a State.'⁴³ This requirement 'prevents a state from fixing its tax talons on extra-territorial values.'⁴⁴ The justification of formulary apportionment arises from 'the impossibility of precise location of the source of income' arising from certain corporate activities.⁴⁵

When an enterprise operates in several states, not through separate entities but, rather, as an integral operation with each part relying on the other to derive income, a further complication arises in the apportionment of the results of such operations. In fact, it is the proliferation of

³⁹ J.R. Hellerstein, *State and Local Taxation: Cases and Materials*, 3rd ed., (St Paul: West Publishing, 1969) 303.

⁴⁰ J.W. Huston, 'Allocation of Corporate Net Income for Purposes of Taxation', (1932) 36 *Illinois Law Review* 725, at 727.

⁴¹ At an early date the U.S. Supreme Court has favoured taxes on net income rather than taxes on gross income. The Court thus pointed out that a gross income tax affects each transaction in proportion to its magnitude, irrespective of whether it is profitable whereas a tax on net income does not arise unless a gain is shown over expenses and losses. *Glue Co. v. Town of Oak Creek*, 272 U.S. 321, 328-29 (1918) (dictum). See Hartman, *supra* note 38, at 1097.

⁴² The two other techniques to determine the portion of income attributable to a given state for tax purposes are: (a) separate accounting, and (b) specific allocation of particular categories of income. See A.D. Lynn, 'The Uniform Division of Income for Tax Purposes Act Re-Examined', (1960) 46 *Virginia Law Review* 1257, at 1261.

⁴³ Hellerstein, *supra* note 39, at 308.

⁴⁴ Hartman, *supra* note 38, at 1059.

⁴⁵ United States, House Committee on the Judiciary, *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce* H.R. Rep. No. 565, 88th Cong, 1st Sess., Vol. 1 (1965) (*Willis Committee Report*), at 247-48 in Hellerstein (1969), *supra* note 39, at 310.

such integrated enterprises which, in the U.S. states' environment, finally destroyed any confidence among tax officials that the separate accounting/arm's length method could efficiently determine a particular state's share of an enterprise's income.⁴⁶ The problem of apportioning the income of integrated businesses is comparable to those which arose with the earlier capital stock taxes. Not surprisingly the solution to the problem mirrored that which had emerged in the earlier capital stock cases. Thus, the importation of the unitary method in the realm of states' business taxation. The driving force for the adoption of the unit rule was the perception that it was the most equitable method, given the circumstances. In *Pullman Palace Car Co. v. Pennsylvania*, which has been called 'the foundation of the unit rule',⁴⁷ the U.S. Supreme Court said:

[T]his was an equitable and just method of assessment, and if it were adopted by all states the company would be assessed upon the whole value of its capital stock and no more.⁴⁸

It is therefore remarkable that, in a period of less than a century, a method which was qualified by the U.S. Supreme Court as 'equitable and just' is now being described by the U.S. Treasury as arbitrary. The more so when one finds that the premise on which the U.S. Supreme Court relied to sanction the method, that is the integrated nature of the enterprise, has become within that same period of time the predominant method of operation of modern transnational corporations.

The unitary business principle was articulated in the late nineteenth century as an offshoot of the 'unit rule' developed for apportioning property values of railroad, telegraph, and express companies to state or local taxing jurisdiction.⁴⁹ The State Railroad Tax cases reproducing the early railroad property cases reveal the judicial construction of the unit rule:

[T]he theory of the system is manifestly to treat the railroad track, its rolling stock, its franchise, its capital, as a unit for taxation, and to distribute the assessed value of this unit according to the length of the road in each county, city, and town bears to the whole length of the road.⁵⁰

In other words, in order to determine the value of a company's property that was properly attributable to the taxing jurisdiction, the value of the whole operating system was first ascertained. Then, a portion of that value was attributed to the taxing state or locality based on

⁴⁶ P.J. Hartman, 'State Taxation of Corporate Income From a Multistate Business', (1960) 13 *Vand. Law Review* 21, at 63.

⁴⁷ *Ibid.*

⁴⁸ 141 U.S. 18 (1890).

⁴⁹ I. Elcanon, 'The Unit Rule', (1926) 35 *Yale LJ* 838.

⁵⁰ *State R R Tax Cases*, 92 U.S. 575, 601 (1875), in W.D. Dexter, 'The Unitary Concept in State Income Taxation of Multistate-Multinational Businesses', (1978) 10 *Urban Lawyer* 181, at 184 n 6.

a formula representing the ratio of the amount of some identifiable factor within the state or locality to the total amount of the factor in the entire system. In *Adams Express Co. v. Ohio State Auditor* the Supreme Court said:

[A]s to railroad, telegraph, and sleeping-car companies, engaged in interstate commerce, it has often been held by this court that their property in several of the states through which their lines or business extended, might be valued as a unit for the purposes of taxation, taking into consideration the uses to which it was put and all the elements making up aggregate value, and that a proportion of the whole fairly and properly ascertained might be taxed by the particular state, without violating any Federal restrictions....The valuation was, thus, not confined to the wires, poles, and the instruments of the telegraph company; or the roadbed, ties, rails, and spikes of the railroad company; or the cars of the sleeping-car company; but included the proportionate part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of operation.⁵¹

In a string of cases following *Adams Express*, the Supreme Court refined the unitary concept and proceeded to agree to its application in cases involving taxpayers other than multistate businesses.

Concurrently with the process of articulating the unitary concept, the Court was required to determine the attributes of the formula used by the states for the apportionment of the tax base as determined by that method.

One important factor in these earlier cases was that there was a continuous physical unity in the systems that businesses subjected to the unit rule were exploiting. In later cases mere physical unity was superseded by operational unity which then became one of the indicia of a unitary business.

The use of the unit rule was not confined to the taxation of utility companies. A second phase in the application of the unitary concept occurred with the introduction of state capital stock taxes. The same problem of apportionment between states occurred, and formulary apportionment was again found to be the most appropriate mechanism to determining the proportion of the value of a corporation's capital stock attributable to the states in which the taxpayer carried out its business.

Further developments in the use of the unit rule were achieved with the introduction in 1911 of a corporation tax by Wisconsin. At first, the states, which had followed Wisconsin's example and introduced a corporation tax, allowed the corporations to use separate accounting to determine the net income attributable to a particular state operation. The only condition for the use of the separate accounting method was that relevant accounting entries had to be sufficiently detailed to allow the accurate determination of income attributable to the operation. However, the difficulty of complying with what was perceived as an impracticable method led

⁵¹ 165 U.S. 194 (1897).

to formulary apportionment based on the unitary concept becoming the standard for the division of income multistate businesses.⁵²

The U.S. Supreme Court in *Underwood Typewriter Co. v Chamberlain* formally sanctioned the use of formulary apportionment in a unitary environment.⁵³ The Court concluded that when corporate income is largely earned by a series of transactions beginning with manufacture in one state and ending with sale in other states, the separate accounting methodology for income attribution was inappropriate. Instead, the Court decided that formulary apportionment was a realistic method for assigning the taxpayer's income to each of the various states. Furthermore, the Court placed the burden of proof upon the taxpayer to show that a given formula is unreasonable.

In a second major case, *Bass Ratcliff & Gretton Ltd v State Tax Commission*,⁵⁴ the U.S. Supreme Court again examined the division of income of a taxpayer by formula. In this case, the enterprise operating a distribution office in New York had actually sustained a loss in that jurisdiction. The facts were as follows: Bass Ale was brewed in England and shipped to New York from where it was sold in the U.S. The New York tax administration considered the total profits of the company, treated a portion thereof as being realised in New York, and imposed tax on that portion. That methodology was approved by the U.S. Supreme Court in spite of the fact that the company had sustained a loss from its activities within the U.S. which the Court found to be irrelevant to its decision.⁵⁵

The Court's decision enabling a jurisdiction to levy tax in a case where there is a loss reported in that jurisdiction may well appear to be surprising.⁵⁶ First, *Bass Ratcliff* seems to question the principle whereby a state's income tax base should be limited to such income that is fairly apportioned to the corporation's activities within the state. The Court, however, found that the operations in the taxing state had to be considered as part of the entire unitary multistate enterprise. As such, New York was entitled to a portion of the entire income of the unitary operation. The second issue raised by *Bass Ratcliff* relates to the issue of the fairness of an

⁵² C.W. Gerstenberg, 'Allocation of Business Income', (1931) *NTA Procs*, 301 at 306. See also R.S Ford, *Allocation of Corporate Income for the Purposes of State Taxation* NY State Commission, Special Report No. 6 (1933), in Hellerstein, *supra* note 23, at 315.

⁵³ 254 U.S. 113, 120 (1920).

⁵⁴ *Bass Ratcliff & Gretton Ltd v State Tax Commission* 266 U.S. 271 (1924).

⁵⁵ 'It was in the *Bass Ale* case that the Court first attached the term "unitary tax" to describe the activities which could be considered in determining the income attributable to an individual state.' See P.M. Plant et al., 'California Unitary Taxation and Water's Edge Election', (1989) 29 *European Taxation* (No. 7) 211, at 213.

⁵⁶ See also *Butler Bros v McColgan* 315 U.S. 501 (1942).

apportionment formula. One of the first theoretical requirements of an apportionment formula is that it should not be ‘inherently or intrinsically arbitrary’⁵⁷ in its effects. In *Hans Rees Sons, Inc. v. North Carolina*⁵⁸ the Supreme Court attempted, with limited success, to determine what constitutes an ‘arbitrary’ or ‘unreasonable’ formula.⁵⁹ Indeed, the Court did not endorse a general description of such labels. Rather, it held that each case had to be decided upon its merits. In general, however, pursuant to Supreme Court jurisprudence, it is generally admitted that a formula must possess ‘internal consistency’, that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed.⁶⁰ It also agreed that ‘factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.’⁶¹ In *Bass Ratcliff*, therefore, the principle that an apportionment formula should be fair was carried to its logical conclusion. If a formula apportions income to a local business in a way that is not unreasonable or arbitrary, then that local business which forms part of a globally integrated enterprise cannot be denied a share of the global profit derived by that enterprise just because its own localised results show a loss.

A further development occurred when the unitary method was used to apportion income of groups of companies conducting multistate unitary businesses. It was reasoned that state taxation could not be affected by the juridical organisation of a business into subsidiaries rather than branches. In *International Harvester Co. v. Evatt*⁶² the right of the states to devise appropriate apportionment formulas for the apportionment of the income derived by enterprises carrying on a unitary business interstate was formally recognised. As a result, many formulas were used by different states depending on their fiscal objectives. Apportionment formulas varied not only with respect to the basic factors used, but also with respect to the definition of each of the factors used in the formula.⁶³ The Supreme Court, from the start, had consistently refused to harmonise such diverse practices. In fact, the Court invariably upheld any apportionment formula provided the latter did not breach the established judicial tests. Obviously, the wide discretion enjoyed by the states in adopting different formulas created a

⁵⁷ *Underwood Typewriter Co. v Chamberlain* 254 U.S. 113, 121 (1920).

⁵⁸ *Hans Rees’ Sons, Inc v North Carolina ex rel. Maxwell* 283 U.S. 123, 133 (1931).

⁵⁹ See Huston, *supra* note 40, at 731.

⁶⁰ *Container Corp. of America v Franchise Tax Board* 463 U.S. 159 (1983), at 169.

⁶¹ *Ibid.*

⁶² 329 U.S. 416 (1947).

⁶³ Hartman, *supra* note 46, at 75.

serious risk of double or even multiple taxation. The need for a common policy on these matters was urgently felt.

ii The Harmonisation Process

As early as 1916, the National Tax Association (NTA) began work on a uniform model for state income tax law.⁶⁴ In order to promote equality at the state level, uniformity had to be reached in at least three major areas:⁶⁵

- the definition of an acceptable jural connection between the taxing jurisdiction and the tax subject - the nexus question;
- a uniform definition of the tax base and uniform administrative practices; and
- the adoption of a proper method for dividing the tax base between those states entitled to tax.

Achieving a comprehensive tax system acceptable to all U.S. states level has proved to be an elusive goal because of political rather than technical imperatives. However, in July 1957, the National Conference of Commissioners on Uniform State Laws approved the final draft of the proposed legislation and a semblance of uniformity was achieved with the emergence of the Uniform Division of Income for Tax Purposes Act (UDITPA) whose main objective of the UDITPA is 'to provide a state-level solution to a uniform approach to the division of a multistate enterprise's income.'⁶⁶ By 1982, over 23 states had adopted the UDITPA either verbatim or with certain modifications to suit their particular situations.⁶⁷

One important feature of the UDITPA is that it does not deal with the nexus question since it assumes a state's jurisdiction to tax. Nexus describes the amount and degree of business activity that must be present before a state can tax an entity's income. The UDITPA also assumes that the constitutionality requirements are satisfied. Likewise, it neither deals with the problem of what constitutes income, nor does it provide for the taxation of income derived from a multistate business. In brief, the definition and computation of the tax base and other related rules are determined by State legislation. The UDITPA deals predominantly with the

⁶⁴ The NTA, an organisation of tax officials from various states, held its first annual conference in Columbus, Ohio in 1907. In 1973 the NTA merged with the Tax Institute of America, and the organisation is now referred to as the NTA-TIA; see D.M. Hudson & D.C. Turner, 'International and Interstate Approaches to Taxing Business Income', (1984) 6 *Northwestern J Int'l L & Bus* 562, at 594 n 195.

⁶⁵ See Lynn, *supra* note 42, at 1260.

⁶⁶ See Hudson and Turner, *supra* note 64, at 595.

⁶⁷ S. Picciotto, *International Business Taxation* (London: Weidenfeld and Nicolson 1992), at 233.

issue of apportioning and allocating income of a multistate enterprise to individual states. It achieves this objective through, inter alia, the use of the Massachusetts formula consisting of three equally weighted factors: payroll, property and sales. The three-factor formula as proposed by the UDITPA actually aims at providing a reasonable allocation of the tax base as between the states. Indeed, the effect of the three factors is to determine the percentage of income to be apportioned to each state. The basic scheme adopted by the UDITPA requires a classification of all income as either ‘business income’ or ‘non-business income’. There are four types of non-business income:

- rents and royalties from real and tangible personal property;
- capital gains and losses from sales of real and personal property;
- interest and dividends; and
- patents and copyright royalties.

Such non-business income is allocated to a particular taxing jurisdiction according to the situs of the property or activity that produces the income or to the commercial domicile of the taxpayer. Business income is defined as:

[I]ncome arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer’s trade or business operations.⁶⁸

Once business income has been isolated, an intermediary step requires the determination of which activities generating business income may appropriately be classified as arising from unitary operations. In other words, a business may carry out certain activities that are clearly unitary in character and others which are not. Unfortunately, the UDITPA does not provide any rule for conducting this crucial exercise. Consequently, the tests elaborated by the courts are applicable to achieve that objective. After business income derived by an enterprise engaged in a unitary operation has been determined, the UDITPA apportions such income by using the three-factor formula.

Whilst it is undeniable that the UDITPA has to a certain extent been successful in its harmonisation effort, it is also evident that the success of the system has been somewhat mitigated by the attitude of the U.S. Supreme Court. Indeed, in spite of the advantages of harmonised rules, the Supreme Court, in *Moorman Manufacturing Co. v. Bair*,⁶⁹ refused to pressure the states into adopting it. In this case, the Court sanctioned the use of a one-factor

⁶⁸ United States, 7A Uniform Laws Annotated § 1(a) in Hudson & Turner, *supra* note 64, at 595-96.

⁶⁹ 437 U.S. 267 (1978).

formula, although in a strong dissenting judgement, Powell J. made it clear that a one-factor formula based on sales acted as a tariff on goods imported from the manufacturing states and was consequently inappropriate.

In the U.S., the harmonisation of state taxation practices has been attempted by a second method, the Multistate Tax Compact. Powerful lobby groups considered that the only way of reversing adverse court decisions in the field of formulary apportionment could only be achieved through the introduction of federal legislation banning such practices. In order to pre-empt federal legislation instituting such a ban, the State Tax Administrators Association issued on 20 December 1966 a model of a State Tax Statute. That model came to be known as the Multistate Tax Compact (MTC). Article IV of the Multistate Tax Compact actually adopts in toto the provisions of the UDITPA. The MTC, which became effective on 4 August 1967 when the seventh state adopted it, had four objectives:

- To facilitate the proper determination of state and local tax liability of multistate taxpayers including the equitable apportionment of tax bases and settlement of disputes;
- To promote uniformity or compatibility in significant components of tax systems;
- To facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and
- To avoid duplicate taxation.

As a result of the MTC, the Multistate Tax Commission was created. It is a body composed of a representative of each member state. One of the main purposes of the Multistate Tax Commission is to conduct, either on its own initiative, or if requested by member states, ‘a consolidated audit of the records of a multistate enterprise.’⁷⁰ In addition, the Commission is required to monitor the application of the UDITPA by the states where it is applicable.

The MTC is the first comprehensive attempt at state level to reach uniformity in state taxation. It survived a constitutional challenge⁷¹ and has the potential to become a multilateral state agreement. Yet, this potential has never been fully realised. Several reasons as summarised below have been suggested for the relative failure of the MTC.

- First, states are not required to adopt the UDITPA in toto. Indeed, they are allowed to select whatever part of the scheme they deem fit, relative to their policy objectives. Often states have adopted a modified version of the UDITPA provisions. This

⁷⁰ *Supra* note 64, at 598.

⁷¹ *United States Steel Corp. v Multistate Tax Comm’n* 434 U.S. 452 (1978).

prevents the emergence of a uniform interpretative jurisprudence. Had these provisions been adopted verbatim, their interpretation would have been greatly facilitated.

- Second, the MTC regulations are only advisory in character. Thus, states may adopt, amend, or reject any regulation put forward by the Commission.
- Third, the critical reason for the relative failure of the UDITPA and the MTC stems from the absence of a supervisory body to which it should have been entrusted the duty of policing the uniform interpretation and application of the rules and regulations thereon.

There have been calls for the creation of such an agency. As Professor Hellerstein has argued, the administration of a coherent state taxation system:

arising out of the tax laws of fifty States and large numbers of local governments, is simply not viable unless an administrative agency is utilized to implement its terms, its purposes and its objectives.⁷²

However:

many people recoil from this suggestion because, at first blush, it [...] would mean more federal control of states revenues, distribution according to population or some other imagined 'needs' basis, and other federal bureaucracy.⁷³

B The Application of the Unit Rule to International Operations

The application of the unit rule to international operations is commonly known as worldwide combined reporting (WWCR) or global formulary apportionment. In general, under WWCR, the business income of individual companies in a unitary business is aggregated regardless of whether individual companies are domestic or foreign. As in the domestic context, the unitary concept applied to international transactions requires that the level of business activity in that state determine the share of the combined income attributable to a particular state. That share is likewise measured by means of a formula.

i Worldwide Combined Reporting

In the 1970s California pioneered the use of global formulary apportionment for the allocation of income of unitary businesses with international operations. The Californian State Authorities

⁷² J. Hellerstein, 'Allocation and Nexus in State Taxation Interstate Businesses', (1964) 20 *Tax Law Review* 259, at 283. See also P. Studenski, 'The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist viewpoint', (1960) 46 *Virginia Law Review* 1121, at 1148.

⁷³ D.K. Barnes, 'Prerequisites of a Federal Statute Regulating State Taxation of Interstate Commerce', (1960) 46 *Virginia Law Review* 1121, at 1272-73.

did not advocate WWCR as a matter of deliberate policy choice.⁷⁴ Rather, acceptance of the method was gradually secured as a result of the whole culture surrounding the taxation of interstate business. That a business with both domestic and foreign operations could be treated as unitary had already been sanctioned by in *Underwood Typewriter Co. v. Chamberlain*,⁷⁵ and in *Bass, Ratcliff & Gretton Ltd v State Tax Commission*.⁷⁶ In both cases, the Court found no reason to prevent the application of the unitary method to apportion income derived through international rather than domestic operations.

For several decades, the initiative for the application of the unitary method rested with the Californian tax authorities. However, in the 1960s, in order to improve their tax position in California, two transnational oil companies operating in poor profitability conditions argued that they were carrying a worldwide unitary business. The Franchise Tax Board objected and the matter was taken to the Californian Supreme Court. In the *Superior Oil v. Franchise Tax Board*⁷⁷ and *Honolulu Oil v. Franchise Tax Board* cases,⁷⁸ the Court found against the Franchise Tax Board. It rejected the Board's contention that unity of operations existed only when such operations were 'necessary and essential' to each other. The Court ruled that unity existed when the operations contributed to or were dependent on each other regardless as to whether they were necessary and essential for the business. Although these decisions were in favour of the taxpayers, they paved the way for the routine application of WWCR in California to both foreign subsidiaries of American corporations, and to the Californian subsidiaries of foreign corporations.

ii Foreign Subsidiaries

In *Appeals of the Anaconda Co., et al.*⁷⁹ the company, whilst agreeing that it carried a unitary business on the domestic front, challenged the determination of the Franchise Tax Board that its subsidiaries operating in Chile and Mexico were part of that unitary business. The appeal was rejected and the Board's finding that Anaconda carried on a unitary business with its foreign subsidiaries was upheld. The Court also found that, although in *Chase Brass*

⁷⁴ Picciotto, *supra* note 67, at 235.

⁷⁵ 254 U.S. 113 (1920).

⁷⁶ 266 U.S. 271 (1924).

⁷⁷ 60 Cal 2d 406 (1963).

⁷⁸ 60 Cal 2d 417 (1963).

⁷⁹ United States, 4 Cal Tax Rep (CCH) para 204-759 (11 May 1972).

and *Copper Co. v. Franchise Tax Board*⁸⁰ the Californian Court of Appeal had refused to treat foreign operations as part of the unitary business of the appellant, it had never by the same token enunciated a general rule that foreign subsidiaries or affiliates were to be excluded in determining the scope of a unitary business.⁸¹

The scope of the unitary business concept was again extended by the decision of the Californian State Board of Equalization in *Appeal of Grolier Society, Inc.*⁸² The only link to California of Grolier's foreign subsidiaries was through its parent corporation headquartered in New York, which also operated a subsidiary in California whilst indirectly controlling its foreign subsidiaries through a wholly-owned subsidiary. Finally, in 1983, as will be examined further below, in *Container Corporation of America v. Franchise Tax Board*⁸³ the Supreme Court, while addressing the issue as to whether WWCR was constitutional, fully confirmed that states could extend the *Bass* principle to tax the worldwide combined income of a unitary business having a U.S. parent corporation and foreign subsidiaries.

iii Foreign-owned and Controlled Parents

The most extreme extension of the unitary doctrine to foreign businesses occurred with the decision of the Californian State Board of Equalization in *Appeal of Beecham Inc.*⁸⁴ In that case, it was held that the income of a foreign parent resident and operating in the U.K. could be included in the combined report of the parent's subsidiaries. The Board decided that there was strictly no difference between foreign-source income and other income when it came to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state.⁸⁵ As noted by E.G. Rudolph whose opinion was quoted by the Board in the *Appeal of Beecham*, the fact that no distinction was made between foreign-source income and other income of unitary business stems from logic. The extension of global formulary apportionment to encompass the worldwide income of a unitary enterprise does not mean that a state is allowed to tax the foreign-source income of that enterprise, just

⁸⁰ 10 Cal App 3d 496, 86 Cal Rp tr 350 (1970); petition for rehearing denied, 10 Cal App 3d 496, 87 Cal Rptr 239 (1970).

⁸¹ G.T. Yamate, 'California's Corporate Franchise Tax: Taxation of Foreign Source Income?', (1980) 20 *Santa Clara LR* 123, at 133.

⁸² 4 Cal Tax Rep (CCH) paras 205-301 (19 August 1975).

⁸³ 463 U.S. 159 (1983).

⁸⁴ 4 *Cal Tax Rep* (CCH) paras 205-635 (2 March 1977).

⁸⁵ E.G. Rudolph, 'State Taxation of Interstate Business: The Unitary Concept and Affiliated Corporate Groups', (1970) 25 *Tax L Rev* 171, at 295.

as the extension of that methodology to multistate businesses does not mean that a state is allowed to tax extra-territorial income. Income allocated to a particular state in such instances is merely income which arose as a result of the existence of a unitary business, that is, one where, inter alia, the local operation is dependent on the foreign operations of the enterprise.⁸⁶ In Rudolph's words:

[I]n both situations the total income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state. This proposition, so far as foreign source income is concerned, was recognized in the early Supreme Court case of *Bass, Ratcliff & Gretton v. State Tax Commission*. While the *Bass* case involved a single corporation, the rationale is just as applicable where a unitary business is being conducted by an affiliated group of corporations, even though some of the corporations are beyond the jurisdiction of the taxing state. This was in substance the holding in *Edison Stores*.⁸⁷

This reasoning was again applied in *Mobil Oil Corp. v. Commissioner of Taxes*⁸⁸ where the Supreme Court declared that a taxing state could attribute the business income of a foreign corporation to a domestic corporation only if the two comprised a unitary business.

Notwithstanding all these decisions, litigation aimed at restricting the use of formulary apportionment continued well into the 1990s. In general, in spite of their relative failure, taxpayers sought to restrict the states' recourse to the unitary method by requiring the courts to adjudicate on the constitutionality of the method. The latest in this long series of cases argued in the Supreme Court is that of *Barclays Bank plc v. Franchise Tax Board & Colgate-Palmolive Company v. Franchise Tax Board*.⁸⁹ The immediate effect of the publicity generated by these cases was to force California to revise its commitment to WWCR. Thus, even prior to the Supreme Court hearing the case, California, reacting to the threat of retaliatory measures from the U.K. Government and Federal legislation, opted to limit the application of its taxation policy to the so-called water's-edge concept.⁹⁰

In truth, worldwide unitary taxation has raised more political than technical problems. The method is portrayed as a crude tax-grabbing exercise, a reputation that is sustained by the often opportunistic behaviour of several U.S. states. It has also been portrayed as one designed to favour U.S. multinational groups at the expense of foreign business conglomerates.

⁸⁶ *Ibid.*

⁸⁷ *Ibid.*, (citation omitted).

⁸⁸ 445 U.S. 425 (1980).

⁸⁹ U.S. 129 L. Ed. 2d. 244, 114 S. Ct. 2268 (1994).

⁹⁰ R.M. Hammer, 'Will the Arm's Length Standard Stand the Test of Time? The Specter of Apportionment', (January 1996) 24 *Intertax*, at 3. See also s 6AB(6) of the *Australian Income Tax Assessment Act 1936*. The water's-edge concept is examined in detail further below.

Given the hostility towards global formulary apportionment, one may speculate about the real reasons underlying this attitude. It may well be that international business does not want to see a worldwide expansion of this method. The reason for this antagonism can no doubt be traced to the fact that worldwide unitary taxation truly brings within the taxing net all, rather than part, of TNCs' profits. The attitude of present-day TNCs should be contrasted with that expressed by the owner of one of the most powerful conglomerates that existed at the beginning of the twentieth century. Indeed, Sir William Vestey, the beef baron, testifying before the British Royal Commission of 1919-20 as to the nature of his operations said:

[I]n a business of this nature you cannot say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in 50 different countries. You cannot say how much is made in England and how much is made abroad. That is why I suggest you should pay a turnover tax on what is brought into this country ...⁹¹

It may well be that Sir William Vestey's position, expressed in the following words, is not totally shared by some of the present-day TNC directors:

[I]t is not my object to escape payment of tax. My object is to get equality of taxation with the foreigner, and nothing else.⁹²

C The Waters'-Edge Concept

The 1983 U.S. Supreme Court decision in *Container Corp.* brought a frenzy of protest from foreign TNCs as well as foreign governments. It was even suggested that the U.S. government should, as a conciliatory measure, support a petition requiring the rehearing of the *Container* case.⁹³ While such a course of action was not followed, President Reagan set up a working group under Treasury Secretary Regan. The Worldwide Unitary Taxation Working Group was also directed to study the states' use of worldwide unitary taxation and recommend any measures that would safeguard the interests of both the states concerned and those of U.S. trading partners. The working group itself formed a task force and after a number of meetings these two bodies were unable to arrive at a satisfactory solution to the problem. However, agreement was reached on three principles:

- a water's-edge combination for both U.S. and foreign-based TNCs;
- increased federal assistance and cooperation with the states to promote compliance by taxpayers; and

⁹¹ Picciotto, *supra* note 67, at 15.

⁹² *Supra* note 67, at 15.

⁹³ Plant et al., *supra* note 55, at 219.

- a renewed effort to achieve a competitive balance between U.S. and foreign TNCs and purely domestic businesses.

As far as the first principle was concerned, the Regan Report advocated the introduction by the states of an optional ‘water’s-edge’ unitary combination. Basically, under the water’s-edge principle, unitary combination is limited to U.S. business of both domestic and foreign firms. In other words, ‘a state taxes its apportioned share of the taxpayer’s domestic net business income, and apportionment is based on the ratio that the taxpayer’s local property, payroll, and sales bear to its domestic property, payroll, and sales.’⁹⁴

Moreover, the Regan Report provided that worldwide unitary taxation could be used when the use of separate accounting for the allocation of income between the U.S. and foreign component of a TNC, whether American or foreign, resulted in tax evasion, or was clearly inappropriate to reflect income, or failed to comply with disclosure requirements. In order to enable the states to monitor the application of the water’s-edge principle, federal assistance was to be given to them. It was thus agreed that the states would share the information obtainable from treaty partners. It was also agreed that the Internal Revenue Service (IRS) would share any information that would be acquired as a result of a vigorous audit program targeting international businesses that the Service intended to carry out. As for the application of the third principle, no method could be found for reconciling the water’s-edge principle and equality of competition between domestic, foreign and purely local businesses.

The Regan Report was cautiously welcomed by international business. Pressure was maintained on recalcitrant states like California to adopt the water’s-edge concept by threats of massive disinvestment. Retaliatory legislation had already been introduced by the British Parliament in its *Finance Act* of 1985 and there were renewed threats for activating these measures. Britain thus contemplated the withdrawal of the Advanced Corporation Tax refunds on dividend payments from the British subsidiaries of U.S. parent corporations located in unitary tax states.⁹⁵

Finally, in 1986, under the threat of federal legislation, California enacted legislation offering taxpayers a water’s-edge alternative. Senate Bill (‘S.B.’) 85 was signed by Governor Deukmejian in 1986 to establish an election by corporations doing business in California to compute California income by excluding from combined unitary income subject to apportionment income earned outside the U.S. by certain non-U.S.-incorporated affiliates.⁹⁶

⁹⁴ *Supra* note 55, at 212.

⁹⁵ D. Sandler, ‘The Continuing Debate Over Unitary Taxation and Worldwide Combined Reporting’, [1994] *BTR* 572, at 584.

⁹⁶ Plant et al., *supra* note 55, at 219.

In fact the legislation contained three major elements, a water's-edge election, a foreign dividends exclusion, and domestic disclosure requirements.⁹⁷ The election, known as the water's-edge election, became effective for income years beginning on or after 1 January 1988. The conditions of this election were further modified in 1993, effective for income years beginning on or after 1 January 1994. The original measures enacted in 1986 contained provisions relating to the contractual nature of the election as made between the taxpayer and its group of companies on the one hand and the Franchise Tax Board on the other hand. Those taxpayers that were eligible to make the water's-edge election were referred to as 'qualified taxpayers'. In addition, there were provisions regarding the composition of the water's-edge group. Some corporations, for example, those with less than twenty per cent of the average of their property, payroll, and sales factors in the U.S., as well as foreign banks, were treated as 'excluded entities' except to the extent of their U.S.-derived income. The election term was for a 60-month period and there were provisions for its termination by either the taxpayer or the Franchise Tax Board. Finally, an election fee was payable to the Franchise Tax Board, which equalled 0.03 per cent of the sum of the taxpayer's property and payroll factors for the income year of 1986, plus California sales in the current year.⁹⁸

As mentioned earlier, amendments to these provisions became effective for income years beginning on or after 1 January 1994. The annual election fee was removed, certain administrative burdens eased, and the period of election extended from five to seven years. Furthermore, instead of the Franchise Tax Board having power to disregard the election, certain monetary penalties were imposed in case of non-compliance.⁹⁹

Although the conditions for the application of the water's-edge election were strict, they were welcomed by most foreign TNCs as well as by the British Government which suspended its threat of taking retaliatory measures against California. However, American TNCs were not satisfied and argued that the third condition agreed upon by the Regan Working Group, that is, the assurance of competitive equality between domestic and foreign TNCs, was not met. Notwithstanding this sour note, so much was thought of California's enactment of its water's-edge election that when the *Barclays* case¹⁰⁰ came to be heard before the Supreme Court, the

⁹⁷ G.N. Carlson & R.B. Bernstein, 'Worldwide Unitary Combination: History and Prospects', (14 November 1986) 15 *Tax Management International Journal* 407, at 415.

⁹⁸ Plant et al., *supra* note 55, at 219-21.

⁹⁹ Sandler, *supra* note 95, at 584-85.

¹⁰⁰ U.S. 129 L Ed 2d 244, 114 S Ct 2268 (1994).

Solicitor-General of both California and the United States moved to have the case struck out on the grounds that the water's-edge election made the case moot.¹⁰¹

Section III The Unitary Theory: Tests and Operation

The adoption of WWCR by some of the most commercially significant U.S. states in the 1970s ignited an often-heated debate as to the desirability of this method. In the U.S. opponents of the method reacted by aligning their attack on its constitutionality, a litigation strategy that can be traced to the earlier general property taxes. WWCR, it was alleged, breaches both the Due Process and the Commerce Clauses of the U.S. Constitution. It was also argued that when state taxing authorities target instrumentalities of foreign commerce, the risk of double taxation is increased, and the Federal Government is deprived of its ability to speak 'with one voice when regulating commercial relationships with foreign governments.'¹⁰² In other words, it was claimed that worldwide unitary taxation impaired the Federal Government's exclusive powers to deal with foreign affairs and to regulate international trade.

This constitutionality issue is obviously restricted to the U.S. environment. It should, therefore, have no relevance in determining the adequacy of the system on an international level. Still, it is necessary to review the judicial decisions relative to these questions, given that they relate to such crucial issues such as the jurisdictional threshold to tax, or the articulation of the concept of a unitary business.

1 The Jurisdictional Threshold Question

Liability to tax arises in the presence of certain connecting factors between the tax subject and a particular jurisdiction. This is the so-called nexus question which is defined as the amount and degree of business activity that must be present before a state can tax an entity's income. Since the inception of the League of Nations Model Treaties the minimum connecting factor has been, in the case of a single entity enterprise, the permanent establishment, whereas for a subsidiary the place of incorporation or management is a prime factor for the determination of the enterprise's economic allegiance and, thus, its tax-paying obligations.

¹⁰¹ Sandler, *supra* note 95, at 585.

¹⁰² *Japan Line, Ltd v County of Los Angeles* 441 U.S. 434 at 451, (1979), 60 L Ed 2d 336, 99 S Ct 1813.

In the U.S., Public Law 86-272, enacted in 1959, provides for ‘a minimum activity test’ to determine a state’s jurisdiction to impose net income tax on a multistate business.¹⁰³ This legislation prohibits the imposition of a net income tax by any state on income derived within its borders by a person engaged in interstate commerce if the only business activity which that person carries out within the state is, inter alia, the solicitation of orders in that state for the sale of tangible personal property.¹⁰⁴ This minimum activity test is far from achieving the certainty of the well-known PE threshold test as used in international taxation or in the Canadian provincial tax scene. Indeed, the rejection of the permanent establishment as establishing the necessary nexus for the purposes of state taxation has often been criticised.¹⁰⁵

Notwithstanding the existence of Public Law 86-272, the establishment of the jurisdictional threshold question remains to a large extent the privilege of the Courts in the U.S. state tax scene. Basically, the issue revolves around the interpretation of two clauses in the U.S. Constitution by the Supreme Court on state tax sovereignty.¹⁰⁶ The Court’s jurisprudence imposes two conditions on a state’s jurisdiction to impose income tax:

- First, a connection must exist between that state and the corporation’s activities which produce that income.
- Second, the state may only tax the portion of the corporation’s income that is fairly attributable to the corporation’s income-producing activities in that particular state.

A The Sufficient Nexus Requirement

The two principles involved in this context are:

- A state must have a significant nexus or a rational relationship with a particular corporation before it may seek to tax the corporate earnings of the latter; and
- the taxing state must offer certain benefits for which it can reasonably expect something in return.

The sufficient nexus requirement is closely connected with the U.S. constitutional requirement that ‘no state may deprive any person of life, liberty, or property, without due process of

¹⁰³ For a critical examination of Public Law 86-272, see R.L. Roland, ‘Public Law 86-272: Regulation or Raid’, (1960) 46 *Virginia Law Review* 1172.

¹⁰⁴ R.L. Hirshberg & A.L. Nedry, ‘A Federal Concept of Doing Business’, (1960) 46 *Virginia Law Review* 1241.

¹⁰⁵ J. Dane, ‘Small Business Looks Public Law 86-272 in the Perspective of its Alternatives’, (1960) 46 *Virginia Law Review* 1190, at 1209-10.

¹⁰⁶ J. Hellerstein, ‘State Taxation of Corporate Income From Intangible: *Allied-Signal* and Beyond’, (1993) 48 *Tax Law Review* (No. 4) 739.

law'.¹⁰⁷ A state's jurisdiction to tax extends to persons and subjects with some degree of connection with the state. The question that arises, therefore, is the extent of such a connection. In other words, how much connection with a state is required to meet the constitutional requirement. This question is of concern to both state residents and non-residents alike.

As far as the state residents are concerned, the U.S. Supreme Court held, earlier on, that states have plenary power to tax residents and domestic corporations on income derived both in and outside the state¹⁰⁸ so long as the tax is not 'palpably arbitrary or unreasonable'.¹⁰⁹ The state's taxing jurisdiction is grounded on the idea that, in respect of its residents, a state provides protection and privileges, including the right to receive and enjoy income. Understandably, the states may reap some revenue in return for the benefits they have conferred upon all businesses operating within their borders whether they are local, interstate, or international operations. A further extension of the state's taxing power was achieved when the Supreme Court held that the State of New York could tax a resident on income derived exclusively from sources outside the state.¹¹⁰ In its decision, the Supreme Court reasoned that the fact of domicile itself affords a basis for tax jurisdiction, and the enjoyment of privileges of residency and protection of state laws require residents to share the costs of government. Taxes, the Court went on to say, 'are what we pay for civilized society.'¹¹¹

As the League of Nations tax experts had established, non-residents deriving income or having property in a foreign country are also required to contribute to the upkeep of the host government by paying taxes. However, there arises with non-residents a problem relating to the demarcation of a state's taxing power since a non-resident does not enjoy the state's stock of public goods as extensively as a resident. Upon considering this question, the Supreme Court held that constitutional jurisdictional nexus is based on the quality of the relationship existing between the non-resident and the state.¹¹² A state's power to tax depends on the state's granting of opportunities, protections, and benefits to the non-resident. The Court reasoned that the Due Process standard, as applicable in this particular context, requires the

¹⁰⁷ U.S. Const. Amend XIV § 1, in Hudson & Turner, *supra* note 64, at 585 n 131.

¹⁰⁸ *Kirtland v Hotchkiss*, 100 U.S. 491, 498 (1879).

¹⁰⁹ *Lawrence v State Tax Comm'n of Mississippi*, 286 U.S. 276, 279-80 (1932).

¹¹⁰ *New York v Graves*, 300 U.S. 308 (1937).

¹¹¹ *Id.*, at 313 quoting *Compañía General de Tabacos v Collector*, 275 U.S. 87, 100 (1927).

¹¹² *Winconsin v J. C. Penny Co.*, 311 U.S. 435 (1940).

determination of ‘whether the state has given anything for which it can seek return’.¹¹³ This test was further refined a few years later when the Court held that the Due Process standard required that ‘some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.’¹¹⁴ It is this rational relationship between the in-state activities of a taxpayer and the state’s territory that enables state authorities to tax income generated by these activities.

B The Substantial Nexus Requirement

Whereas the sufficient nexus requirement is aimed at securing a minimum connection between the taxpayer and the taxing state, the substantial nexus requirement requires for its part an assessment of the extent of the corporate activity within the state. In general, the states include within their taxing power every corporation resident within their boundaries and every foreign corporation ‘doing business’ therein.¹¹⁵ However, the vagueness of the ‘doing business’ concept is such that the Supreme Court has had to intervene very early in order to prevent the creation of internal barriers to commerce between the states through the latter using unprincipled taxation methods to raise revenue. Thus, the Supreme Court has linked the nexus question to the so-called Commerce Clause restriction. This grants Congress explicit power to enact federal legislation to govern commerce among states and with foreign countries.¹¹⁶ It is also interpreted to prohibit states from enacting legislation that violates federal policy in areas where federal uniformity is essential.¹¹⁷

The constitutional attack on the states’ power to impose unitary taxation based on the Commerce Clause gave the Supreme Court an opportunity to articulate its doctrine relative to the substantial nexus requirement. In other words, the Supreme Court examined the extent of the corporate activity within the state that would justify that state’s jurisdiction to tax. In doing so, the Court ignored the principles applicable at the international level whereby a country’s right to tax is triggered only in the presence of a permanent establishment.

¹¹³ *Id.*, at 444.

¹¹⁴ *Miller Brothers Co. v Maryland*, 347 U.S. 340, at 344-45 (1954).

¹¹⁵ Hartman, *supra* note 46, at 54.

¹¹⁶ U.S. Const. Amend XIV § 8, c 1.3, in Note, ‘State Taxation of Foreign Source Income Through Worldwide Combined Reporting’ (1984) 17 *Vanderbilt Journal of Transnational Law*, 95, at 107.

¹¹⁷ In *Quill Corp. v North Dakota*, 112 S.Ct. 1904, the U.S. Supreme Court ruled the Commerce Clause required a taxpayer to have some physical presence in a state in order for it to be taxed. This restriction known as the negative commerce clause aims at preventing abusive state taxation. See J.R. Hellerstein, ‘State Taxation Under the Commerce Clause: A Historical Perspective’, (1976) 29 *Vand. L. Rev.*, 335.

In *Complete Auto Transit, Inc v Brady*,¹¹⁸ the Supreme Court articulated a four-part negative Commerce Clause test which maintained that a state's taxing jurisdiction is premised on the existence of a substantial nexus with the corporate activity; the tax should be fairly apportioned and be non-discriminatory; and, finally, it should be fairly related to the services provided by a state. Two other tests were later articulated in the *Japan Line* case.¹¹⁹ A state taxation system may not increase the risk of multiple taxation and it should not impair federal uniformity in the regulation of foreign commerce.

Obviously, the fair apportionment test of *Complete Auto* as an offshoot of the negative Commerce Clause overlaps with territorial due process. This is because if the taxing state has not justly determined the income earned within the state by fair apportionment, then the state violates territorial due process by taxing income not connected with the taxing state.¹²⁰ The fair apportionment test requires that the income earned within a state be determined by an acceptable accounting method. Traditionally the states opted for the formula apportionment methodology. However, although the states have exercised great flexibility in applying this methodology, the Supreme Court has attempted to control this flexibility by limiting the application of the formula to unitary businesses. What constitutes a unitary business will be examined further below. At this stage the issue that needs to be explored is the relationship between a unitary business and the states' jurisdiction to tax.

This question has been resolved in the *Mobil Oil* case¹²¹ where the Court decided that a taxing state could attribute the business income of a foreign corporation to a domestic corporation only if the two comprise a unitary business. In other words, the decision of the Court provides that the rational relationship between the taxing state and the income, or added value, that the state seeks to tax as provided for by the Due Process clause is satisfied if the corporation in question forms parts of a unitary business. Thus, the Court stated that 'the linchpin of apportionability in the field of state taxation is the unitary business principle.'¹²² The Court's analysis in dicta of the relationship between apportionability and the concept of unitary business is interesting. It shows that when a business is granted the privilege of conducting business in a state, it exposes itself to income taxation. However, such taxation would fail the

¹¹⁸ 430 U.S. 274 (1977).

¹¹⁹ *Japan Line, Ltd v County of Los Angeles*, 441 U.S. 434 (1979).

¹²⁰ See Note, *supra* note 116, at 109 n 83.

¹²¹ *Mobil Oil Corp. v Commissioner of Taxes*, 445 U.S. 425 (1960).

¹²² *Id.*, at 439.

substantial nexus test if that business were not part of a unitary business having a nexus with that state.

To sum up, both the Due Process Clause and the Commerce Clause require that an enterprise be engaged in a unitary business before a taxing jurisdiction can apply a formulary apportionment methodology and tax an amount of profits allocable to that state.¹²³

C The Relationship between Nexus and Attribution Rules

The legal rules for dividing income among the various states has a common objective and as the *Willis Committee Report* puts it, they are designed ‘to assign to the taxing state that portion of a corporation’s total net income which is fairly attributable to the State’.¹²⁴

In general, it is assumed that a fair attribution of income is achieved by conceding jurisdiction to tax income where it is earned. Traditionally, it was assumed that this would be accomplished if the geographical source of income could be determined. However, the impossibility of precisely locating the source of business income led to the adoption of formulary apportionment for the sharing the profits of corporations operating in several states.

Yet, special rules for the attribution of specific items of non-business income derived by a corporation, which could lend themselves to precise geographic location, have been maintained. These rules are based on either the residence of the recipient of the income or its source. However, prior to the harmonisation process sought by the UDITPA, the states experimented with a plethora of source rules which produced an extraordinarily complex system, especially as it interfaced with formulary apportionment applicable to business income. For instance, it is assumed that the source of non-business income derived from property such as investment income coincides with the location of that property.¹²⁵ The source of income from tangible property is usually taken to be at the situs of such property. However, serious difficulties arise in the case of intangible property. Pursuant to the *mobilia sequuntur personam* doctrine,¹²⁶ the location of intangibles may be assumed to follow the taxpayer. In other words, the intangible property is located at the domicile of the taxpayer.¹²⁷ Moreover,

¹²³ B.L. Burgner, ‘Barclays and Worldwide Combined Reporting’, (1991) 17 *The International Tax Journal* 4, at 44.

¹²⁴ *Willis Committee Report*, in Hellerstein, *supra* note 45, at 310.

¹²⁵ *Id.*, at 312.

¹²⁶ ‘Movables follow the person.’ See P.G. Osborn, *A Concise Law Dictionary*, 5th ed. (London: Sweet and Maxwell, 1964), at 212.

¹²⁷ *Id.*, at 114. The meaning of the term ‘domicile’ is, in this instance, taken to be that as used in the common law system.

intangible property may also be located at the ‘business situs’ of the taxpayer, or it may be assumed to be at the location of the entity which makes payments to the taxpayer.¹²⁸

The interaction of such specific allocation methods with formulary apportionment creates numerous problems ranging from overly complex rules, which undermines compliance to problems in the division of deductions, which are so complicated ‘as to perplex even the most sophisticated tax specialist’.¹²⁹ What is of more immediate relevance in the context of this thesis is that ‘the separate treatment of the questions of location of a corporation for jurisdictional purposes and the location of its net income has led to a lack of congruence between nexus rules and attribution rules.’¹³⁰ The result is that if a corporation is deemed not to satisfy the nexus requirement as studied earlier, then the income derived by that corporation from sources within that state escapes taxation. One device for recapturing income attributable to a state where it might not be taxed is the so-called throwback/throwout rules.¹³¹ These rules effectively reassign to a state with tax jurisdiction income which would normally be attributed to a state where such income could escape taxation. The relationship between the nexus and attribution rules must also be analysed relative to what may be considered as an appropriate apportionment formula. This study will be carried out in Chapter 5.¹³² For now, the conclusion that may be drawn is that the interaction of the nexus and attribution rules causes such serious difficulties that any attempt to tax income at its source have had to be abandoned.¹³³ Instead, the U.S. states have embraced the concept of unity in business operations as the theoretical justification for their right to tax business income.

2 The Concept of Unity in Business Operations

A unitary business may be defined as one which carries business partly within and partly without a taxing jurisdiction in an integrated fashion.¹³⁴ It is generally admitted that a corporation carries on a unitary business when some or all of its operations are so integrated

¹²⁸ *Willis Committee Report*, in Hellerstein, *supra* note 45, at 312.

¹²⁹ *Supra* note 45, at 312.

¹³⁰ *Supra* note 45, at 312.

¹³¹ For a discussion of throwback/throwout rules, see R.D. Pomp, ‘Reforming a State Income Tax’, (1987) 51 *Albany Law Rev.* 375, at 704-707.

¹³² See Chapter 5, Section I, 2, A & B, at 192ff.

¹³³ Hellerstein, *supra* note 45, at 312.

¹³⁴ F.M. Keesling & J.S. Warren, ‘The Unitary Concept In the Allocation of Income’, (1960) 12 *Hastings LJ* 42, at 46.

that that income segregation to a specific source is impracticable.¹³⁵ In other words, the unitary business test is satisfied if the activities carried out within and without the state are such that they constitute inseparable parts of a single business. A unitary business implies the existence of common elements, which either bind the various activities together or are responsible for the viability of these activities in their present form. The Supreme Court whilst adjudicating on the constitutionality of unitary taxation has articulated the indicia of a unitary business.

A What is a Unitary Business?

In the U.S., the courts have relied on several tests to determine when a parent company and its branches and subsidiaries constitute a unitary business. In a string of cases the Supreme Court has indicated that such elements as management controls, functional integration and economies of scale are, depending on their degree, indicative of a unitary business.¹³⁶

In *Butler Bros v McColgan*,¹³⁷ the Supreme Court enunciated ‘the three unities test’, which became the most used test for the determination of a unitary business. Pursuant to that doctrine, a unitary business exists if a parent and a subsidiary share, common ownership, common management, and common operations.

The first crucial element of the test is the existence of common ownership between the businesses concerned. The ownership test is satisfied if a company directly or indirectly owns fifty per cent of another company’s shares, or if the first company exercises a strong controlling position on the second. The degree of ownership can thus be determined objectively and subjectively. The subjective analysis, presumably carried out by the taxing authority, is bound to create disputes between those concerned.

As for the common management criterion, the general belief is that it is met in the presence of interlocking boards of directors, or where there is an exchange of key personnel between the companies concerned. Finally, the third criterion, that is, common financing, trademarks, research and development ,or other significant activities is, in conjunction with the first two, indicative of a unitary operation. The Supreme Court has also relied on the dependency test to determine whether a group of companies is operating on a unitary basis. When this test is

¹³⁵ B.J. Issac, ‘State Taxation of Multinationals and the Unitary Business Concept: A Contemporary View’, (1984) 10 *Brooklyn J Int’l L* 115, at 124.

¹³⁶ *Butler Bros. v McColgan* 315 U.S. 501, 508 (1942); *F. W. Woolworth Co. v Taxation and Revenue Dep’t* 458 U.S. 354, 364 (1982); *ASARCO Inc. v Idaho State Tax Comm’n* 458 U.S. 307, 317 (1982); *Mobil Oil Corp. v Commissioner of Taxes* 445 U.S. 425, 438 (1980); *Japan Line, Ltd. v County of Los Angeles* 441 U.S. 434 (1979); *Container Corp. of America v Franchise Tax Board* 463 U.S. 159 (1983).

¹³⁷ 315 U.S. 501 (1942).

used, the critical factor is whether the operations carried out by a corporation in one state depend or contribute to the operations of another corporation located in a different state.

The existence of a number of different tests does not add certainty to the quest of what constitutes a unitary business. The Supreme Court in the U.S. has provided general guidance for delineating the scope of a unitary business without committing itself to any particular approach.¹³⁸ Business needs certainty in its tax environment. Therefore, in order to be considered as a viable alternative to separate accounting, it is essential that this open-ended attitude prevailing in the American states' version of the unitary method be resolved and a definite set of criteria be agreed upon in order to determine the scope of a unitary business. Unfortunately, there seems to be no agreement as to what criteria are acceptable as indicative of a unitary business in the U.S. for the time being. Therefore, as will be explored in a later chapter, it may well be that the unitary concept as articulated in the U.S. will need to be abandoned if the model proposed in this thesis is to stand the test of certainty, simplicity and administrative ease.

The three unities test has been widely criticised.¹³⁹ What is apparent is that, even among the proponents of the unitary tax system, there is a serious divergence of views as to the acceptable criteria of a unitary business. Such disagreement is well illustrated in a spirited exchange between Charles E. McLure, Jr and Jerome Hellerstein in a series of articles which appeared in *Tax Notes* in 1983. In the first of these articles, Professor McLure¹⁴⁰ disputes the contention of the attorney for Container Corp., a corporation litigating before the Supreme Court, that the Court should establish a bright line test of the reality of a unitary business based on the existence of a substantial flow of goods between affiliate firms.¹⁴¹ In this regard, counsel for Container Corp. was drawing on an argument made earlier by Professor Jerome Hellerstein in an article which appeared in *Tax Notes* on 25 January 1982.¹⁴²

¹³⁸ J. Hellerstein, 'State Income Taxation of Multijurisdictional Corporations: Reflections on Mobil, Exxon and Hr. 5076', (1980) 79 *Mich L Rev* 113.

¹³⁹ *Ibid.* See also Keesling & Warren, *supra* note 134.

¹⁴⁰ C.E. McLure, Jr., 'Operational Interdependence Is not the Appropriate 'Bright Line Test' of a Unitary Business-At Least, Not Now', (10 January 1983) 18 *Tax Notes*, at 107-110.

¹⁴¹ A bright line test or a bright line rule is 'one that is specific, unambiguous, and clear. A "bright-line" would mean that sometimes a taxpayer may be advantaged and sometimes not, but, at least the answer will be known and appropriate planning can be undertaken.' See C.J. Getz & D. Van Horn, 'Ralph's corporate panacea', (February 2000) *The Tax Specialist* (No. 4) 170, at 172.

¹⁴² *Id.*

In *Container Corp.*¹⁴³ the U.S. Supreme Court found that ‘the prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*.’¹⁴⁴ Thus, this flow of value test (rather than a flow of goods test) supplements the traditional tests for determining the existence of a unitary business.¹⁴⁵ To the Court, therefore, if a flow of value occurs between the elements of an enterprise within a taxing state, then the minimum constitutional linkage that justifies unitary taxation on the basis that the system is theoretically sound is satisfied.¹⁴⁶

Professor McLure rejected the argument that a substantial flow of goods should constitute the bright line test of a unitary business. He maintained that although:

under most circumstances a substantial flow of goods should be sufficient to establish a presumption that separate accounting may fail and a finding of unitariness is in order...it is clearly not necessary that transactions occur for two or more firms to be engaged in a unitary business.¹⁴⁷

Professor McLure proposed a three-tier test of unitariness involving the following inquiry:

- Is there common ownership and management? If not, there can be no unitary business.
- If there is common ownership and management, which expenses are shared, what other economies of scale and scope or intra-group transactions or other forms of economic interdependence are there?
- If there is economic interdependence, is it ‘so substantial that separate accounting would fail to produce a satisfactory division of profits between the members of the group?’

What Professor McLure suggests is that in spite of the absence of substantial operational interdependence, a business should be classified as unitary if the centralised management has the power to manipulate the group’s operations in order to achieve whatever optimal tax position it perceives.

In his reply Professor Hellerstein explored the indicia of operational interdependence.¹⁴⁸ He then deplored the advocacy of ‘broad vague tests of unitariness, employing such loose

¹⁴³ *Container Corp. of America v Franchise Tax Board* 463 U.S. 159 (1983), at 192.

¹⁴⁴ *Id.* A ‘flow of value’ exists when a business relationship between two entities provides to one advantages that do not accrue to other entities outside this relationship.

¹⁴⁵ B.J. Issac, ‘State Taxation of Multinationals and the Unitary Business Concept: A Contemporary View’, (1984) 10 *Brooklyn Journal of International Law* 115, at 146.

¹⁴⁶ D.L. Simmons, ‘Worldwide Unitary Taxation: Retain and Rationalize, or Block at the Water’s Edge’, (1985) 21 *Stanford Journal of International Law* 157, at 173.

¹⁴⁷ McLure, Jr., *supra* note 140, at 113.

yardsticks as whether a branch or subsidiary ‘contributed to’ or is ‘dependent upon’ the rest of the enterprise.’ He stressed that such tests are burdensome, time consuming, expensive to comply with, and are difficult to administer. Furthermore, he argued that such tests would cause severe distortion and misattribution of income. Professor Hellerstein went on to suggest that, in the apportionment area, what was required was not a method akin to a scientific analysis. Such a test would often be flawed if any one of the assumptions on which it is based turned out to be inaccurate. Instead, he advocated a rough approximation in the attribution of income as would be achieved by the use of the interdependence requirement which, contrary to the ‘contribution’ or ‘dependency’ tests, is an objective one.

In October 1983, Professor McLure responded to Professor Hellerstein’s critique.¹⁴⁹ He noted first that the U.S. Supreme Court in *Container*¹⁵⁰ had refused to adopt the substantial flow of products between affiliated firms as a bright line test of a unitary business. He then proceeded to argue that at the heart of the unitary debate is the fact of economic interdependence that makes the isolation of profits in an integrated group a virtual impossibility. Economic interdependence is not solely apparent in transactions in goods and services. As pointed out by the Supreme Court in *Container*: ‘Substantial mutual interdependence can arise in any number of ways; a substantial flow of goods is clearly one but just as clearly not the only one.’¹⁵¹

Professor McLure stressed that if the term basic operational interdependence is synonymous with a flow of goods or services between affiliated firms, then the test is objective, but it remains insufficient for the determination of unitariness. However, if the test encompasses more than a flow of goods and services, it remains appropriate as a test of unitariness, but it can no longer be considered as objective. This result is achieved, according to Professor McLure because:

- First, the quantification and aggregation of various aspects of interdependence is akin to measuring various aspects of satisfaction and adding them up; and
- Second, interdependence needs to be identified even if it cannot be measured.

¹⁴⁸ J. Hellerstein, ‘The Basic Operations Interdependence Requirement of a Unitary Business: A Reply to Charles McLure, Jr.’, (28 February 1983) 18 *Tax Notes*, at 723.

¹⁴⁹ C.E. McLure, Jr., ‘The Basic Operational Interdependence Test of a Unitary Business: A Rejoinder’, (10 October 1983) *Tax Notes* 91.

¹⁵⁰ *Container v Franchise Tax Board* (1983) 51 U.S. Law Week 4987.

¹⁵¹ *Id.*, at 4992.

However, even this identification process cannot be made on an objective basis because of the shifting distinction in Professor Hellerstein's definition of basic and non-basic activities.

It appears that Professor McLure's proposition is more realistic, although in Professor Hellerstein's opinion this is a 'sweeping view of the scope of the unitary business'.¹⁵² Indeed it is difficult to agree that a business is unitary only if the management of the affiliate corporations act in a concerted way. It seems realistic to hold that individual companies in a group are engaged in a unitary business if they operate within a structure where centralised management can manipulate the tax position of the individual members of the group whether or not it actually engages in such manoeuvres. Consequently, the first two tiers of Professor McLure's test appear to be adequate.

Otherwise, the third tier seems to be immaterial. Indeed, it is not essential to define a unitary business relative to the separate accounting theory. Once common ownership and management is established and the fact that each member of the group, because of such membership, is able to achieve substantial economies of scale, share expenses and engage in intra-group transactions, then *prima facie* the fact of unity is established. When the first two tiers of the test are satisfied, it is difficult to see the purpose of the third tier, that is, whether separate accounting fails to produce an acceptable division of income between the members of the group.

Separate accounting is a method of allocating profits to various entities. If the degree of economic and operational interdependence is high, then, whether separate accounting can or cannot achieve a proper allocation of income, it does not alter the fact that basically those enterprises are unitary. Indeed, if unity of management and ownership is demonstrated, and there are frequent instances of concerted action between the various members of the group so that a unitary business is deemed to exist, then, because of the fully integrated nature of the enterprise, separate accounting is highly unlikely to produce a satisfactory apportionment of income.

Thus, for the present purpose only the first two tiers of Professor McLure's test seem to be adequate. However, even this construction had been held to be too conservative long before the present rationalisation in the operations and structures of TNCs.

B The Main Objections to Worldwide Combined Reporting

It will be apparent from the above that the objections to formulary apportionment have often been, in the U.S. context, linked to constitutionality issues. Other objections have also been

¹⁵² Hellerstein, *supra* note 148, at 727.

voiced, the more serious being its inherent theoretical imperfection. The main objections to worldwide formulary apportionment are summarised in the 1995 OECD Report.¹⁵³ The U.S. Supreme Court has already dismissed most of these objections. Thus, for example, the OECD claims that ‘the most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation.’¹⁵⁴ Yet, as far back as 1983 the U.S. Supreme Court had, in *Container Corp.*, dealt with this problem and there is no reason to believe that its reasoning is not be applicable in an international context. The Court held that, in the case of a domestic group, double taxation was not an ‘inevitable result’ of worldwide unitary taxation and could occur even if the arm’s length principle was used to determine the income of such corporations. The Court extended this conclusion to cases involving foreign-based multinationals and maintained that the foreign residence of a taxpayer or the taxpayer’s parent was a factor whose weight was insufficient to warrant special treatment. The Court went on to say that the fact that the arm’s length principle was an internationally accepted norm was not sufficient ‘to dictate this Court’s Commerce Clause jurisprudence.’¹⁵⁵ In other words, the Court made it clear that the international acceptance of the separate accounting/arm’s length principle does not preclude any attempt to find an alternative solution that would be more equitable.

Moreover, the Californian WWCR produces lower burdens in at least two situations:

- First, if a corporation operates at a loss, worldwide unitary combination allows it to include loss corporations that have no nexus with California in the combined report of its unitary business. Since such losses will necessarily offset income from other corporations in the group, less income will be returned in the pre-apportionment combined report.
- Second, with WWCR, the apportionment percentage of the California taxpayer reflects the property, payroll, and sales of all members of the unitary business. The apportionment percentage of a unitary business that includes foreign corporations is likely to be lower than under a water’s-edge approach but only if U.S. corporations are included in the combined report. The lower percentage may more than offset the increase in the pre-apportionment tax base which results from including therein the results of profitable foreign corporations.

¹⁵³ OECD 1995 Guidelines, *supra* note 17, at III-19-III-24 paras 3.58-3.73.

¹⁵⁴ *Supra* note 17, at III-21 para. 3.64.

¹⁵⁵ 114 S Ct at 2281.

Accordingly, there is no systematic bias in WWCR one way or the other.¹⁵⁶

Double taxation under a global formulary system will occur if it is applied unilaterally by one or two countries in isolation while the rest remain committed to the separate accounting/arm's length principle. This is the reason why suggestions have been made as to its implementation within trade blocs like the EU, NAFTA or APEC with a proper interface being devised to regulate inter-bloc trade.¹⁵⁷ Even in this instance the OECD foresees serious political and administrative problems during the transition period. In any event, any serious attempt to minimise such risks requires the cooperation of the major trading nations on a multilateral basis as proposed in this thesis.

Moreover, it has often been argued that global formulary apportionment is unfair or arbitrary. It has extraterritorial effects, given that it seeks to apportion to a particular jurisdiction value which presumably is not sourced within that jurisdiction. This argument reveals the extent to which the debate is hostage to the residence/source dichotomy. The basic principle of formula apportionment is that it seeks to apportion to a particular jurisdiction the real quantum of income derived through the use of facilities located within its borders, or made possible by the protection offered by that jurisdiction. As Mr Justice Holmes puts it:

[T]he only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of things within it, when they are part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart - not, in other words, to open to taxation what is not within the State.¹⁵⁸

To achieve this end a formula must be fair. Fairness is achieved 'when the formula actually accomplishes the allocation to a state of only that value which may reasonably be considered as within the state and subject to tax and not outside the state where it may also be subject to tax by another state.'¹⁵⁹

Moreover, a closer analysis of the objections to global formulary apportionment reveals that a certain number of them relate to purely administrative problems, which, it is submitted, are manageable. Multilateral cooperation in taxation matters is still in its infancy. However, it is no longer just a remote possibility. There is a move towards using multilateral instruments in

¹⁵⁶ R.D. Pomp & M.J. McIntyre, 'Double Trouble: Double Taxation Aspects of Formulary Apportionment in the International Context', in F.C. Stocker & J.L. Stanton, eds, *Paper presented at the 1994 Proceedings of the 87th Annual Conference on Taxation, National Tax Administration* (Columbus, 1995), at 237.

¹⁵⁷ *Id.*, at 227.

¹⁵⁸ *Wallace v Hines* 253 U.S. 66 (1920), at 69.

¹⁵⁹ F.E. Britton, 'State Taxation of Extraterritorial Value: Allocation of Sales to Destination', (1960) 46 *Virginia Law Review* 1160, at 1165.

international taxation matters in order to mirror the conditions prevailing in international trade. Taxation is merely an adjunct of international trade. Its existence, and indeed its incidence, depends on the efficiency of trading as a whole. If, multilateral cooperation is being achieved albeit slowly in such a general area as trade, then it is arguable that it is likewise achievable in the particular area of international taxation which owes its very existence to international trade. New ways of reconciling specific instances of fiscal sovereignty with the general requirements of efficiency in trade relations need to be developed. As will be shown later, there is already, in the transfer pricing area, a modest impetus towards the partial surrender of fiscal sovereignty to the OECD in order to enhance the application of uniform guidelines in this area. Thus, the creation of an international organisation whose primary objective would be to coordinate the implementation of a global formulary apportionment system may not, after all, be such a radical proposition.

The question of the composition of the group of enterprises subject to global formulary apportionment is also a major concern. If the soundness of the argument that 'all income from commonly owned business activities should be combined and apportioned by a single formula whether or not such activities are unitary'¹⁶⁰ is proven, then the ideal solution to the problem on hand is to abandon the concept of the unitary business and to consider the income of a TNC in its entirety rather than on business lines. This solution is simple, can be uniformly applied, and is easily administered.

The OECD voices concerns about the difficulties of determining the factors that would be included in an eventual formula, the 'intolerable compliance costs', such as the problem of exchange rate fluctuations, differences in accounting rules, valuation of property and sales, separate company efficiencies, the relevance of withholding taxes, and the artificial shifting of production factors to low tax countries. The U.S. Supreme Court has also rejected the reality of the 'intolerable compliance costs' argument. On 1 November 1993, the Supreme Court agreed to hear two appeals in worldwide unitary taxation cases: *Barclays Bank plc v. Franchise Tax Board* and *Colgate-Palmolive Company v. Franchise Tax Board*. The cases were heard on 28 March 1994, and decided on 20 June 1994.¹⁶¹ The cases were heard together and, in both instances, the Court found for California. It rejected Barclays' argument that the administrative and financial costs of complying with the Californian law requiring combined reporting were prohibitive thereby enabling U.S.-owned companies to enjoy a competitive edge over their foreign competitors in breach of the Commerce Clause. The Court

¹⁶⁰ F. Keesling, 'A Current Look at the Combined Report and Uniformity in Allocation Practices', (1975) 42 *J. Tax'n* 109.

¹⁶¹ U.S. 129 L Ed 2d 244, 114 S Ct 2268 (1994).

found that there was an alternative open to Barclays in the use of approximations of costs which Californian law permitted and which Barclays had not pursued.

Most of these objections stem from the assumption that global formulary apportionment is implemented on a country-by-country basis. There is some justification to the fear that a unilateral approach would create major interfacing problems. However, it is also certain that many 'red herrings' are pulled out of the barrel in the case of formulary apportionment.¹⁶² For example, as far as the exchange risks are concerned 'it should be clear that it is far simpler to translate into dollars the annual net income of an entire subsidiary than it is to determine which two parties in a cross-border transaction is actually bearing foreign exchange risks and then value this for pricing purposes.'¹⁶³

This thesis proposes a model whereby the system would be implemented on a multilateral basis by most of the significant trading nations of the world. If that multilateral route is not feasible, the network of bilateral treaties that exists already may be used instead. That system would be administered by an international organisation that would be required to apply international accounting standards to measure the worldwide profits of all TNCs that fall within its competence. Members of that organisation would be required to furnish to it information pertaining to the operation of any TNC operating within their jurisdictions. With this information available for control purposes, TNCs would be required to file consolidated accounts drawn according to international accounting standards with the proposed international organisation. In many jurisdictions, TNCs are already required to furnish consolidated accounts to the authorities. For example, the unitary nature of certain operations is recognised with the consolidation of subsidiary losses.¹⁶⁴ Therefore, the high-compliance costs argument, for example, relative to the production of consolidated accounts is not sound, as the U.S. Supreme Court found in *Barclays*.¹⁶⁵ Once a critical mass of countries participating in the system is achieved, the apportionment formula could be set so as to attribute no business income to states that do not participate in the system.¹⁶⁶ This measure would deal with attempts to use tax havens to defeat the system.

¹⁶² D.R. Bucks & M. Mazerov, 'The State Solution to the Federal Government's International Transfer Pricing Problem', (1993) 46 *National Tax Journal* 385, at 389.

¹⁶³ *Ibid.*

¹⁶⁴ R.M. Bird & D.J.S. Bream, 'The Interjurisdictional Allocation of Income and the Unitary Tax Debate', (November/December 1986) 34 *Canadian Tax Journal* 1377, at 1389.

¹⁶⁵ *Id.*, at 1409.

¹⁶⁶ M.J. McIntyre, 'Guidelines for Taxing International Capital Flows: The Legal Perspective', (1993) 46 *National Tax Journal* 315, at 319.

The primary purpose of international cooperation in tax matters is to achieve a fair division of the international corporate income tax base among various competing nations. As the U.S. Supreme Court found in *Container Corp.*,¹⁶⁷ the unitary method is a ‘proper and fair method of taxation’. The major guideline is that, from a theoretical point of view, the apportionment formula must not be ‘inherently or intrinsically arbitrary’.¹⁶⁸ In other words, as already argued, a formula must possess ‘internal consistency’, that is, the formula must be such that if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed.¹⁶⁹

In reality, there are only two major objections to global formulary apportionment. First, although not penned in such obvious terms, it is evident that the first objection of the OECD to worldwide unitary taxation stems from that fact that the latter is perceived as the antithesis of separate accounting. Separate accounting is at the very heart of the whole of the OECD’s philosophy. If the OECD were to reject separate accounting in favour of worldwide unitary taxation, then it would likewise have to reject the whole network of bilateral treaties based on its own Model treaty. This may be viewed by the OECD as a self-scuttling exercise. However, the question is not whether it is too painful to wipe the slate clean, but rather whether international cooperation in the field of taxation of international flows of income is achieving its stated objective which is to allocate to each relevant country a fair share of cross-border income. In other words, international cooperation is aimed at apportioning to each relevant country a fair share of the corporate income tax base so as to enable it to obtain a fair share of revenue. If, to carry out this objective, undue reliance is put on a system which does not promote that fair division, then what is effectively being promoted is a particular system rather than the primary aim of international cooperation, that is, an equitable division of the international corporate tax base. In other words, it may well be that the means have overtaken the end in importance. As Professor Vann suggests, ‘the debate is hostage of the bilateral treaty network.’¹⁷⁰ It is arguable that the genesis of the OECD’s objections to formulary apportionment stems from the risk of it having to relinquish its grip on international taxation questions if the system were to be adopted worldwide. Such a blanket opposition is unwise. Indeed, as will be shown in the following chapter, after some structural modifications, the

¹⁶⁷ *Container Corp. of America v Franchise Tax Board*, *supra* note 60, at 181 & 184.

¹⁶⁸ *Underwood Typewriter Co. v Chamberlain* 254 U.S. 113, 121 (1920); see also *Hans Rees’ Sons Inc v North Carolina ex rel. Maxwell* 283 U.S. 123, 133 (1931).

¹⁶⁹ *Container Corp.*, *supra* note 60, at 169.

¹⁷⁰ R.J. Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’, (1991) 45 *Bull Int’l Fiscal Documentation* 105, at 151.

OECD may well be the most appropriate organisation to administer the system as proposed in this thesis.

The second objection to formulary apportionment arises out of ‘the perceived inability of the international community to agree to the various components necessary for WWCR’.¹⁷¹ These various components being the very definition of a unitary business, the arbitrariness of the formula or formulas to be applied, and a clear definition of the international tax base. Such major concerns as voiced in the OECD 1995 Report as well as the question of exchange rate movements, the necessity to renegotiate double tax treaties with the view to adjusting, for example, withholding taxes to the global formulary environment,¹⁷² will be addressed in the following chapters.

C The Application of the System by the U.S. at the Federal Level: A Brief Overview of the Issues

There have been calls over several years for the implementation of formulary apportionment at the federal level in the U.S.¹⁷³ Among the most vocal advocates of this shift is U.S. Senator Byron L. Dorgan who believes that the separate entity/arm’s length method allows massive artificial price manipulation and, therefore, profit shifting by TNCs.

In a recent study Joann Weiner examines the issues that would need to be addressed if senator Dorgan’s campaign were to be successful.¹⁷⁴ First, should the U.S. replace its detailed income-sourcing rules and its expenses allocation rules with a formula for apportioning taxable income? Second, should the U.S. separately apply an apportionment formula to the taxable income of each member of a group of companies? Third, should the income of the group be consolidated for the purposes of applying the formula? This thesis favours the last option and in this sense suggests the formulary apportionment method as an alternative to the arm’s length principle.¹⁷⁵

¹⁷¹ Sandler, *supra* note 95, at 593. WWCR is the acronym for World Wide Unitary Combination.

¹⁷² OECD 1995 Guidelines, *supra* note 17, at III-19-III-24 paras 3.58-3.73.

¹⁷³ See, for example, R.S. Avi-Yonah, ‘Slicing the Shadow: A Proposal for Updating U.S. International Taxation’, (1993) *Tax Notes*, at 1511-15; and J.R. Hellerstein, ‘Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment’, (1993) *Tax Notes*, at 1131-45.

¹⁷⁴ J.M. Weiner, ‘Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level’, (23 December 1996) *Tax Notes Int* 12113.

¹⁷⁵ J.M. Wetzler, ‘Should the U.S. Adopt Formula Apportionment’, (September 1995) XLVIII *National Tax Journal* (No. 3) 357, at 357-58.

The unilateral implementation of formulary apportionment at the federal level within the U.S. would certainly be highly inefficient.¹⁷⁶ Although the separate accounting/arm's length methodology is far from being the best system the world can achieve, its major strength is that it is based on consensus. This has enabled industrialised nations to minimise the most blatant incidence of double taxation or undertaxation. In any case, it promotes international trade and contributes to a certain degree to the efficient allocation of capital resources.¹⁷⁷ Even if the U.S. were to unilaterally switch to formula apportionment with the hope that this would encourage other countries to do so, it is doubtful whether the U.S., in spite of its economic clout, could enforce the standard so as not to disadvantage U.S. TNCs. To police any international taxation system a country requires information which, relative TNCs operating globally, is scattered over many jurisdictions. Without international cooperation it would be precarious for the U.S. to attempt enforcing such controversial rules. Other countries would certainly construe this action as an attempt by the U.S. to grab more than its fair share of taxes. This perception could well lead to what has been termed 'tax-based trade retaliation' as illustrated by the U.K.'s threats following California's dispute with Barclays Bank PLC, a British multinational bank.¹⁷⁸ Moreover, the implementation of global formulary apportionment unilaterally by the U.S. would mean that it would have to either renegotiate all of its double tax agreements or effectively override these agreements. Different treaty partners would have to agree to such issues as the definition and calculation of the tax base, the apportionment formula, and the delineation of a unitary business. The methods for solving of any disputes that would eventually arise would also need to be agreed upon.

To conclude, this overview of the American states' tax scene and its seemingly intractable problems foretells the difficulties that would arise if global formulary apportionment is to be adopted on a worldwide basis. However, this experience should not be regarded as absolute. Problems which in the U.S. seem to be insoluble have been successfully resolved in other jurisdictions. The strength of the Canadian system, for example, arises as a result of a few fundamental principles being agreed upon. Thus, in the U.S., contrary to the situation in Canada, there is no common agreement to use the federal concept of the tax base; nexus rules are loosely articulated; states are free to adopt whatever formula they think fit provided these formulas adhere to some basic constitutional prescriptions. Finally, there is no central

¹⁷⁶ *Id.*, at 358ff.

¹⁷⁷ L.C. Tyson, 'Unitary Apportioning: A Key to Global Tax Harmony', (1996) 22 *International Tax Journal* (No. 3) 35, at 48.

¹⁷⁸ The *U.K. Finance Act*, 1985, ch. 54 § 54 & sch. 13 or the so-called Grylls clause. See D. Devgum, 'International Fiscal Wars for the Twenty-First Century: An Assessment of Tax-Based Trade Retaliation', (1996) 27 *Law and Policy in International Business*, (No. 2) 353, at 369-71 nn 99-102 and accompanying text.

collection or coordination mechanism to ensure uniform interpretation and application of basic uniform rules. Yet, a clear indication of the vitality and inherent strengths of the system is that, in spite of all these shortcomings, it has survived in the U.S. and Canadian domestic contexts. In an international framework, its implementation would require a genuine cooperation between fiscal authorities. However, even with the present system of separate accounting/arm's length standard, such cooperation is sluggish, to say the least.¹⁷⁹

¹⁷⁹ J. Killaly, 'International Tax Into the Future: An ATO Perspective', *Paper delivered at the Taxation Institute of Australia, International Tax Intensive Retreat* (14-15 June 1996, Mount Eliza Business School) 6.

The Worldwide Implementation of Formulary Apportionment: Preliminary Steps

This chapter examines the preliminary conditions for the worldwide implementation of a global formulary apportionment methodology. Section I considers the theoretical justifications as well as the perceived advantages of the methodology. Section II surveys the existing international organisations concerned with taxation with the view to determining whether these organisations could, under certain conditions, evolve into one to deal specifically with international taxation. Finally, Section III discusses the rationale for the creation of an international tax organisation designed to supervise the interjurisdictional allocation of the corporate tax base.

Section I The Theory of Global Formulary Apportionment

In his opening speech to the Treasury conference on formula apportionment held on 12 December 1996, the Deputy Secretary of the Treasury, Lawrence Summers, observed that the central objective of any international tax system is to create a tax environment that promotes competitiveness and prevents tax avoidance.¹ It is the contention of this thesis that these objectives may be achieved, as far as the taxation of transnational corporations (TNCs) are concerned, by means of a global formulary apportionment methodology. To demystify formulary apportionment, and to demonstrate that it is a conceptually more correct approach to the problem of international taxation, it is essential to examine its basic premises.

1 A Brief Technical Analysis

Many papers arguing for or against global formulary apportionment do not offer a clear picture of the issues raised by this methodology. Indeed, the hesitations that characterise the traditional study of the principles of international taxation have permeated the analysis of global formulary apportionment. In this regard, Professor MJ McIntyre admits that he has found little enlightenment from the principles that the tax specialists have traditionally proposed for structuring their international tax discussions. He describes these principles as ‘metaphors...[which] have achieved their modest level of acceptance from their imprecision

¹ L.H. Summers, ‘Strengthening Our International Tax System’, Tax Analysts Document Number: Doc 96-32098.

and lack of bite.’² He then proceeds to examine these principles. In doing so, he exposes their flaws and inconsistencies, and uncovers the real nature of global formulary apportionment.

A The Source Principle, Capital Import Neutrality and Formulary Apportionment

Revenue authorities worldwide have always sought to tax income sourced within their jurisdictions whether that income accrues to residents or non-residents. However, there is no universally admitted definition of source.³ It is generally agreed that the concept is broad enough to comprise income ‘arising in’ or ‘having its origin in’ or ‘having a domestic source’.⁴ In broad terms, therefore, the term ‘source’ is used to describe ‘the geographical situs of the economic activity or legal protections giving rise to various classes of income.’⁵ In other words, ‘source’ is used in two senses:

- (a) to describe the geographical place from which income is derived; and
- (b) to describe the class of income to which an amount belongs, for example, dividends, interest, rents, royalties, business, and personal services.⁶

Moreover, the ‘why’ of source-based taxation is not absolutely clear.⁷ Taxing domestic-sourced income of residents may be justified on several grounds. First, as examined extensively in Chapter 1, the derivation of income within a geographical area is made possible, or is facilitated, as a result of the source country providing the necessary infrastructure for that purpose. Second, since tax is payable according to one’s ability to pay, the availability of income as it arises at one specific location is a potent sign of this ability. Third, it is harder to avoid than residence-based taxation.

The theoretical justification for the taxation of income derived in a particular jurisdiction by non-residents is somewhat more elaborate although it is arguable that it does have the down-to-earth appeal of a tax on foreigners. Non-residents are not part of the country’s community; they do not use the existing infrastructure to the same extent as residents. Therefore, on equity

² M.J. McIntyre, ‘The Design of Tax Rules for the North American Free Trade Alliance’, (1994) 49 *Tax Law Review* 769, at 771.

³ J.F. Avery-Jones et al., ‘Tax Treaty Problems Relating to Source’, (1998) 38 *European Taxation* 78, at 79.

⁴ R.J. Patrick, (General Reporter) ‘Rules for Determining Income and Expenses as Domestic or Foreign’, (1980) 65b *Cahiers de Droit Fiscal International* 15, at 16.

⁵ J.L. Andrus, ‘Determining the Source of Income in a Changing World’, (1997) 75 *Taxes* 839, at 840.

⁶ R.L. Hamilton & R. Deutsch, *Guidebook to Australian International Taxation* 5th Student Edition, (Sydney: Legal Books, 1998), at 2-25.

⁷ D.M. Ring, ‘Commentary: Exploring the Challenges of Electronic Commerce Taxation Through the Experience of Financial Instruments’, (1996) 51 *Tax Law Review* 663, at 665.

grounds, the full cost of government ought not be allocated to them through the tax system. Yet, non-residents are effectively taxed on their income sourced within the taxing jurisdiction. According to Professor McLure,⁸ the rationale for taxing non-residents is based on the entitlement principle which enables a state to tax the value added within its borders by foreign factors of production. In practice, source countries often tax income both as it arises and through withholding taxes. As for business income derived by non-residents, the source principle sanctions the taxation of such income if derived through a permanent establishment (PE) in the taxing jurisdiction. In the end, whatever the theoretical justifications of source-based taxation, on a practical level, it achieves a certain sharing of taxing power between two competing tax powers.⁹

This conventional construction of the source principle is closely associated with the concept of capital import neutrality (CIN) which itself is a proxy for the efficient allocation of capital resources worldwide.¹⁰ The weaknesses of the CIN paradigm are the following.

- First, it is doubtful whether a country focusing on achieving CIN would derive the level of economic benefit which its proponents claim is achievable. Indeed, in order for CIN to operate, the capital-exporting country must exempt foreign-source income from taxation. As a result, both national and international tax revenue are reduced.
- Second, this exemption undermines residence taxation which is a necessary component of a fair tax system.
- Third, to achieve CIN, not only must residence taxation be abandoned, but also, in an era of emerging trading blocs, preferential trade and tax policies must likewise be forsaken.

The undermining of residence taxation in favour of an exclusively source-based taxation system has, according to Professor McIntyre, deleterious effects on a country's tax system. The source principle is based on a vague concept. It postulates that the source of income is the geographical place where it arises.¹¹ Whilst most authors, it would seem, 'take "source" to be a natural, self-defining concept',¹² in reality, the source of income is often determined by

⁸ C.E. McLure, Jr., *Economic Perspectives on State Taxation of Multijurisdictional Corporations* (Arlington, Virginia: Tax Analysts, 1986), at 164.

⁹ Ring, *supra* note 7, at 665.

¹⁰ See M. Gammie, 'The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement', (1994) 49 *Tax Law Review* 615, at 632.

¹¹ In an economic sense source has been defined as the place of the income generating activity; see P. Musgrave, 'International Tax Base Division and the Multinational Corporation', 27 *Public Finance* (1972) 394, at 397.

¹² See K. Vogel, 'Worldwide vs. Source Taxation of Income-A Review and Re-evaluation of Arguments (Part I)', [1988/8-9] *Intertax* 216, at 223. (Part II [1988/10] *Intertax* 310, Part III [1988/11] *Intertax* 393.)

reference to the residence of the person deriving it.¹³ Such is the case, for instance, regarding the determination of international shipping income,¹⁴ or the gain on the sale of shares.¹⁵ As previously stated, interest income derived from a cross-border loan is assigned to the place of residence of the debtor,¹⁶ although cross-border interest income has a nexus with both the country of the lender and that of the borrower. The source of income, it is frequently argued, is the place where economic value is added to the activity generating the income.¹⁷ This is also a debatable claim given that the relationship between income and value added, or the linkage between the place where income arises and the place where value is added, are quite insubstantial.¹⁸

The difficulties arising with the source concept are, according to Professor Klaus Vogel, traceable to the fact that it is often impossible to clearly define the type of connection that establishes the source of the income at a specific geographic location.¹⁹ In practice, the application of a pure source-based taxation system is unrealistic. If a country were to rely on a system of pure source taxation, that country would be incapable of operating an effective tax system. Furthermore, source taxation and CIN inevitably lead to tax competition. A country with a system based exclusively on taxation at source is precluded from extending its jurisdiction to tax beyond its national boundaries. This induces capital flight as residents of that country endeavour to move their capital to a country with a lesser rate of taxation. As a result, that country is required to impose taxes that cannot be shifted easily. Thus, broad-based income taxes and wealth taxes have to be abandoned in favour of commodity taxes or wage taxes on immobile workers. The inevitable consequence of an exclusive source basis taxation system is, therefore, a regressive tax structure.²⁰

¹³ See Andrus, *supra* note 5 for a critique of 'residence-based source rules' as promulgated by the U.S. *Tax Reform Act of 1986*.

¹⁴ Article 8 of the OECD *Model Double Taxation Convention on Income and Capital* (Paris: OECD, 1992) loose leaf (1997 update), at M-17. (Note: A 2000 update is now available.)

¹⁵ *Id.*, Article 13(4), at M-26 and commentary, at C (13)-9 para. 30.

¹⁶ *Id.*, Article 11, at M-22 & M-23.

¹⁷ On the other hand the only positive statement that can be made is that 'source' refers to a state that in some way or other is connected to the *production* of the income in question, or to the state where *value is added* to a good. See Vogel, *supra* note 12, at 223.

¹⁸ McIntyre, *supra* note 2, at 775 n 16.

¹⁹ Vogel, *supra* note 12, at 223.

²⁰ McIntyre, *supra* note 2, at 774. Professor McIntyre notes that proponents of the source principle are also proponents of consumption taxes.

It is often assumed, following an article written by Professor Charles McLure in 1981, that a formulary apportionment system is basically a source-based system.²¹ However, if, as Professor Vogel points out, the concept of ‘source’ itself is part of the problem²² as evidenced by the variety of approaches recorded at the 34th Congress of the International Fiscal Association in Paris in 1980,²³ then to rely on the concept in a global formulary environment is bound to cause serious problems.

It would appear that Professor McLure’s position was aimed primarily at distinguishing taxation based on the status of the person subject to taxation (residence taxation) from that based on the status of the income subject to taxation (source taxation). This position does not capture the essence of formulary apportionment. As Professor McIntyre argues:

[T]he uncontested fact is that a formulary apportionment system does not use source rules. It is not source-based, therefore, unless the term ‘source’ is given a rather special meaning.²⁴

The fact that ‘the federal concept of source is irrelevant in a formulary apportionment/combined reporting system’²⁵ is clearly illustrated by the mechanics of global formulary apportionment. Global formulary apportionment is concerned with the total, or combined, taxable income of a unitary business. In the U.S., this total taxable income, or pre-apportionment income as it is often called, is then divided between the states with a legitimate claim to it by means of an apportionment formula.²⁶ This formula is not founded on the source principle. Indeed, it does not attempt to exclude from the system any foreign-source income. Thus, for example most states in the U.S. include portfolio dividends received from a foreign corporation in the pre-apportionment tax base. Moreover, notwithstanding the recent adoption of the water’s edge concept by California, formulary apportionment as applied through

²¹ C.E. McLure, Jr., ‘Towards Uniformity in Interstate Taxation: A Further Analysis’, (13 July 1981) 13 *Tax Notes* 51. This confusion has been cleared in CE McLure, Jr., & J.M. Weiner, ‘Deciding Whether the European Union Should Adopt Formula Apportionment of Company Taxation’, a paper prepared for presentation to the International Seminar in Public Economics/Research Center for Economic Policy Conference on Reform and Harmonization of Company Taxes in the European Union, The Hague, April 3-5, 1997. Professor CE McLure, Jr., graciously furnished the unpublished version of this paper for use in this thesis.

²² Vogel, *supra* note 12, at 229.

²³ Patrick, *supra* note 4, at 15.

²⁴ McIntyre, *supra* note 2, at 776.

²⁵ *Id.*, at n 23. See also R.D. Pomp, ‘Issues in the Design of Formulary Apportionment in the Context of NAFTA’, (1994) 49 *Tax Law Review* 795, at 801. Professor Pomp makes the following statement: ‘I would prefer that discussions about formulary apportionment avoid use of the word “source” entirely because of the federal baggage that accompanies it. If source is to be used at all, I would limit it to describing the amount of income assigned to a taxing jurisdiction after the application of formulary apportionment.’

²⁶ Uniform Division of Income for Taxation Purposes Act, Art 9, 7A Uniform Laws Annotated, at 348 (1985).

WWCR, deliberately includes foreign-source income in the pre-apportionment income of a TNCs computed on a global basis.

To conclude, a formulary apportionment system is designed in such a way that both source rules and the legal form of doing business are ignored for corporate tax purposes.²⁷ Income derived by an entity of a unitary business is included in the group's pre-apportionment income whether or not the income has a foreign-source.

B The Residence Principle, Capital Export Neutrality and Formulary Apportionment

A class of persons often derive certain benefits as a result of its allegiance to a particular state. Taxing norms were expanded to permit the taxation of such persons on their worldwide income. In order to identify this particular class of persons, most states adopt residence as the definitional basis. The residence principle (with citizenship) has thus emerged as the second rule in international tax.²⁸

Residence basis taxation is closely related to the concept of capital export neutrality, (CEN). The object of CEN is to secure the equal treatment of investors whether they invest at home or abroad. CEN is thought to be desirable because it avoids distortion of the locational decisions of TNCs. A country achieves CEN when investors in that country 'pay the same amount of tax on investments with equal pre-tax yields whether the investment is domestic or foreign.'²⁹

CEN is, however, rarely reflected in the tax rules of traditional capital-exporting countries. Even where a foreign tax credit is used countries defer the taxation of income accumulated in foreign companies until repatriation except for specific cases such as those covered by various controlled foreign corporations (CFC) legislation. A long enough deferral period is equal to an exemption of the foreign-source income.

Again Professor McIntyre questions the validity of the CEN premises. He claims that in spite of all its theoretical justifications, the fact remains that no single government prefers foreign to domestic investments. This is because revenue generated by local investment stays in the coffers of that government whereas if that investment is made abroad, it is the source country

²⁷ M.J. McIntyre, 'Design of a National Formulary Apportionment Tax System', (1991) 84th Conf. on Tax'n, Nat'l Tax Ass'n 118, at 119.

²⁸ U. Kohl, 'The Horror-Scope for the Taxation Office: The Internet and its Impact of Residence', at <<http://www.austlii.edu.au/au/other/unswlj/thematic/1998vol21no2/kohl.html>>.

²⁹ M. Rigby, 'A Critique of Double Tax Treaties As a Jurisdictional Coordination Mechanism', (1991) 8 *Australian Tax Forum*, 302, at 413.

which would derive immediate tax revenue. Therefore, any government is more likely to favour home-based TNCs capable of achieving a high degree of competitiveness in world markets.³⁰

CEN is achieved and capital is allocated efficiently throughout the world if:

- all taxes on foreign-source income are fully creditable;
- all foreign-source income is taxed and credits allowed on a current basis by the residence jurisdiction; and
- the structure of corporate taxation among countries does not differ in essential respects.

In the real world, countries cannot simultaneously embrace these three attributes. Indeed, these may be contemplated only within a trading bloc such as the European Union (EU) or North American Free Trade Association (NAFTA).

If the source/residence dichotomy is to be maintained as a basis for analysing the proposed system, then the global formulary apportionment system using worldwide combined reporting may be regarded as a 'pure' residence-based system given that it is 'a system that taxes exclusively according to residence and eschews source taxation.'³¹

According to Professor McIntyre:

[A] formulary apportionment system imposes tax on that portion of the income of an enterprise that is attributed to the taxing state under the apportionment formula. The 'enterprise' subject to formulary apportionment may be defined as the worldwide activities of some group of related corporations (and other related legal entities). The factors used in the apportionment formula serve as rough proxies for the portion of the activities of the enterprise that are conducted in the taxing state. Those activities in the taxing state may be described as a 'branch' of the enterprise. Thus, the tax imposed by the state in a formulary apportionment system is a tax on a 'branch.' The 'branch' is taxable on its worldwide income without reference to the source of the income and without adjustment for any taxes that might have been imposed on that income by other taxing jurisdictions. Such worldwide taxation without adjustment for the source of the income is the hallmark of a pure residence system.³²

It is important to note the sense of the word 'enterprise' in the context of global formulary apportionment. In this context, 'enterprise' means an aggregation of the worldwide activities of a group of entities forming part of the TNC. Such a global view of the activities carried out by the TNC is at the core of global formulary apportionment as opposed to the separate accounting theory which considers the activities of the numerous separate entities forming part of the conglomerate in total isolation. In reality, state in a formulary apportionment system,

³⁰ McIntyre, *supra* note 2, at 778.

³¹ *Supra* note 2, at 780.

³² *Supra* note 2, at 780.

those activities that are carried out in a particular may be described as being carried out through a ‘branch’ of the enterprise.³³

Conventionally, a branch tax has often been considered as a tax on local activities. As such, a branch tax is viewed as a source-based tax. This view is not strictly in accord with the concept of the PE as found in double tax treaties where the taxation of branches is contemplated on a ‘quasi-residence basis’. Thus, pursuant to Article 7(1) of the OECD Model³⁴, a country may tax the profits of a foreign enterprise if that enterprise carries on business within its jurisdiction through a PE. However, the profits that may be taxed are those that are ‘attributable’ to the PE. These may have two sources. First, these may accrue to the PE as a result of its activities within that country, an obvious illustration of the conventional source principle. Second, profits having a source outside the country where the PE is located, that is foreign-sourced profits, may still be attributed to it if such profits arise as a result of its business activities. In this second case, therefore, the tax on the PE is simply a residence-based tax.

To sum up, a formulary apportionment system taxes income derived from local activities exclusively. However, such a system cannot be characterised as source-based. Indeed, activities whether local or foreign, are not subject to tax. What is subject to tax is income associated with local activities regardless of whether such income has a local or a foreign-source.³⁵

2 The Mechanics of Global Formulary Apportionment

Having determined what global formulary apportionment is, it is now necessary to discuss the preliminary steps that need to be taken for its worldwide implementation. The first question relates to the threshold for taxing business income under the system. Closely related to this is the issue of the tax unit.

³³ Professor McIntyre quotes, in support of this argument, IRC § 989(a); Reg. § 1.989(a)-1(b)(2)(ii) defining a qualified business unit as a collection of activities with respect to which books of accounts are kept. See McIntyre, *supra* note 2, at 780 n 29. Moreover, consolidation accounting in fact results in separate companies being treated as de facto branches of the holding company. Thus, at its inception consolidation was labelled ‘the branching of profits and losses’. Walker states that: ‘Early texts described consolidated statements as depicting the affairs of a holding company and its subsidiaries *as if* they were a simple organization or *as if* the subsidiaries were merely branches of the parent.’ See R.G. Walker, *Consolidated Statements: A History and Analysis* (New York: Arno Press, 1976).

³⁴ OECD (1992), *supra* note 14.

³⁵ McIntyre, *supra* note 2, at 780 n 30.

A The Threshold for Taxing Business Income and the Taxable Unit

Conventionally, jurisdiction to tax arises if an enterprise has a substantial presence in a country. An enterprise has such a substantial presence when it carries on business in a particular country through a permanent establishment. The question that arises is whether this internationally agreed jurisdictional threshold is adequate and should therefore be reproduced in the proposed system.

As already noted, the Canadian provinces and the Swiss cantons have broadly maintained the permanent establishment as the minimum jurisdictional nexus. As such, the Canadian and Swiss systems adhere to the international conventional rule for the allocation of taxing rights even though the concept is broadened to suit certain specific local conditions. With regard to the American states' approach, it will be recalled that the taxation of business is characterised by the presence of the unitary business concept which has, therefore, replaced the PE principle as the primary jurisdictional threshold rule.³⁶

At the outset it must be said that the utility of the concept of the permanent establishment in its current form is under investigation as a result of the structural changes in international business.³⁷ Thus, in an age of digitised information, the question arises as to whether the PE is an appropriate indication of the economic allegiance of an enterprise to a given jurisdiction.³⁸

One of the fundamental issues in international taxation is the proper allocation of taxing rights between various countries. This allocation problem was resolved by the League of Nations relying on a method which, to an appreciable extent, satisfied both theoretical and administrative considerations. Taxation rights arise when a taxpayer has a nexus or connecting factors with a particular jurisdiction. Connecting factors, as examined earlier,³⁹ may be the residence of the taxpayer or the source of its income. Non-residents are usually liable to tax on income earned from doing business in a particular jurisdiction through a PE. The primary function of the PE concept has already been studied.⁴⁰ In addition, it is also worth mentioning that the concept is an attempt to prevent governments overreaching their taxing power based

³⁶ State jurisdiction has also been constrained by federal statute. Thus, a minimum standard for the imposition of state net income tax is provided for at 15 U.S.C. § 381 (1994) (Public Law 86-272). See Chapter 4, Section III, 1, at 164.

³⁷ See, for example, A.A. Skaar, *Permanent Establishments*, (Deventer: Kluwer Law International, 1991), at 557ff. See also L. Peschcke-Koedt, 'A Practical Approach to Permanent Establishment Issues in a Multinational Enterprises' (18 May 1998) *Tax Notes Int'l* 1143.

³⁸ OECD, *Application of the Permanent Establishment Definition in the Context of Electronic Commerce* (Paris: OECD, 1999) DAF/FE/CFA/WP1(99)4.

³⁹ See Chapter 1, Section II, at 18ff.

⁴⁰ See Chapter 1, Section II, 1, B, at 21.

on insignificant presences within their jurisdictions. Thus, for example, it is arguable that the PE notion has helped to streamline the domestic threshold rules applicable in the United Kingdom.

U.K. domestic legislation distinguishes between the concepts of ‘trading with’ and ‘trading within’ the U.K.⁴¹ A non-resident enterprise is assessable in respect of profits or gains arising from any trade it carries within, as opposed to with, the U.K.⁴² Trade is defined as ‘every trade, manufacture, adventure or concern in the nature of trade.’⁴³ The British position is that profits arise from trade and trade is concluded through contracts. Since contracts are ‘the very foundation of trade’,⁴⁴ then the source of the profits is the place where the contract of sale is concluded. This principle was refined in the *Maclaine & Co v Eccott*⁴⁵ and *Firestone Tyre and Rubber Co v Lewellin* cases.⁴⁶ The opinions of Lord Cave and Lord Radcliffe in these two cases respectively, when read together, indicate that the place of the contract remains the most important, and indeed a crucial question in determining the source of the profits. However, other factors, such as the place where the payment is to be made for the goods sold and the place where the goods are to be delivered, may combine to outweigh the importance of the place where the contract of sale is made.⁴⁷ To determine the source of income, the formulation generally preferred is the rhetorical question of Lord Atkin LJ. ‘Where do the operations take place from which the profits in substance arise?’⁴⁸

Arguably, the British domestic jurisdictional rule rests on the concept of the business establishment rather than on that of the permanent establishment.⁴⁹ The business establishment

⁴¹ See the opinion of Lord Herschell in *Grainger & Son v Gough* [1896] AC 325, at 335.

⁴² Butterworths U.K. Tax Guide 1995-1996, at 1686. According to English jurisprudence, the words ‘trade’ and ‘business’ are indistinguishable. See Lord Morris dicta in *Grainger & Son v. Gough* (1896) A.C. 325. See also *London Australia Investment Co. Ltd v. F C of T* (1977) 77 ATC 4398.

⁴³ See U.K. *Taxation Act* section 527.

⁴⁴ Per Esher MR, *Werle & Co v Colquhoun* 2 TC 402 at 410. See also Rowlatt J. who, in *F. L. Smidth & Co v Greenwood* (1920) 8 TC 193, at 199, said ‘until the sale is effected the trade is incomplete’.

⁴⁵ [1926] AC 424.

⁴⁶ [1957] 1 All ER 561.

⁴⁷ Canada uses the place of the contract if these are habitually concluded in the country. See G. Gagné, National Reports: Canada, ‘Rules for Determining Income and Expenses as Domestic or Foreign’, 65b *Cahiers de Droit Fiscal International*(1980) 291, at 292.

⁴⁸ *F. L. Smidth & Co v Greenwood* [1921] 3 KB 583, at 593. It is submitted that the modern version of Lord Atkin’s question is the functional analysis which may well show that several jurisdictions have contributed to the generation of profits from a single business activity. However, in the jurisdictional threshold context, the question is not where the income arises. Rather, it revolves on the strength of the economic link between the income and the place where the activities giving rise to it are located.

⁴⁹ ‘The characterization of business and investment income for income tax purposes is a mixed question of fact of law. Broadly speaking, income from an investment derives from holding property through a passive process. Investments income is a yield on the property. In contrast, business income derives from the *use* of property, a process that generally combines labour and capital...Although there is a refutable presumption that corporate

concept, grounded as it is in the law of contract, has a far wider application in the sense that it may be regarded as favouring the force of attraction principle.⁵⁰ Thus, it tends to impose tax on all income with a source in a particular jurisdiction.⁵¹ However, it also provides that a non-resident cannot be taxed on the profits of a trade carried on by him or her elsewhere than in the U.K.⁵²

Is a business establishment, as conceived in the domestic tax rules of the U.K., applicable in a global formulary environment? The British threshold rule is very wide. It even captures an adventure or concern in the nature of trade. As such, even an isolated transaction can be regarded as a business and governments may seek to tax on such insignificant grounds.⁵³ Consequently, it is submitted that to rely on the business establishment concept is inappropriate in as much as it may hinder business expansion. In addition, given that, contrary to the traditional PE which combines both a source and a resident element, the business establishment concept focuses solely on a geographic source of business income.

If the business establishment concept is an unacceptable jurisdictional threshold in a global formulary environment, the question then arises as to the adequacy of the traditional PE concept to fill that role. The traditional PE rule of Article 5 of the OECD Model⁵⁴ is well known and is currently subject to revision within the OECD. Therefore, at a time when a reformulation of the concept is widely debated,⁵⁵ it may be worthwhile to examine the variants of the concept as proposed in fora other than the OECD. However, Jacques Sasseville of the

income is business income, the distinction is essentially a question of fact'; see V Krishna, 'International Income Taxation of Electronic Commerce' (January 1999), 9 *Canadian Current Tax* (No. 4) 33, at 37. (footnote omitted). See also *Californian Copper Syndicate v Harris* (1904) 5 T C 159, *Blockey v FC of T* (1923) 31 CLR 503, and *Ericksen v Last* (1881) 8 Q.B 414.

⁵⁰ OECD (1992), *supra* note 14, at C (7)-3 para. 5.

⁵¹ M.B. Carroll, 'International Tax Law: Benefits for American Investors and Enterprises Abroad, Through International Agreement', 2 *Int'l Law* 692 at 700 in D.M. Hudson & D.C. Turner, 'International and Interstate Approaches to Taxing Business Income', (1984) 6 *Northwestern J Int'l L & Bus* 562, at 573-74 n 73.

⁵² See *Simon's Direct Tax Service*, Binder 3 Schedule D Capital Allowances (London: Butterworths, 1995), at 3113.

⁵³ According to Mitchell Carroll, 'the British Board of Inland Revenue [even] sought to impose liability...[on] sales through a local commission agent...[although]...the non-resident and his British intermediary took pains to conclude the contract abroad.' M.J. Graetz & M. O'Hear, 'The 'Original Intent' of U.S. International Taxation' (1997) 46 *Duke L.J.* 1021.

⁵⁴ OECD (1992), *supra* note 14, at M-10.

⁵⁵ O. Ralph, 'Changing World Leaves PE standing', (February 1999) 10 *International Tax Review* (No. 2) 17. See also OECD, 'The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Proposed Clarification of the Commentary on Article 5 of the OECD Model Tax Convention', (May 2000) 40 *European Taxation* (No. 5) 190.

OECD, at the March 2000 Canadian Tax Conference whilst acknowledging the uncertainties relative to the concept concluded that:

the question is not whether there is uncertainty at the margin, but whether we have reached a critical mass of uncertainty; I don't think we're there yet...I don't see the urgent need for a change.⁵⁶

The notion of the PE, as conceived by the League of Nations, also acts as a check on governments' propensity to exercise their taxing power based on insignificant presence within their jurisdictions. The PE threshold is higher than the British test. Its starting point is similar to the latter in that it encompasses the notion that a foreign corporation is taxable on its business profits only if it trades *in* rather than *with* a country. To trade in (or within) a country implies some form of economic presence that is substantial enough to justify taxing jurisdiction in terms of the benefit theory. The PE rule rationalises this initial test. It defines the depth of the economic presence required of an enterprise within a country in order to legitimately enable the taxation of that enterprise's income. To reach that necessary depth of presence, an enterprise must exhibit a certain 'stability, productivity and dependence'⁵⁷ relative to the place where it operates. These requirements are satisfied if the enterprise operates from a fixed place of business. A fixed place of business is one which is established at a particular geographical location and is characterised by a degree of permanence, that is, one which is not temporary or tentative in character. The PE concept as wrought out by the League encompasses all these attributes, and its emergence was regarded as a fundamental breakthrough in the search for an appropriate jurisdictional rule.

Nonetheless, while on a conceptual basis the PE was generally accepted as the optimum solution to the problem of allocating tax jurisdiction, consensus was more difficult to achieve with regard to the exact parameters of the notion. Thus, for example, the League of Nations Mexico Draft of 1943⁵⁸ provides a very wide definition of the PE concept. It has even been argued that under the Mexico Model 'business profits could be taxed by the source state regardless of the existence of a PE, provided that the relevant activities did not merely take the form of isolated or occasional transactions.'⁵⁹

⁵⁶ A. Fernandez & T.F. Field, 'Canadian Tax Foundation Holds First World Tax Conference', (6 March 2000) 20 *Tax Notes Int'l* (No. 10) 1056, at 1059.

⁵⁷ Krishna, *supra* note 49, at 41.

⁵⁸ Fiscal Committee, *London and Mexico Model Tax Conventions, Commentary and Texts* League of Nations Document C. 88. M. 88. 1946. II. A., (November 1946) in *Legislative History of United States Tax Conventions, Volume 4: Model Tax Conventions*, (Washington D.C.: U.S. Government Printing Office, 1962), Articles IV(1) and IV(2), at 4319 and 4380 respectively.

⁵⁹ See S. Zapata, 'The Latin American Approach to the Concept of Permanent Establishment in Tax treaties With Developed Countries' (June 1998) 52 *Bulletin for International Fiscal Documentation*, (No. 6) 252.

The United Nations Model Convention maintains, in general, the PE concept as in the OECD Model whose foundation was the League of Nations London Draft.⁶⁰ Nevertheless, the U.N. Model's definition of the PE is wider than that proposed in the OECD Model. Thus, the U.N. Model recognises a restricted 'force of attraction' principle according to which profits from direct sales and other business activities derived directly by the non-resident enterprise are also attributable to that PE.⁶¹ As for country practices in this area, they often differ markedly. Thus, in order to safeguard their interests, countries have routinely created 'PE fictions' which differ from the standard of the model conventions in several ways.

Professor Richard Pomp has conducted in-depth studies of these difficult threshold questions applicable to a formulary system.⁶² In his view, there is a fundamental relationship between an apportionment formula and the jurisdictional threshold rules. This relationship may be illustrated by means of an example. Income arising from the manufacture of goods in one country and sales in another has an economic nexus in both the country of manufacture and the country of sale. Accordingly, in a combined reporting system the income is shared between the two jurisdictions. In the traditional system, taxing rights arise in the jurisdiction of the sales only if the sales are made through a PE of the manufacturing enterprise. Increasingly, however, especially with emerging technologies, an enterprise may conduct substantial business operations in a source country without establishing a level of presence that would be considered a PE pursuant to the provisions of Article 5 of the OECD Model. Therefore, if the high tax threshold embodied in the PE concept were to be adopted in a formulary-based system, TNCs might seek to avoid tax in one jurisdiction by deliberately structuring their presence so as to preclude the emergence of a PE. With this in mind, Pomp proposes, as an acceptable threshold, in lieu of the traditional PE, a certain level of market penetration evidenced by the level of gross receipts derived in a particular country.⁶³

⁶⁰ United Nations, Department of International Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (United Nations publication ST/ESA/102, 1980); League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions, Commentary and Texts*, *supra* note 58, at 4333.

⁶¹ According to Sonia Zapata, 'the principle is said to be a "restricted" one because the rule does not apply to all kinds of sales or activities effected by the non-resident, but only to those of the "same" or "similar" kind to those effected through the PE.' See Zapata, *supra* note 59, at 253.

⁶² Pomp, *supra* note 25, at 813.

⁶³ This entails a clear definition of sales as an apportionment factor. This issue will be examined in Chapter 7. The level of market penetration is an economically meaningful jurisdictional standard since it makes no sense that an enterprise capable of building a turnkey factory in a foreign country in a period of five months for \$10 million should escape taxation merely because it did not have a permanent establishment (PE) as conceived in the conventional treaties. See Pomp, *supra* note 25, at 813-14 n 64. Obviously, any proposal at modifying the PE concept is an eminently political question rather than a pure technical one.

The objective of a threshold rule is to ensure that a particular jurisdiction obtains a fair share of tax revenue. In line with the OECD's current thinking on this question, it is submitted that such a rule needs to reflect a jurisdiction's commercial and economic contribution to the value created by a TNC operating within its bounds.⁶⁴ In other words, what needs to be determined is the value added by the jurisdiction through it providing the necessary infrastructure for the derivation of that income by the TNC. To determine such value, one needs to focus on the activities of the TNC by submitting it to a comprehensive functional analysis. Income is derived primarily through commercial activities relying upon the 'benefits' provided by the jurisdiction as well as on the enterprise's ability to exploit its own resources through the assets it uses and the risks it assumes. It follows that, in order to determine the quantum of profits resulting from such activities, one must consider all the factors whose presence in a particular location have contributed to the creation of income. Hence, one finds the relationship between apportionment factors and the jurisdictional rule. In other words, the focus must be on such factors, which, if present, should be regarded as equivalent to an enterprise having a PE in that jurisdiction. Put differently, if a TNC has apportionment factors in a country, then that enterprise is deemed to have a PE in that country.⁶⁵ Accordingly, the presence of such factors should be regarded as a sufficient connecting factor equivalent to the enterprise having a PE in that jurisdiction. Furthermore, this rule enables a particular jurisdiction to tax income attributable to the economic contribution made by factors located with the PE whether such income arises within or without that jurisdiction. It thus satisfies the theoretical objective of formulary apportionment, which, as examined earlier, is designed to capture such contributions regardless of where they arise.

In a sense, therefore, this threshold rule comes close to the PE concept as defined in the OECD Model. However, it expands that concept by emphasising economic rather than purely legal relationships. It therefore fits the theory of economic allegiance as studied in Chapter 1. Moreover, a threshold rule of this nature is less likely to be avoided because it is consistent with the rules defining apportionment factors.⁶⁶ Finally, if a TNC operates in several

⁶⁴ See Australia, 'Improving Australia's International Tax Regime' in *Review of Business Taxation: A Tax System Redesigned*, (Ralph Report) (Canberra: AGPS, 1999), at 686.

⁶⁵ McIntyre, *supra* note 2, at 789.

⁶⁶ Note, however, that the adoption of formulary apportionment does not eliminate all possibilities for tax evasion. Theoretically, an enterprise may move its assets and employees to jurisdictions with low tax rates. However, manipulation of formula-based allocations would require an enterprise to incur real economic costs - those of moving assets or employees rather than just adjusting its bookkeeping entries. In addition, since the rationale for the formula is that its factors represent the situs of the enterprise's economic activity, it follows that if an enterprise moves its assets and employees to another country, then the latter should tax a greater share of the enterprise's income because it has become the situs of a greater portion of the enterprise's economic activity. See A. Bhansali, 'Globalizing Consolidated Taxation of United States Multinationals', 4 *Texas Law Review* (1996) 1401, at 1415 n 58.

jurisdictions through subsidiaries, then those subsidiaries are automatically regarded as PEs of the enterprise since, as shown, the proposed threshold rule focuses on economic rather than legal relationships. Thus, the whole purpose of global formulary apportionment, which is to treat ‘a group of affiliated companies as a common enterprise operating in branch form’⁶⁷, is fully achieved.

B The Unitary Business Concept Revisited

Critics of the global formulary apportionment methodology have often argued that the apparent problems of defining a unitary business is one of the insurmountable difficulties inherent to the method.⁶⁸ It is worthy to note, again, that what prevents the adoption of global formulary apportionment is the strong political opposition to the method rather than its inherent technical difficulties. Such opposition may well have been stirred by the TNCs, given that the implementation of global formulary apportionment could eliminate the almost intractable transfer pricing problems faced by tax authorities and, therefore, hinder their ability to minimise their overall tax burden by curtailing their ability to engage in aggressive tax planning.⁶⁹ TNCs operating in California, for example, cannot claim that the method is unfamiliar to them. Their opposition to it may well stem from the fact that they do not want the methodology to be applied on a worldwide basis.⁷⁰ Moreover, national governments are convinced that global formulary apportionment is a tax grab exercise by the U.S. and hinders the competitiveness of their national enterprises. They would rather, it would appear, risk a constant erosion of their tax revenue through, for example, a steady decrease of effective tax rates than forego their so-

⁶⁷ McIntyre, *supra* note 2, at 790.

⁶⁸ See, for example, E. Coffill & P. Wilson, ‘Federal Formulary Apportionment as an Alternative to Arm’s Length Pricing: From the Frying Pan to the Fire?’, (24 May 1993) *Tax Notes* 1103.

⁶⁹ It has been suggested that the opportunity to engage in transfer pricing is a major reason for the existence of TNCs. Transfer pricing provides these enterprises with a potential method of reducing the inefficiencies resulting from the discrepancies in tax rates among jurisdictions. See R.S. Avi-Yonah ‘The Structure of International Taxation’, (1996) 74 *Texas Law Review* 1301, at 1341. Pagan & Wilkie have recently argued that TNCs do not deliberately engage in international transfer pricing; see J. Pagan & S. Wilkie, *Transfer Pricing Strategy in a Global Economy* (IBFD Publications, 1993). However, evidence to the contrary is available from various sources. In this regard, see, for example, General Accounting Office, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* in The Auditor-General, *Australian Taxation Office: International Profit Shifting*, Efficiency Audit Report (Canberra: AGPS, November 1987) 18. See also R. Altshuler & T.S. Newlon, ‘Effects of Tax Planning on the Foreign Income Flows of U.S. Multinational Corporations’, (1991) 84th Conf. on Tax’n, Nat’l Tax Ass’n, 205. For an insight into the connections between tax evasion, tax havens and Offshore Finance Centres, see M.P. Hampton, ‘Exploring the Offshore Interface: The Relationship Between Tax Havens, Tax Evasion, Corruption and Economic Development’ (1996) 24 *Crime Law & Social Change*, at 293-317.

⁷⁰ As a result of the appreciation of the yen against the dollar in the late 1990s, Japanese TNCs were actually returning less income in California at the height of the dispute regarding WWCR. This opposition from these firms may be explained by their fear that the Californian system ‘would be replicated throughout the Pacific Rim’; see Pomp, *supra* note 25, at 797.

called tax sovereignty. In truth, by perpetuating the existing international tax system, countries may not appear to lose their tax sovereignty, but they are surely losing tax revenue.⁷¹

In any event, the issue that needs to be dealt with at this stage is whether the unitary business principle, as evolved in the American states' taxation context should be transposed to the model proposed in this thesis. At the outset, it is important to note that the concept of the unitary business has evolved in the U.S. in such a way as to satisfy the Due Process Clause of the American Constitution. Consequently, the concept is a non-essential element in the context of the proposed model. It follows that the objections to global formulary apportionment relative to the difficulties of determining a unitary business are not relevant here. Most countries already tax resident corporations on their worldwide income. A move to formulary apportionment would simply mean that a corporation would be required to file a combined statement as to its worldwide profits. However, one problem remains: that of finding an acceptable criterion for defining the scope of a business subject to global formulary apportionment. In other words, should an enterprise with different business lines still be required to file a combined report? Frank Keesling, the father of the extended unitary business concept, has advocated a radical solution to the problem of defining the scope of a unitary business. He has argued that 'all income from commonly owned business activities should be combined and apportioned by a single formula whether or not such activities are unitary.'⁷² He justified his argument on the grounds of simplicity, uniformity and ease of administration.

Keesling questioned the popular concept that there are unitary and non-unitary businesses. The starting point of his argument is the fact of common ownership. Indeed, there is consensus on this particular point: there cannot be a unitary business if there is no common ownership as between the various components or affiliates constituting a group. Keesling parts company with mainstream thinking in this area when he wrote: 'At this point, it is questionable whether there is such a thing as a non-unitary business.'⁷³ If there is common ownership, then, in Keesling's view, certain amounts of common management as well as centralised performance of certain functions are bound to occur. Common ownership, therefore, brings a certain

⁷¹ In a release summarising his intervention at a Treasury conference of formulary apportionment held on 12 December 1996, Senator Byron Dorgan claimed that under the separate entity/arm's length standard, the U.S. fails to collect at least \$10-15 billion in taxes each year. See Tax Analysts Document Number: Doc 96-32099. In his most recent allegation, Senator Dorgan, relying on a study by two Florida International University Professors, Simon J. Pak and John S. Zdanowicz, claims that TNCs avoid paying at least \$35 billion a year to the IRS. However, the methodology of this study has been questioned. See R.A. Clark, 'Dorgan's Charges of Transfer Pricing Abuse Unfounded', (31 May 1999) 18 *Tax Notes Int'l* (No. 22) 2263.

⁷² F. Keesling, 'A Current Look at the Combined Report and Uniformity in Allocation Practices', (1975) 42 *J. Tax'n* 106.

⁷³ *Id.*, at 109.

degree of integration regardless of whether the integrated businesses are engaged in diverse industries. Professor Pomp, formulates the same view:

[A] corporation's unitary business can be defined in various ways from the most specific to the most general. To illustrate, consider a corporation that manufactures widgets for use in the aerospace industry. On the least general level, the corporation could be described as conducting a unitary business of manufacturing widgets for the aerospace industry. On a slightly more general level, the unitary business could be described as manufacturing widgets. More generally, the unitary business could be described as a manufacturer. On the most general level, the corporation could be described as in the business of allocating its resources to maximise its internal rate of return.⁷⁴

It follows that all of the corporate group's activities and all of its profits would constitute a unitary business. Therefore, the simple fact that a business is fully integrated means that it should be considered a 'unitary business'.⁷⁵

These arguments are eminently persuasive. A business does not commence operations in several different industries simultaneously. If it wishes to expand outside the particular industry where it operates, it usually uses its own accumulated resources, looks for new equity or obtains loan finance on the strength of its reputation in the market. Therefore, it can be argued that, in many instances, the original business has contributed significantly to the setting up of the new operations. For example, often, key personnel of the original business would be used to provide management expertise to the new business. In addition, it is quite common for different business lines, and indeed different entities within a group, to share expenses and other overheads, or participate in research and development efforts through the so-called cost sharing agreements.

There are several advantages in adopting the accepted view that, by its very nature, a TNC is a unitary business. To start with, the difficulties of defining a unitary business along the American states' practice would presumably disappear. So would the often-intractable administrative problems that still plague the application of the unitary concept in the U.S. Compliance would therefore be much easier to achieve.⁷⁶ The rule would be simple and devoid of all these fine lines which are so easily misconstrued by either taxpayers or the

⁷⁴ Pomp, *supra* note 25, at 805.

⁷⁵ R.M. Bird, 'A View From the North', (1994) 49 *Tax Law Review* 745, at 752. See also R.M. Bird, 'Shaping a New International Tax Order', (1988) 42 *Bull Int'l Fiscal Documentation* 292; R.M. Bird & D.J.S. Bream, 'The Interjurisdictional Allocation of Income and the Unitary Tax Debate', (November/December 1986) 34 *Canadian Tax Journal* 1377.

⁷⁶ According to Binh Tran-Nam, 'administrative costs are the costs to the government of collecting taxes and compliance costs the value of scarce resources expended by taxpayers in meeting their tax obligations. The sum of administrative and compliance costs are conceptually analogous to transaction costs of market activities.' See Binh Tran-Nam, 'Tax Reform and Tax Simplification: Some Conceptual Issues and a Preliminary Assessment', (1999) 21 *Sydney Law Review* 500.

administration and, therefore, resulting in expensive and time-consuming litigation. Thus, from this point onwards, the term global formulary apportionment will refer to the broad application of a formula for the apportionment of the consolidated profits of a TNC without reference to the unitary character of such enterprises.

A remaining problem is the level of ownership that would trigger the combined report. In California, the rule is that in order for combined reporting to occur more than 50 per cent of a corporation's voting stock must be held directly or indirectly by another corporation.⁷⁷ Tennessee, by contrast, uses an 80 per cent test similar to the federal rules on electing consolidated return treatment.⁷⁸

Whatever the proposed threshold of common ownership, there will always be arguments demonstrating the arbitrariness of the figure. Indeed, the percentage of voting stocks enabling control is never definite. Rather, this figure depends on stock dispersion which, if wide, enables control to be achieved with a much lower threshold.

In 1980 Eugene Corrigan proposed that the 50 per cent threshold be construed as presumptive evidence that two or more firms constitute a unitary business.⁷⁹ This means that if the 50 per cent threshold appears to be too generous or restrictive, evidence may be adduced to that effect and a new threshold determined. Professor Charles McLure criticised this proposal.⁸⁰ In his view, Corrigan's proposal amounts to treating firms in the manufacturing sector differently to those in other sectors. In the first case the presumptive standard would be maintained, while in the other sectors 'special consideration' should be given before deciding on the appropriate threshold of ownership. McLure further argued that if special consideration were to be given to any sector, firms would by artificial means contrive to be classified in that sector. McLure's argument reveals his unwillingness to consider firms operating in different sectors to be unitary. He rightly claims that, for example, the three-factor formula does not operate well when applied to the finance and service sector. It would seem though that the question at issue here is not so much the likely effects of a formula, but rather whether or not a group of companies is unitary. The appropriateness of any formula used can only be assessed after determining whether or not a unitary business is present.

Corrigan's proposal has some merit although it tends to move away from the objective test of a definite percentage of ownership. In certain cases, the most appropriate level of ownership

⁷⁷ Keesling, *supra* note 72, at 109. A more than 50 per cent test is relatively easy to manipulate as shown with the Subpart F requirements of the IRC (IRC § 957(a)). See also Pomp, *supra* note 25, at 809 n 45.

⁷⁸ Tenn. Code Ann. § 67-4812(c)(2) (1994).

⁷⁹ E. Corrigan, 'Towards Uniformity in Interstate Taxation', (15 September 1980) *Tax Notes* 507.

⁸⁰ McLure, Jr., *supra* note 8, at 134-36.

could be linked to the concept of control. If a corporate shareholder has effective control of a company, or has potential control of that company by virtue of its share ownership relative to the rest of the shareholding, then the two companies should file a combined report. This test would entail an analysis of each group of companies on a case-by-case basis. However, individual analysis could be avoided if the companies, on lodgement of their return, are required to declare whether or not they are in control as defined above.

In any event, it is submitted that, for general purposes, a 50 percent ownership is an appropriate and objective test which, as Professor Pomp notes, has the additional merit of including legitimate joint ventures in a combined report.⁸¹ However, if it were to be shown that, in certain cases, a 50 per cent level of ownership is inadequate⁸², then, as a matter of exception, a more appropriate level would need to be determined. Moreover, if there were to be any dispute concerning these questions, then the dispute resolution procedure could be invoked to determine the appropriate solution on a facts-and-circumstances basis.⁸³

Two other issues need to be examined: These are the determination of the tax base and the choice of appropriate formulas to apportion that base. Prior to doing so, the question relative to the creation of an international organisation to administer the proposed global formulary system must be addressed. The two main functions of this organisation would be to determine the pre-apportionment base and the apportionment formulas to be used for allocating to various countries an appropriate share of the latter. However, before adopting this internationalist stance, it may be opportune to consider the implementation of global formulary apportionment on a more modest scale, that is, within an existing trading bloc.

C The Trading Bloc As a Testing Ground for Formulary Apportionment

The gradual emergence of the European Union (EU) as a significant economic unit may have convinced other countries of the advantages of a free market. Thus, for example, the creation of the North American Free Trade Agreement (NAFTA),⁸⁴ the Asia-Pacific Economic

⁸¹ Pomp, *supra* note 25, at 809.

⁸² In this regard, the control rule as provided by the Australian Controlled Foreign Companies Legislation, Part X *Income Tax Assessment Act* 1936 provides for a strict control test whereby a foreign company is regarded as a CFC if a group of five or fewer Australian entities hold at least 50 per cent associate-inclusive control interest in the foreign company. To prevent manipulation of this rule, alternative tests based on an economic concept of control and the *de facto* control test are provided for in the legislation. There are two *de facto* tests referred to as the objective *de facto* control test and the subjective *de facto* control test; see L. Burns, *Controlled Foreign Companies* (Melbourne: Longman Professional, 1992), at 18 para. 2-050.

⁸³ P.R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', (1994a) 49 *Tax Law Review* 691, at 712.

⁸⁴ See L. Eden, 'The Emerging North American Investment Regime', (December 1996) 5 *Transnational Corporation*, (No. 3) 61.

Cooperation (APEC), the Association of Southeast Asian Nations (ASEAN),⁸⁵ and the Indian Ocean Rim Association for Regional Co-operation may be construed as an effort to duplicate the advantages achieved by the EU members. The development of such homogeneous trade blocs may well create novel problems in the taxation area. Conversely, if it is agreed that there are conceptual and practical links between trade policy and tax policy,⁸⁶ then it is arguable that the presence of trading blocs may simplify the international tax problem. Indeed, if various trading blocs were to emerge, it may well be that, ultimately, the international tax problem would be that of adjusting the tax principles prevailing in a few major trading blocs in lieu of the seemingly impossible present task of coordinating the tax systems of numerous individual nations.⁸⁷

There have been numerous calls for the testing of some type of global formula apportionment within a homogeneous trading bloc such as NAFTA.⁸⁸ It would seem that the EU offers such an ideal testing ground. It has moved to create a single market, a single currency, and is in the process of harmonising its accounting principles.⁸⁹ In addition, since 1989 the European Commission has been exploring the possibility of a single European company (Société Européenne or SE), which would be considered as a European company rather than an entity of a single member country. The profits of the SE would presumably be computed on a consolidated basis thus duplicating to some extent the conditions for the emergence of the U.S. concept of the unitary business.⁹⁰

The difficulties that both NAFTA and the EU would have to address, if they were to replace the separate accounting/arm's length standard with some form of formulary apportionment may be regarded as less daunting compared with the prospect of implementing the system on a worldwide basis. Yet, even in these restricted environments objections abound. It is submitted that the first step in that direction would be the realisation that, in a common market as exists in

⁸⁵ See at <www.us-asean.org>. For tax policy questions in the ASEAN, see H. Wunder, 'Association of Southeast Asian Nations: Economic and Political Structure and Tax Policy', (14 February 2000) 20 *Tax Notes Int'l* (No. 7) 763.

⁸⁶ This is a debatable issue. See New York University School of Law, 'Colloquium on NAFTA and Taxation', 49 *Tax L. Rev.*, at 525- 795.

⁸⁷ R.J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region?' (1991) 45 *Bull Int'l Fiscal Documentation* (Part I) 99.

⁸⁸ R.S. McIntyre & M.J. McIntyre, 'Using NAFTA to Introduce Formulary Apportionment', (April 5, 1993) 6 *Tax Notes Int'l* (No. 14) 851; and P.R. McDaniel, *supra* note 83, at 691. See also P.R. McDaniel, 'NAFTA and Formulary Apportionment: An Exploration of the Issues', (1994b) 3 *Intertax* 105.

⁸⁹ McLure, Jr., & Weiner, *supra* note 21.

⁹⁰ Sven-Olof Lodin & M. Gammie, 'The Taxation of the European Company', (1999) 39 *European Taxation* (No. 8) 286.

the EU and as ultimately envisioned by NAFTA, a formulary apportionment methodology is the more logical method of allocating revenues among member countries.⁹¹

The implementation of formulary apportionment in either NAFTA or the EU requires addressing such issues as the jurisdictional threshold question or the definition of the tax base. As for the nexus question, there arises the problem of the adequacy of the permanent establishment concept. If found to be inadequate for modern trading, then NAFTA and the EU would need to refine the standard to suit the evolution in business methods. Moreover, an acceptable definition of the taxable base is imperative. Should the distinction between business and non-business income as provided for by section 4 of the Uniform Division of Income for Tax Purposes Act (UDITPA) in the American states' context be transposed to these environments? What is the status of portfolio business income? Should it be allocated separately to the state of 'commercial domicile'?

One of the most contentious issues in the context of the American states' taxation is the definition of the taxable unit, that is, the definition of a unitary business. Should the concept be transposed in the EU, as it would appear to be the case with the concept of the SE, or made applicable within NAFTA? In addition, there also arises the question of whether to include a corporation's worldwide income and factors in the apportionment formulas, or whether NAFTA and the EU should elect to confine the base to the 'water's-edge' concept. Harmonised solutions to such questions are critical if double taxation is to be avoided and if the concept of neutral taxation is to be the guiding principle within the trading blocs.

Another important issue relates to the treatment to be afforded to the transactions carried out between the various unitary businesses of one enterprise. It has been suggested that the arm's length principle be applicable to such situations.⁹² To Professor McDaniel, this is not the optimal solution, as it would entail applying both formulary apportionment and the arm's length standard to TNCs, leading to unnecessary complications and compliance costs. In his view, if there is a significant level of transactions between supposedly separate unitary businesses, then a strong presumption is created to the effect that there is only one single unitary business. The burden of proof to the contrary should then rest with the TNC. They would be allowed to use the arm's length reporting for inter-enterprise transactions if they can provided ultimately that

⁹¹ In a common market the driving principle should be a fair division of the tax base. Under the separate accounting/arm's length standard, such a fair division, based as it is on the geographic source of income and the national location of a given corporate entity, are generally irrelevant. See McDaniel (1994b), *supra* note 88, at 106.

⁹² McIntyre & McIntyre, *supra* note 88, at 121.

this choice does not lead to double taxation or produce a revenue loss for any member country.⁹³

Consensus would also be necessary in the choice of the apportionment formula or formulas. Within NAFTA it is unlikely that the adoption of the three-factor formula comprising payroll, assets, and sales, would be achieved without some opposition from Canada. Indeed, as studied in Chapter 4,⁹⁴ the Canadian system involves a two-factor formula (sales and payroll) which is quite successful. A single sales factor has been advocated but the merits of this are debatable.⁹⁵ Finally, there are also the difficulties of using different formulas for different industries and the possibility of manipulation that could arise thereof.

It is arguable that the eventual implementation of formulary apportionment in the EU would be, as a result of the evolution of the tax harmonisation process there, a relatively less straightforward exercise. Whilst in both NAFTA and in the EU the difficulties of implementing the system are more political than technical, at least two of the NAFTA countries have substantial experience in handling the question. In the EU, the situation is quite different. The harmonisation effort has had sporadic successes in the field of direct taxation. It will be remembered that the Ruding Committee dismissed the method as inappropriate for the EU.⁹⁶ In fact, the root of the problem may be traced to the European 'Constitution', the Treaty of Rome which gave birth to the European Economic Community (EEC), now the European Union (EU). The aim of the Treaty of Rome (as amended) is to create a single market comprising all Member States. To achieve this, Article 3 of the Treaty seeks:⁹⁷

- the abolition of obstacles to freedom of movement of persons, services, and capital;
- the institution of a system which ensures that competition in the common market is not distorted; and
- the approximation of the laws of Member States to the extent required for the proper functioning of the common market.

⁹³ Professor McDaniel believes that the use of the arm's length standard as a backstop is important, more especially if different apportionment formulas are adopted for particular industries. McDaniel (1994b), *supra* note 88, at 113.

⁹⁴ See Chapter 4, Section II, 1, A & B, at 143ff.

⁹⁵ See R.S. Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating U.S. International Taxation', (15 March 1993) 58 *Tax Notes* 1511.

⁹⁶ The European Communities, *Report of the Committee of Independent Experts on Company Taxation* (Luxembourg: Office for Official Publications of the European Communities, 1992), at 129-30 (*Ruding Report*).

⁹⁷ See United Nations Treaty Series, 'Traité Instituant la Communauté Economique Européenne', No 4300, Vol. 294, at 25.

Clearly, the authors of the EEC Treaty perceived ‘the need for harmonization of indirect taxation at least and specifically provided a juridical basis for such action’,⁹⁸ for without such harmonisation their stated goal would have been unattainable. Moreover, Articles 95 to 99 of the Treaty of Rome deal explicitly with the harmonisation of indirect taxes, whereas Article 100 provides for the approximation of laws, including tax laws, to establish the common market. The Treaty, therefore, does not contain any direct authority for dealing with the question of direct taxes, save the prohibition of double taxation of Article 220. It has nevertheless been accepted that the above provisions, read in conjunction with Article 52 of the Treaty prohibiting restriction in the establishment of enterprises in other Member States, ‘can, with only a slight stretch, be interpreted as requiring harmonising of direct tax systems’.⁹⁹ Leaving aside the difficulties faced by the EU in its attempt to achieve the harmonisation of direct taxes, attention is drawn to the new environment created by the Maastricht Treaty¹⁰⁰ and the Treaty of Amsterdam¹⁰¹ which entered into force on 1 May 1999.¹⁰²

The amendments to the Treaty of Rome and the Single European Act wrought out by these two treaties, while reaffirming certain principles of Community Law, nonetheless, compounded the difficulties faced by the EU in its effort to achieve a harmonised tax system. Thus, the need to preserve the principle of subsidiarity and the principle of unanimity in the decision-making process upheld by such amendments do not facilitate the emergence of a European tax

⁹⁸ A. Easson, ‘Harmonisation of Direct Taxation in the EEC’, (1992 a) 40 *Canadian Tax Journal* 3, at 602.

⁹⁹ C.E. McLure, Jr., ‘Coordinating Business Taxation in the Single European Market: The *Ruding Committee Report*’, (1992) 1 *EC Tax Review* 13.

¹⁰⁰ Treaty on European Union-Concluded at Maastricht on 7 February 1992, (1993) United Nations Treaty Series Vol. 1757, I. No. 30615.

¹⁰¹ Treaty of Amsterdam signed on 2 October 1997, (1998) 37 *ILM* 56.

¹⁰² Four basic treaties contain EU primary law:

- the treaty establishing the European Community or TEC. This is consolidated version of the original 1957 Treaty of Rome resulting in the 1997 Treaty of Amsterdam and its previous amendments and containing the institutional and substantive provisions of EC law;
- the Treaty on European Union, or TEU. This is the consolidation version of the then 1992 Treaty of Maastricht, resulting in the 1997 Treaty of Amsterdam and containing the fundamental rules on establishing the European Union starting in 1993;
- the European Coal and Steel Community Treaty, or ECSC, approved in Paris in 1951 and containing common rules for the coal and steel sector; and
- the European Atomic Energy Community Treaty, or Euratom, approved in Rome in 1957 and containing the common rules and policies on atomic energy.

A report released on 14 May 2000 by the Robert Schuman Centre of the Florence European University Institute, Reorganization of the European Treaties proposes the introduction of a new Basic Treaty on European Union that reorganise the legal framework of EU law. See P. Carlo, Report on Reorganization of EU Treaties Will Affect EU Tax Law, Tax Analysts Document No: Doc 2000-15676 (24 May 2000).

system.¹⁰³ In the context of company taxation, the principle of subsidiarity mandates the EU's action only if the interaction of different corporate systems across the EU results in serious distortions in the single market. The form of such action is on the coordination and approximation of policies rather than harmonisation.¹⁰⁴

The eventual adoption of a formulary apportionment methodology with a uniform definition of the tax base, uniform measurement of apportionment factors, and perhaps a uniform tax administration system could be, arguably, a violation of the principle of subsidiarity since it entails a loss of fiscal autonomy by Member States. In the EU, therefore, there is a challenge to reconcile uniformity and subsidiarity. It may well be that a form of equalisation, as present in Canada, would need to be implemented in the EU to overcome the eventual opposition of those Member States that would lose revenue as a result of the redistribution of the tax base that the introduction of formulary apportionment would entail. If this were to be achieved, then the application of formulary apportionment would be less problematic.

A final point needs to be mentioned. If the formulary apportionment methodology were made to apply within a trading bloc, then the problem of interface with the rest of the world using the separate accounting/arm's length standard would require attention. It would thus be necessary to develop an adequate mechanism to ensure that international double taxation does not result from this interaction.¹⁰⁵

Under a formulary system within the trading bloc certain administrative and procedural issues would need to be resolved. Businesses operating within the trading bloc would need to file consolidated returns or some form of combined returns with each country. A reliable system of exchange of information in tandem with a reinforced competent authority procedure would be essential. To cater for inevitable disputes some form of innovative dispute resolution involving the taxpayer would have to be put into place. In this regard, and as examined earlier, an arbitration procedure would have several advantages. To conclude, it is interesting to speculate on the relations between NAFTA and the EU if both were to adopt a formulary apportionment system. In such a scenario, a duplication of functions could be avoided if the two blocs could set up an organisation to deal with the procedural and technical aspects of the

¹⁰³ F. Vanistendael, 'The Limits to the New Community Tax Order', (1994) 31 *Common Market Law Review*, at 293-314.

¹⁰⁴ See M. Van Heukelen, 'The Assignment of Corporate Tax Competencies in the European Community', (1990) mimeo in McLure, Jr., & Weiner, *supra* note 21, at 30.

¹⁰⁵ According to Professor McDaniel, if a worldwide formula apportionment were used within the trading bloc, it would be rather simple to deal with tax haven activities. Under the so-called throwback rule, any of the factors, for example sales, otherwise attributable to a tax haven would be ignored. Consequently, each member would benefit from the share otherwise attributable to the tax haven. See McDaniel (1994a), *supra* note 83, at 733.

system.¹⁰⁶ Nonetheless, in the model proposed in this thesis, these procedural matters would be handled by an international tax organisation.

Section II: An Appropriate Environment for the Implementation of Global Formulary Apportionment

This thesis is premised on the argument that it is time to implement a systemic rather than a cosmetic change to the prevailing system of international taxation. This entails the creation of an international organisation by way of a multilateral treaty to administer the nascent system. In fact, a multilateral treaty to replace the whole network of bilateral treaties is often portrayed as capable of solving some of the shortcomings of the present system of international taxation.¹⁰⁷

1 A Multilateral Approach to International Taxation

Obviously a fair division of the tax take cannot be envisaged without enhanced international cooperation, which exists in areas of common interest already exists and the vehicle for such cooperation is the multilateral treaty. For instance, one of the most recent multilateral treaties concerns the reduction of carbon emission for the protection of the ozone layer and the prevention of global warming.¹⁰⁸ The non-existence of a multinational tax treaty and the resistance to its implementation is indeed an anachronism in today's global economic integration.

A The Characteristics of Multilateral Treaties

As early as 1928 the option of a multilateral tax treaty was explored by the League of Nations.¹⁰⁹ Unfortunately, an inter-governmental meeting designed to consider the proposals

¹⁰⁶ A North Atlantic Tax Organisation?

¹⁰⁷ Since the inception of the League of Nations' work on the problem of double taxation as described in Chapter 2, the possibility of a multilateral model had been canvassed. Thus, T.S. Adams, the U.S. representative with the League 'pressed for a multilateral solution to the problem of international taxation, despairing of the complexity, administrability, and manipulability of taxation under a large number of bilateral tax treaties.' See Graetz & O'Hear, *supra* note 53, at 1105.

¹⁰⁸ See the 1985 Vienna Convention for the Protection of the Ozone Layer, U.K.T.S. 1 (1990), Cm 910, and the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer, U.K.T.S. 19 (1990), Cm 977. See also the United Nations framework Convention on Climate Change signed on 9 May 1992 in New York and the Kyoto Protocol to that Convention, at <<http://www.unfccc.de/>>.

¹⁰⁹ Earlier, on 12 October 1923, a multilateral tax treaty was signed between Austria, Hungary, Poland, Italy, Romania and the Kingdom of Serbs, Croats and Slovenes; see M. Lang, 'The Concept of a Multilateral Tax Treaty', in M. Lang, ed., *Multilateral Tax Treaties: New Developments in International Tax Law*, (Kluwer Law

failed to achieve this objective. In recent years, a certain number of multilateral tax treaties have come into existence, for example, the Organisation Commune Africaine Malgache et Mauricienne (OCAM) Treaty of 1971, the Arab Treaty of 1972, the Nordic Tax Convention, the Andean Tax Treaty of 1972, and the Double Taxation of the Caribbean Community (the CARICOM group) of 1974.¹¹⁰ Of these, only the last three are in operation.¹¹¹

Both the OECD and the U.N. have entertained hopes that their bilateral treaties would eventually evolve into multilateral treaties. It would seem, therefore, that a multilateral approach has always been regarded as having the potential to solve the inherent defects of the bilateral treaties.¹¹² Unfortunately, this evolutionary change to multilateralism has not yet occurred. It never will unless 'some fundamental shift in circumstances favourable to change' first occurs.¹¹³ To date, experiments in regional multilateral tax treaties have met with limited success.¹¹⁴

International, 1998) 189, at 189. See also P.A. Harris, *Corporate Shareholder Income Taxation and Allocating Taxing Rights Between Countries*, (Amsterdam: IBFD Publication BV, 1996), at 298.

¹¹⁰ CARICOM members are Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St Vincent and the Grenadines, Surinam, and Trinidad and Tobago. See Lang, ed., *supra* note 109, at 88 n 3. Two multilateral tax treaties have also been concluded by Member States of the CMEA (Council for Mutual Economic Assistance also referred to as COMECON), that is, Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Mongolia, Poland, Romania and the Soviet Union. The first treaty, the convention with respect to the avoidance of double taxation on income and net wealth of individuals, was signed on 27 May 1977 in Miskolc, Hungary. A similar treaty for the avoidance of double taxation with respect to income and capital of legal entities was signed on 19 May 1978 in Ulan Bator, Mongolia. The treaties were made effective from 1 January 1979. Although the CMEA as such no longer exists, both tax treaties are still applicable and the relationship among the CMEA countries in the field of international taxation is to a large extent still regulated by these multilateral agreements. See W.G. Kuiper, 'The Multilateral CMEA Tax Treaty and its Relevance Today', IBFD (1991) LEXIS/NEXIS database File IBFD. See also T. Nagy, 'Multilateral Tax Agreements and Tax Coordination in the CMEA', (1979) 19 *European Taxation* 379.

¹¹¹ H.M.A.L. Hamaekers, 'Multilateral Instruments on the Avoidance of Double Taxation', (1986) 40 *Bull Int'l Fiscal Documentation* 99.

¹¹² Divergent bilateral tax treaties concluded between members of the EU may even be multilateralised, eventually, through the jurisprudence of the European Court of Justice. See J. Schuch, 'The Bilateral Tax Treaties Multilateralized by the EC Treaty', in M. Lang, ed., *supra* note 109, at 35.

¹¹³ R.J. Vann, 'A Model Tax Treaty For the Asian-Pacific Region?', (1991) 45 *Bull Int'l Fiscal Documentation* (No. 3) Part II, 151.

¹¹⁴ Note, however, that on 31 May 1996 the newly created Quadripartite Community within the Commonwealth of Independent States (CIS) (that is, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) announced that it would soon take initial steps toward the conclusion of a multilateral tax convention. See D.M. Henry, 'New CIS Quadripartite Community to Explore Multilateral Tax Treaty', 96 *TNI* 106-4. On 25 November 1998 eight members of the CIS signed an agreement on the principles of imposing indirect taxes on the export and import of goods and services on the destination principle. See S. Adamian, 'Eight CIS Member Countries Sign Indirect Tax Agreement' (21 June 1999) 18 *Tax Notes Int'l* 2545. On 4 June 1999, 11 members signed an agreement to cooperate and provide mutual assistance in tax related matters. See S. Adamian, 'CIS Member Countries Sign Tax Agreement on Cooperation and Mutual Assistance', (19 July 1999) 19 *Tax Notes Int'l* 247.

One of the fundamental characteristics of multilateral conventions is that they propose rules and regulations which are required to be applied and interpreted in a uniform way by their signatories. Multilateral conventions are, therefore, more likely to be construed in a uniform way. More uniformity of interpretation would be especially valuable in the field of international taxation where, even at the bilateral level, the OECD Model has failed to achieve such an outcome. Thus, in spite of the OECD Commentaries which aimed at encouraging uniform interpretation of the Model, Contracting States often favour interpretations that suit their immediate objectives.

Although a multilateral treaty would presumably establish uniform tax norms in the major areas of international tax, thus facilitating the interpretation of uniform tax rules, there is serious doubt as to whether agreement could ever be reached on these highly sensitive matters. Certainly the fate of a multilateral tax convention covering one single class of income such as the UNESCO-WIPO *Convention on the Avoidance of Double Taxation of Copyright Royalties* does not promote optimism.¹¹⁵ The Convention was drafted after five years of preparatory work and six weeks of experts' meetings, a three-week diplomatic conference held in 1979. Of the 44 countries taking part in the conference, only three have signed the Convention.¹¹⁶ With this result as a precedent, it is perhaps unrealistic to believe that a multilateral treaty concerning the taxation of TNCs is feasible in the foreseeable future if the same paradigms are maintained.

Multilateral conventions have their own shortcomings:¹¹⁷ They are often rigid and inflexible, and their revision has been described as 'a heavy and lengthy procedure'.¹¹⁸ In general, one third of the countries which have ratified a multilateral convention must support a revision proposal before a conference can be organised.¹¹⁹ Nevertheless, it is reasonable to infer that

¹¹⁵ WIPO (World Intellectual Property Organisation), see at <<http://www.wipo.org/eng>>.

¹¹⁶ Hamaekers, *supra* note 110, at 100.

¹¹⁷ Thus, for example, the headquartering of TNCs within one country undoubtedly enhances the economic strength of that country since it often determines whether one country is a capital importer or capital exporter. Consequently, if that country were to be party to a multilateral tax treaty, then it is likely that these TNCs would, by lobbying the government, manage to influence the latter's position on the drafting of such provisions as the article on associated enterprises and on the right to tax at source inter-company dividends, interest and royalties. Once these provisions are drawn, it is difficult, in a multilateral setting, to refine them in order to redress their most unfortunate consequences. In a bilateral framework, the differences between different parties may be bridged by reciprocal concessions.

¹¹⁸ Hamaekers, *supra* note 110, at 100. The problem of amending, revising or modifying treaties appears to have attracted little academic attention. The International Law Commission has observed that the enormous variety of treaty clauses establishing amendment procedures makes it difficult to trace the development of any detailed customary rules. It thus contented itself with formulating a few very basic principles to govern the amendment process. These were incorporated with minor modifications as Articles 39-41 of the Vienna Convention on the Law of Treaties. For an examination of this process, see M.J. Bow man, 'The Multilateral Treaty Amendment Process-A Case Study', (July 1995) 44 *International & Comparative Law Quarterly* 540.

¹¹⁹ Hamaekers, *supra* note 110, at 100.

the amount of effort than would be necessary to revise an eventual multilateral tax treaty would not be greater than the aggregate efforts that are necessary to update, on an ongoing basis, the current network of bilateral tax treaties.

Until recently a multilateral tax treaty was simply not conceivable on a worldwide basis. Although it may now be argued that the slow convergence of major economies is rendering the prospect of a multilateral tax treaty more probable, there still remain serious difficulties pertaining to the significant differences in the economic infrastructures and tax traditions among the different countries. The world is still a patchwork of nations with different economic strengths and different legal systems and tax traditions. Yet, in view of the serious limitations of the bilateral alternative, there cannot be any other option: sooner or later serious efforts would need to be made in order to produce a comprehensive multilateral tax treaty on income and capital.¹²⁰ While this may be true, it is also important to note that in order to avoid the mistakes of the past:

a multilateral treaty should build on bilateral treaty practice with which individual States are familiar to ensure that it will be generally accepted. [W]e should be satisfied with putting former bilateral treaty practice on a multilateral level. For that reason, considerable significance must be given to the OECD Model Tax Convention, because the OECD Model Tax Convention has gained extraordinary distinction in bilateral treaty practice.¹²¹

B Attempts at Instituting Multilateral Treaties

There are currently three multilateral tax treaties in operation: The first is the Nordic Tax Convention between Denmark, Finland, Iceland, Norway and Sweden;¹²² the second is the Andean Treaty between Bolivia, Chile, Colombia, Ecuador, and Peru;¹²³ and the third is the Double Taxation of the CARICOM Group of 1974.¹²⁴ Significantly, though, these treaties involve regional countries of similar social and economic traditions. The general sentiment is that if this type of experiment is attempted in countries of different cultures and traditions,

¹²⁰ In a recent letter to the OECD Fiscal Committee and to the European Commission, 'the Austrian Ministry of Finance recently suggested reviving the idea of a multilateral tax treaty. The Ministry of Finance believes that a multilateral tax convention would be an indispensable prerequisite to implement the single market in the European Union. In a single market it would be intolerable for international flows of capital and the international movement of individuals and businesses to be distorted through diverging rules of bilateral tax conventions or, even worse, through the lack of such conventions, as is the case in the area of inheritance and gift taxes. The ministry, therefore, has expressed support for a review of the idea of an EU-wide multilateral double taxation convention.' See F. Rodler, 'Austria Proposes Multilateral Tax Treaty', 97 *TNI* 183-2.

¹²¹ Lang, *supra* note 109, at 192-3.

¹²² The *Nordic Countries Multilateral Income and Capital Tax Convention* signed on 23 September 1996 has replaced the 1972 Nordic Tax Convention; see 98 *TNI* 9-25.

¹²³ Chile has since left and Venezuela has joined the Andean Group. See Vann, *supra* note 87, at 151.

¹²⁴ H.M.M Bierlaagh, 'The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation? (March 2000) 54 *Bulletin for International Fiscal Documentation* (No. 3) 99.

friction is bound to occur, as with the EU, even though in this particular case the economic strengths of each is roughly comparable to the others.

Moreover, even the promotion of regional multilateral treaties may, in certain circumstances, be counter-productive. This is because the bilateral mechanism is likely to reappear in relation with countries external to the group, with the latter on one side and the former on the other. It follows that the 'adoption of regional norms in dealings by a regional group with outside countries then flows back to affect the tax relations within the grouping.'¹²⁵ Therefore, in order for a multilateral tax treaty to be successful, it needs to be signed and implemented by the most significant countries of the world.

The OECD still believes that its bilateral Model Convention could evolve into a multilateral convention. However, according to Ken Messere, then Head of the Fiscal Affairs Division of the OECD:

the work done helped to persuade everyone that such a multilateral Convention could never work outside a limited number of countries with similar laws and traditions (e.g. the Nordic countries) so there was no point in pursuing the idea. Again, the aim of agreeing a common OECD approach to cross-border investment when countries had different tax systems (classical, split rate, imputation, etc.) was found after hundreds of pages of documentation and hundreds of hours of discussion to be quite unrealistic, and it was accordingly agreed that these matters had to be resolved on a bilateral basis, which would take account of the economic relations between two would-be Contracting States.¹²⁶

In spite of these difficulties, the resolution adopting the 1977 OECD Model encouraged groups of countries to use it as the basis of multilateral negotiations whenever possible.

Whilst the idea of a comprehensive multilateral treaty on income and capital seems to be unattainable, in 1981 the OECD sponsored a bilateral model treaty entitled the *Convention on Mutual Assistance in Tax Matters*, which later became multilateral.¹²⁷ There are indications that this multilateral treaty in the administrative area could be a success. Several reasons explain why a multilateral treaty could succeed in the administrative field:

¹²⁵ Vann, *supra* note 87, at 151.

¹²⁶ K. Messere, 'The Precursors and Successors of the New OECD Model Tax Convention On Income and Capital', (1993) 33 *European Taxation* 246, at 249.

¹²⁷ OECD, *Model Draft Convention for Mutual Administrative Assistance in the Recovery of Tax Claims* (Paris: OECD, 1981). The OECD Council's resolution recommending the model to its members referred back to the Fiscal Committee the possible future development of multilateral initiatives. On 25 January 1988 the Council of Europe and the OECD adopted the final version of the earlier draft under the title, *Convention on Mutual Administrative Assistance in Tax Matters* See W.H. Diamond & D.B. Diamond, eds, *International Tax Treaties of All Nations* (Dobbs Ferry: Oceana Publications, 1988). Vol XXX111 Series B, at 497ff. For an analysis of the Convention, see Chapter 3, Section I, 2, A, iii, at 105.

- First, the development of a multilateral treaty in the administrative field is not hampered by the existence of a large network of bilateral treaties, as in the income tax area where their presence could conflict with the aims of the multilateral treaty.
- Second, the objects of the multilateral treaty are not as ambitious as its bilateral counterpart.
- Third, tax administrations in different jurisdictions have probably more in common in terms of objectives and methods.
- Finally, most tax administrators experience the same type of problems regardless of their tax systems when it comes to assessing and collecting taxes and, therefore, they are more ready to cooperate in the administration of revenue laws.¹²⁸ However, this cooperation ‘is regarded with considerable suspicion by many multinational groups’ because of the belief that ‘the tax authorities *in certain countries* are more interested in doing deals with their counterparts in other countries.’¹²⁹

Clearly, if there is not a fundamental shift in the perception of countries, the hopes of an evolution of the bilateral treaty into a multilateral one will always fall short of expectations. History suggests ‘that simple evolution will not lead to higher and better things for tax treaties (multilateralism).’¹³⁰ The main reason for this pessimism is that nations still want to retain the positive side of bilateralism because a move to a multilateral treaty in the field of taxation would mean that their sovereignty in fiscal matters would necessarily be eroded. Such erosion is still regarded as unacceptable even if the advantages of multilateralism seem to be gathering momentum.¹³¹ However, there are signs that, although reluctant, countries are now more willing to seriously consider these advantages in the field of direct taxation. This can be seen in the efforts to combat harmful tax competition. As will be seen further on, the inadequacies of purely national tax policies in an increasingly globalised market has led to dramatic changes in the relationship among domestic tax systems. Globalisation not only leads to competition among businesses in the global market place, but it also has the potential of setting off competition between countries which, for the sake of attracting scarce foreign capital, may be tempted to alter their taxation structure. Whilst such competition is regarded as intrinsically beneficial, it may have some harmful effects arising out of intentional or unintentional mismatches between existing tax systems. Clearly, to eliminate those undesirable effects, the

¹²⁸ Hamaekers, *supra* note 110, at 100.

¹²⁹ I.P.A. Stitt, ‘International Tax: Avoiding Parochialism’, [1997] *BTR* 19, at 30.

¹³⁰ Vann, *supra* note 87, at 151.

¹³¹ A draft for a multilateral tax treaty based on the OECD Model has recently been proposed. See M. Lang et al., ‘Draft for a Multilateral Tax Treaty’, in Lang, ed., *supra* note 109, at 197ff.

most efficient means appears to be cooperation on a multilateral basis as proposed by the OECD.¹³²

One of the major tenets of this thesis is that agreement for the worldwide implementation of global formulary apportionment needs to be achieved through a multilateral agreement. Such a multilateral treaty would also necessarily create an international tax organisation to administer the proposed system. Prior to examining the possible ramifications of an international tax organisation, it is appropriate to consider the role of existing international organisations in the taxation field and consider how they are evolving in the current economic climate. Indeed, there are certainly strong indications that some of these organisations are assuming a more dynamic role in the determination of tax policy and tax administration of their member countries.

2 A Survey of International Organisations Concerned With Taxation

Virtually every international organisation concerned with broad economic matters is, to a varying degree, necessarily concerned with taxation. A number of these organisations have a more prominent role than others in taxation matters.¹³³ For the following five, taxation is of a major concern:

- the Organisation for Economic Cooperation and Development (OECD);
- the European Union and the Monetary Union (EMU);
- the International Monetary Fund (IMF);
- the Inter-American Centre for Tax Administrations (CIAT);
- the G-7 of industrialised nations.

The World Trade Organisation (WTO), formerly the General Agreement on Tariffs and Trade (the GATT), may also be regarded as concerned with taxation matters, albeit in an indirect way.

A The OECD/IMF Axis

From a broad point of view, there is a convenient sharing of functions and interests between the OECD and the IMF. Thus, the OECD is more concerned with international taxation problems affecting primarily developed countries, while the IMF is mainly involved with the

¹³² OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

¹³³ R. Goulder, 'Reference Chart for Leading Multinational Economic and Fiscal Organisations' (28 June 1999) 18 *Tax Notes Int'l* 2603.

domestic tax matters of lesser developed countries (LDCs) such as the provision of technical assistance for the implementation of sensible tax policies and the creation of sound tax administration practices. Therefore, these two organisations may be viewed as complementary institutions but each with its own sphere of influence. However, if they are to survive in an increasingly interdependent world, clearly they need to coordinate their respective actions. In fact, cooperation between the OECD and the IMF is already occurring on a formal basis through the Joint Vienna Institute (JVI).¹³⁴

i The OECD

The historical genesis of the OECD's involvement with international tax matters has already been examined.¹³⁵ In terms of structure, the OECD comprises two main components: the Council and the Committees, with coordination being achieved through the secretariat.¹³⁶ All Member Countries have an equal voice in the OECD irrespective of the size of their budget contribution. Article 6 of the OECD Convention, which requires unanimity, regulates the decision-taking process within the OECD. As a result, within the OECD, both the decision-making and the decision-implementation processes are based on cooperation. Consequently, 'the OECD operates through...non-binding recommendations and informal peer review processes as means of achieving policy cooperation and coordination.'¹³⁷

Taxation is only a small part of the OECD's work program: The Organisation is concerned with a wide range of economic issues and undertakes research in such areas as unemployment,

¹³⁴ The Joint Vienna Institute (JVI) was established in 1992 to provide training and support to Central and Eastern Europe countries, the former republics of the USSR, and some others with the view to enabling them to make the transition from centrally -planned to market-based economies. Five parties have contributed to the establishment of the JVI: the Bank for International Settlements, the European Bank for Reconstruction and Development, the IMF, the World Bank, and the OECD. Recently, the World Trade Organisation joined them as the sixth sponsor of the JVI; see at <<http://www.jvi.org>>. Moreover, the U.S. Treasury also provides such assistance. According to John Lyons, former U.S. Competent Authority (CA), the work of U.S. Tax Administration Advisory Services (TAAS) is on the increase. TAAS is a group in the CA responsible for providing advice and recommendations to other governments, particularly those with newly developed tax regimes, on the most effective way to administer their tax systems; see Deloitte & Touche, U.S. Competent Authority Into the New Millennium: A Look Back and Ahead, Tax Analysts Document Number: Doc 2000-19211 (15 May 2000). It is suggested that such assistance could be provided by the international tax organisation proposed in this thesis.

¹³⁵ See Chapter 1, Section II, 2, A, ii, at 24.

¹³⁶ See *How the OECD is Organised*, at <<http://www.oecd.org/about/organise.htm>>.

¹³⁷ R.J. Vann, 'The Future of International Tax Treaty or Institution? Small Step or Great Leap?' (1996), unpublished paper, at 50.

education, labour, financial and investment affairs.¹³⁸ The OECD is also increasingly performing important work in relation to Non-Member Countries, particularly those from the dynamic Asian and Latin American economies, Central and Eastern Europe, as well as the newly independent states of the former Soviet Union. In addition, reports on the economies of individual Member Countries are produced on an annual basis.

The taxation work is shared among the various working parties established by the Committee on Fiscal Affairs. These are:

- Working Party No. 1, the original Fiscal Committee concerned with double taxation questions.

Four other working parties were created in 1971:

- Working Party No. 2 deals with tax analysis and tax statistics;
- Working Party No. 3 manages issues pertaining to company taxation;
- Working Party No. 4 handles questions relative to the taxation of interest paid on Eurobonds; and
- Working Party No. 5 monitors problems relative to the issue and the tax treatment of securities.

Various other working parties were established and wound up after they had accomplished their mission. Since 1977, the remaining working parties, apart from Nos. 1 and 2 are:

- Working Party No. 6 dealing with taxation and multinational enterprises; and
- Working Party No. 8 managing tax avoidance and evasion issues.¹³⁹

In addition, a Special Session on Innovative Financial Transactions has been created.

The major tax success of the OECD is its Model Double Taxation Convention and its Transfer Pricing Guidelines. Other recent noteworthy contributions include reports on global trading of financial instruments, and on harmful tax competition, anti-bribery conventions and its current work in the field of electronic commerce.

¹³⁸ See J. Sasseville, 'The New OECD Model Tax Convention', in OECD, *Taxation and Investment Flows: An Exchange of Experiences Between the OECD and the Dynamic Asian Economies*, (Paris: OECD, 1994) 131-43, at 131.

¹³⁹ Messere, *supra* note 126, at 247 n 8.

ii The IMF

The International Monetary Fund (IMF) is ‘a cooperative institution that 181 countries have voluntarily joined because they see the advantage of consulting with one another in this forum to maintain a stable system of buying and selling their currencies so that payments in foreign money can take place between countries smoothly and without delay.’¹⁴⁰ In other words, the IMF is a cooperative inter-governmental monetary and financial institution.¹⁴¹

The IMF is the sister organisation of the World Bank, but there are important functional differences between the two.¹⁴² At the Bretton Woods conference where both organisations were created, it was agreed that the International Bank for Reconstruction and Development (IBRD), or the World Bank as it is commonly known, would have the primary responsibility for financing economic development. The IMF, for its part, was set up in a reaction to the financial problems which initiated and prolonged the Great Depression of the 1930s. The IMF is required to monitor the financial policies of member states in order to foster economic growth, international monetary cooperation and exchange stability. By virtue of their voluntary membership of the Fund, and in order to accommodate the needs of the Fund’s entire membership, individual Member Countries are expected to modify their economic and fiscal policies on the advice of the Fund. One of the core functions of the IMF, for which it is better known and often criticised, is the lending for short-term balance of payments support to stabilise currencies. By 1990 100 per cent of the IMF lending was to developing countries so that today most of IMF’s activities concern developing countries.¹⁴³

The influence of the IMF on the taxation policies of Member Countries is indirect. Its main concern is that a borrowing government abides by the conditions attached to the loans provided and repays the IMF promptly, usually between two to three years. In order to boost its repayment capacity, a borrowing government has two choices: it may either cut expenditure or increase taxes. The short-term conditions attached to the IMF loans mean that only crude tax measures are possible. In other words, governments faced with repayment obligations have to use blunt fiscal instruments, such as an increase in excise duties or sales taxes, because broad tax reform, which could also generate the required funds, takes too much time to implement. Moreover, the surveillance function of the IMF further requires it to ensure that

¹⁴⁰ D.D. Driscoll, ‘What is the International Monetary Fund’, at <<http://www.imf.org/external/pubs/ft/exrp/what.htm>>. As at June 1999, the IMF consisted of 182 members. See also Goulder, *supra* note 133, at 2606.

¹⁴¹ See at <<http://www.imf.org>>.

¹⁴² *Ibid.*

¹⁴³ Vann, *supra* note 137, at 52.

coherent fiscal policies be in place in Member Countries so as to lessen the likelihood of that country requiring balance of payments assistance. Thus, the IMF has a strong interest in countries having good tax systems.

B Other Organisations

i The WTO/EU

There are two other major international institutions concerned with taxation: the European Union (EU) and the General Agreement on Tariff and Trade (GATT) (or the World Trade Organisation (WTO) since 1 January 1995).

The involvement of the GATT with taxation has been intimately connected with settling disputes between the U.S. and the EU. For example, it was called upon to determine whether the EU value-added tax (VAT) offended the GATT as claimed by the U.S. This question was answered in the negative, although the saga continues inasmuch as the first U.S. retaliation, the creation of the Domestic International Sales Corporations (DISCs) corporations, was considered as offending GATT's rules.¹⁴⁴ The U.S. then claimed that the exemption systems used by several European countries to relieve double taxation was against the GATT. This contention may be considered as technically justified.¹⁴⁵ However, although the exemption system is still in place, the U.S. did not pursue the case, presumably because the results it has achieved with the Foreign Sales Corporations (FSCs) system, which replaced the disputed DISCs system, have until recently been perceived as being satisfactory.¹⁴⁶ In spite of this sentiment, which prevailed in the U.S., the EU maintained its complaint with the WTO. It alleged that the rules establishing the U.S. FSCs violate a WTO agreement on export subsidies given that FSCs are not required to comply with the internationally recognised arm's length principle. In October 1999, the WTO published its dispute panel's final report on the EU's complaint. The WTO found against the controversial U.S. foreign sales corporation tax regime, which it determined to be an illegal export subsidy.¹⁴⁷ Since more than USD 150

¹⁴⁴ J. Fischer-Zernin, 'GATT versus Tax Treaties? The Basic Conflicts Between International Taxation Methods and the Rules and Concepts of GATT', (1987) 21 *Journal of World Trade Law* 39, at 40.

¹⁴⁵ *Ibid.*

¹⁴⁶ For an analysis of the utility of DISCs and FSCs and their use in transfer pricing malpractice cases in the U.S., see R. Feinschreiber & M. Kent, 'U.S. International Tax Malpractice-DISCs, FSCs, and Transfer Pricing', (31 May 1999) 18 *Tax Notes Int'l* 2273.

¹⁴⁷ Anonymous, 'WTO Publishes Full Text of Panel Report Slamming U.S. FSC Regime', (October 13, 1999). *Tax Analysts* Document Number: Doc 1999-33168. See also R. Goulder, 'WTO's Latest Opinion Substantially Adopts Reasoning of Lower Dispute Panel', *Tax Analysts* Document Number: Doc 2000-5913 (25 February 2000); R. Goulder, 'WTO Rejects U.S. Appeal Regarding FSC Regime', (6 March 2000) 20 *Tax Notes Int'l* (No. 10) 1044; C.M. Bruce, 'The WTO's FSC Ruling: Lets All Relax', (27 March 2000) 20 *Tax Notes Int'l* (No. 13) 1459; S.A. Cohen, 'Will the WTO's FSC Ruling Be the Demise of the Guam Foreign Sales

billion worth of U.S. exports are currently covered by the FSC system, it is certain that the U.S. will act quickly to settle this problem. In May 2000, during talks with the EU, a replacement regime was proposed. The main features of the proposal are that eligible corporations would elect to be taxed under an alternative tax regime, and tax benefits would not be limited to export property although U.S. content would have to be significant.¹⁴⁸

It is worth noting that in terms of trade volume, the FSC controversy has turned out to be the biggest trade dispute to be brought before the WTO.¹⁴⁹

Finally, it has also been noted that the taxation question has again come to prominence with the General Agreement on Tariff and Services (GATS). The difficulties in this area abound because of a lack of uniform rules pertaining to the question of what is meant by services crossing international frontiers.

ii Emerging Trade Blocs and International Tax Associations

Several other organisations and associations are involved in international taxation. The U.N., for example, attempted to enter the arena when in the 1960s it produced its Model Double Tax Convention for Developed and Developing Countries. However, since then nothing significant has happened.

Finally, there are a number of associations of tax administrators attempting to share technical assistance or experience in the field of international taxation. Some of these are:

- The Commonwealth Association of Tax Administrators (CATA);
- The Pacific Association of Tax Administrators (PATA);
- The 'Centre de rencontres et d'études des dirigeants des administrations fiscales' (CREDAF);
- The Study Group on Asian Tax Administrators and Research (SGATAR);
- The Intra-European Organisation of Tax Administrators (IOTA);
- Inter-American Centre of Tax Administrators (CIAT).¹⁵⁰

Corporation?', (10 April 2000) 20 *Tax Notes Int'l* (No. 15) 1627; M.R. Roberts, 'WTO's FSC Ruling Could Prove Detrimental to the USVI's Economy', (10 April 2000) 20 *Tax Notes Int'l* (No. 15) 1626; R. Goulder, 'U.S. Will Comply With WTO Ruling on FSC Regime, but Details Remain Unclear', (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1758; R. Goulder, 'European Union Dissatisfied With Proposed FSC Replacement', Tax Analysts Document Number: Doc 2000-15390, (30 May 2000).

¹⁴⁸ For some details of the proposed regime, see *The Ruchelman Law Firm's Newsletter*, 'Successor Regime to Foreign Sales Corporation Proposed', (May 2000), at <<http://www.ruchelaw.com>>.

¹⁴⁹ Anonymous, 'WTO Panel Says U.S. FSC Rules Violate Accord Due to Lack of Arm's Length Pricing', (28 July 1999) 8 *Transfer Pricing Report* 278.

It is also worth mentioning certain regional trade associations, such as the Asia-Pacific Economic Cooperation (APEC), whose interest in taxation is growing¹⁵¹ as seen by its joint hosting with the OECD of a conference on taxation in Sydney, Australia in October 1996 and in Cebu, the Philippines in 1998. Moreover, the Association of South East Asian Nations (ASEAN) has already taken some measures to address the challenges posed by the need to coordinate the taxation regime of its various members. The organisation has thus produced the *Intra-ASEAN Model Double Tax Convention on Income* ‘developed by an Ad-Hoc Committee on the Harmonization on [sic] Tax Treaties of ASEAN countries.’¹⁵² Moreover, the North American Free Trade Agreement (NAFTA) created in 1994 also has an interest in promoting common tax policy with the view to achieving deeper regional integration in the region.¹⁵³ Finally, it is worth mentioning the G-7 countries, that is, the informal gathering of the seven richest countries whose objective is to foster common policies in the political, military and economic fields. As will be seen in Chapter 6, the G-7 is assuming a prominent role in promoting the idea of harmonised accounting standards.¹⁵⁴ To be successful, any reform of the international tax system as proposed here would need to be supported by the G-7 countries.

There is, obviously, a proliferation of organisations and associations concerned with taxation. Yet, these groups have only tentatively tried to coordinate their respective actions as can be seen, for example, with the joint efforts of the OECD and the IMF, the OECD and APEC, and the OECD and CIAT. What is therefore required is the creation of a compatible interface between these different organisations. Such an objective may be achieved by the creation of a ‘General Agreement for Taxes’.

¹⁵⁰ Inter-American Centre of Tax Administrators. CIAT now has 28 members including North American countries as well as five associate members from Europe, with significant ties with the core Latin American membership. See Goulder, *supra* note 133, at 2606.

¹⁵¹ See G. Richardson & R. Lanis, ‘Harmonizing Taxation Law Within APEC: A Fiscal and Cultural Analysis’, (October 1996) 50 *Bulletin for International Fiscal Documentation* 430.

¹⁵² See A.Q. Yoingco, ‘The view from Taft: Tax Harmonisation in Asia-Pacific Countries’, (27 June 1996) *Business World (Manila)*. Full text in Ausinet Database, (Boolean Search, Search Text: asean & model tax treaty, search sources: all). This Model essentially follows the U.N. Model but contains certain modifications aim at catering for the particular needs of the ASEAN countries; see A.Q. Yoingco, ‘Developments in Economic Integration and Fiscal Harmonization’, (December 1993) 47 *Bulletin for International Fiscal Documentation* 724, at 726.

¹⁵³ It is also important to note that there is the project of creating a ‘Free Trade Area of the Americas’ while such integration schemes as the MERCOSUR have been formed and old schemes such as the CARICOM are being revitalised. See L. Eden, ‘The Emerging North American Investment Regime’, (December 1996) 5 *Transnational Corporations* (United Nations Conference on Trade and Development, Division on Transnational Corporations and Investment) 61, at 63-65.

¹⁵⁴ See Chapter 6, Section II, 2, B, at 277.

Section III A General Agreement for Taxes

The concept of a multilateral approach to the taxation of cross-border transactions in the form of a General Agreement for Taxes (GAT) has been examined over a number of years.¹⁵⁵ There have also been calls for a multilateral agreement on corporate governance such as a comprehensive set of rules relative to how corporations should be managed and liquidated if the need arises.¹⁵⁶ In the field of investments, a multilateral convention has been attempted. The Multilateral Agreement on Investment (MAI), if and when concluded, will be open to accession by OECD members and non-member alike.¹⁵⁷ It is time for such a comprehensive system to be adopted in the broader context of international taxation.

1 The Rationale for an International Tax Organisation

There are several reasons that justify the creation of an organisation which would fulfil, in the taxation area, the same functions as the WTO in the trade area. However, any proposition to create an international agency to administer the taxation of TNCs in lieu of this function being carried out by national governments will raise political rather than technical objections. Myron J Frankman noted that:

[T]he impediment to the establishment of such an organisation is not a technical one, but rather a political one. Mere technical questions are, in the immortal words of Stephen Leacock, 'simplicity itself.' The challenge is to change political perceptions that have been influenced and limited by carefully nurtured and often longstanding systems of myths and rationalizations.¹⁵⁸

Whatever be the weight of the argument, in the face of present political realities, the fact is that if the globalisation of world economies continues, then the chances for the successful implementation of isolated national policies, upon which the survival of the political elite is dependent, is highly compromised. Already, the usefulness of big governments is being questioned.¹⁵⁹ If the survival of governments in their present form is to be achieved, then it is

¹⁵⁵ See for example R. Stanford, 'International Tax Law: The Need for Constructive Change', in H. Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley & Sons, 1988) 93.

¹⁵⁶ See for example, S.J. Rubin, 'Corporations and Society: The Remedy of Federal and International Incorporation', (1973) 23 *Am. U. L. Rev.* 263. See also G. Ball, 'Cosmocorp: The Importance of Being Stateless', (November/December 1967) 2 *Colum J World Bus* 25.

¹⁵⁷ R. Couzin, 'Taxation and the Multilateral Agreement on Investment', (24 June 1996) 12 *Tax Notes Int'l* 26 2049. Strong grassroots opposition to the MAI has resulted in the project being accorded less prominence on the OECD's agenda.

¹⁵⁸ M.J. Frankman, 'Global Taxation: A Search for Generalizable Precedents', (June 1997) 31 *Journal of Economic Issues* 641.

¹⁵⁹ See A.W. Wright, 'Review: OECD Harmful Tax Competition Report Falls Short' (17 August 1998) 17 *Tax Notes Int'l* (No. 7) 461. See also A.W. Wright, 'More on 'Harmful' Tax Competition: A Response to Messrs. Osterweil and Franke' (30 November 1998) 17 *Tax Notes Int'l* (No. 22) 1713.

arguable that they will need to adopt measures that would guarantee them access to the same level of financial resources necessary to fund the activities which justify their presence.

A The Ineffectiveness of Isolated National Economic Policies

One of the most important consequences of globalisation is that purely national problems have been transformed into international ones.¹⁶⁰ Accordingly, the chances of conflict between the national economic policies of various jurisdictions are multiplied.¹⁶¹ Conventional economic theory holds that governments are required to intervene in order to reduce the impact of negative externalities that impede economic growth. Such intervention may be achieved through the use of various instruments such as taxes or subsidies, and regulations, which either encourage or discourage specific economic activities. In an environment of growing internationalisation, these externalities are likely to be international rather than national. Therefore, isolated government actions to control its national economy may not be successful. Indeed, uncoordinated actions have little effect on the power of the international market. Governments are well aware of their relative impotence to control the machinery of the international economy through localised efforts. Yet, 'the mechanism for international coordination of economic policies remain weak [and] nowhere is this more evident than in the tax area.'¹⁶²

There can be no doubt that the present globalisation process is bound to create many deleterious effects which need to be corrected in a concerted way by existing national governments. As argued throughout this thesis, 'the increased interdependency of national economies creates a lower tolerance for diverging national policies and a need for greater international coordination.'¹⁶³ This has been demonstrated by the evident impact of the recent Asian financial crisis on Latin America and Russia. Moreover, in the absence of action, a conflict will arise because some countries will necessarily miss out on the benefits which globalisation promises to deliver.¹⁶⁴ Therefore, the need for a supranational technical organisation, as opposed to a political one, with the mandate and power to deal with the internationalisation of externalities affecting national economies is increasingly being felt in the

¹⁶⁰ This part of the thesis draws on Vito Tanzi, *Taxation In An Integrating World* (Washington, D.C: The Brookings Institution, 1995).

¹⁶¹ J.M. Mintz, 'Is National Tax Policy Viable in the Face of Global Competition?' (5 July 1999) 19 *Tax Notes Int'l* 99.

¹⁶² J. Owens, 'Taxation Within a Context of Economic Globalisation', (July 1998) 52 *Bulletin for International Fiscal Documentation* 282.

¹⁶³ *Ibid.*

¹⁶⁴ For an example of some of the controversial issues raised by globalisation, see Weisbrot, 'Globalization for Whom?', (1998) 31 *Cornell International Law Journal* (No. 3) 631.

area of international taxation. Indeed, the conflict that is brewing as a result of the internationalisation of world economies may erupt in the taxation area.

In sectors other than taxation, serious efforts are being made towards international cooperation. Several international treaties dealing with matters that affect nations on a global basis have been signed. The so-called global warming phenomenon offers a potent example of the need for international cooperation in order to ease out the resistance of certain nations and to achieve the necessary compromises in order to arrive at a satisfactory solution to the problem of greenhouse gas emission. Other examples of international cooperation are often seen in other areas of human activities. Thus, for instance, the World Health Organisation's efforts for controlling communicable diseases would have failed if a fragmented approach had been adopted. Again the IMF, and the OECD, because of their clear mandate, have been relatively successful in achieving their objectives. At times, the usefulness and the legitimacy of such organisations may be questioned,¹⁶⁵ especially by people who hold the view that welfare is maximised if the public sector is maintained at the lowest possible level.¹⁶⁶ However, objective analysis tends to show that whilst their action may seem laborious at times, they have had, in general, a beneficial impact on the human condition worldwide.

In this increasingly integrated world, the allocation of profits from the activities of TNCs is becoming insurmountable. As Vito Tanzi observed:

[L]ike tectonic plates grinding at each other, the tax systems of different countries will develop arbitrage pressures created by different tax rates, by differences in the bases that are taxed, by different possibilities of avoidance and evasion, and so forth. These pressures will be strong in some areas and less strong in some others and will become more intense as the process of world integration proceeds.¹⁶⁷

The impact of globalisation on national economic policies must necessarily have serious consequences on the international tax policies of various countries. It has thus been suggested that:

[T]he removal of economic borders among independent tax jurisdictions...has immense implications for both the structure and the overall burden of the tax system in each of these jurisdictions. When capital, labour, [at least highly skilled] goods, and services can move freely from one tax jurisdiction to another, the tax base becomes global, and its distribution among various tax jurisdictions becomes endogenous to all various tax systems.¹⁶⁸

¹⁶⁵ S. Yanaura, 'Is the OECD Now the Tax Police of the Entire World?', (26 July 1999) 19 *Tax Notes Int'l*393.

¹⁶⁶ *Id.*, at 7.

¹⁶⁷ *Id.*, at 6.

¹⁶⁸ J.A. Frenkel, A.Razin & E. Sadka, *International Taxation in an Integrated World* (Cambridge Mass: MIT, 1991), at 3.

A country's tax policy is often influenced by the taxation policies of its major trading partners.¹⁶⁹ Similarly, TNC strategists also consider the taxation policies of various host nations as important elements when devising their own tax planning. In other words, major economies do not simply coexist: they are dependent upon each other. Therefore, the mechanisms developed to satisfy an age where economies coexisted cannot possibly satisfy the needs of one where an extremely high level of integration has been achieved.¹⁷⁰ However, clearly, on the taxation front, as with other economic issues, national governments can do little on a unilateral basis. In fact, the action of one government in the taxation area may limit those of other governments. Thus, for instance, other governments out of concern that they might miss out on the proper division of the international tax cake often duplicate the action of one government in the taxation area. Thus, it is arguable that the worldwide wave of tax reform in the 1980s was a reaction to the U.S. tax reform process.¹⁷¹

In today's world, any tax initiative of one country is most likely to have spill-over effects across its frontiers prompting action by the foreign nations affected by it.¹⁷² For example, a low level of sales tax in one country may act as an export mechanism for that country's tax burden. Indeed, if foreigners can easily acquire transportable goods at a low price in one country because of a low sales tax level, the incidence of such tax is then shared between its nationals and foreign shoppers. This means, therefore, that the sales tax yield in those countries whose nationals are shopping abroad would be lower because of lower sales.

To conclude, if countries wish to sustain the current level of their individual tax yields, then an isolated approach to business taxation cannot be maintained. The absence of a coordinated approach to international business taxation in an integrated world could lead to severe tax competition that would decrease the overall tax cake to such an extent that the whole system of corporate taxation would be undermined.¹⁷³ What is then needed is the transfer of the

¹⁶⁹ See J. Owens & E. Whitehouse, 'Tax Reform for the 21st Century', (November/December 1996) 49 *Bulletin for International Fiscal Documentation* 538.

¹⁷⁰ The fact that existing rules for the assessment and collection of direct and indirect taxes are rooted in a by-gone era has already been studied in Chapter 2, but see also C. Sanderson, 'Taxing a Borderless World', (December/January 1999) *International Tax Review* 35.

¹⁷¹ This 'imitation effect' or 'fascination effect' with the 1986 U.S. Tax Reform may have its root in the fear of tax competition which would have resulted among the U.S. trading partners since it was widely believed that such reform would result in an increase in inward investments for the U.S.; see K. Messere, '20th Century Taxes and their Future', (January 2000) 54 *Bulletin For International Fiscal Documentation* (No. 3) 2, at 22.

¹⁷² When in 1991 the Canadian Government introduced its goods and service tax (GST), one fifth of the entire Canadian population, that is, five million people entered the United States to shop in the month of May 1991. See McIntyre, *supra* note 2, at 783-84.

¹⁷³ J. Slemrod, 'What Makes a Nation Prosperous, What Makes it Competitive, and Which Goal Should We Strive For?', (1992) 9 *Australian Tax Forum* 373, at 383

responsibility for certain aspects of tax policy from the national to the international level. This measure would enable the institution of ‘a low-rate, broad-base tax system’¹⁷⁴ which would promote competition ensuring, ultimately, a substantial increase in overall welfare.

B Harmful Tax Competition and the Control of Tax Avoidance

One of the major reasons for the creation of a general agreement for taxes arises from the necessity to maintain a level playing field in the area of international taxation. Indeed, as governments worldwide face increased pressure on the economic front, the temptation is to squeeze out certain benefits at the expense of others. On the other hand, TNCs may choose to react to competitive pressures by seeking through elaborate tax planning to avoid paying a fair share of taxes.

i The Proposed Regulation of Harmful Tax Competition

Economic interdependence is most evident when one examines the trends in capital movements on a worldwide basis. The liberalisation of various economies has resulted in a rapid growth in the volume of foreign direct investment (FDI) and foreign portfolio investment. According to the United Nations (U.N.), investments flows in 1995 increased by 40 per cent to an unprecedented \$315 billion.¹⁷⁵ This spectacular growth is not restricted to the developed world. Whilst the latter accounted for the major part of this increase, FDIs in the LDCs reached \$100 billion, and investment flows to Central and Eastern Europe nearly doubled to \$12 billion in 1995.¹⁷⁶ Clearly, FDI is a major force in shaping globalisation and its expansion is being fuelled by continuing liberalisation and privatisation in most countries.¹⁷⁷ In order to attract part of this capital, some countries have put into place incentives which may be harmful to the economic interests of others.¹⁷⁸

Tax competition and ‘tax exportation’¹⁷⁹ are the two by-products of the globalisation process. Both may be regarded as economic inefficiencies given that they reduce overall economic

¹⁷⁴ *Id.*, at 381.

¹⁷⁵ United Nations Conference on Trade and Development, *World Investment Report 1996, Overview* (New York & Geneva: United Nations, 1996), at 1.

¹⁷⁶ *Ibid.*

¹⁷⁷ Concurrently, FDI by G-7 countries in a number of jurisdiction of the Caribbean Basin and in the South Pacific island states which are generally regarded as low-tax countries amounts to more than \$200 billion, a five-fold increase over the period 1985-1994.

¹⁷⁸ A.J. Easson, ‘Tax Incentives for Foreign Direct Investment in Developing Countries,’ (1992b) 9 *Australian Tax Forum* 387, at 389. As for the problem of tax competition in Central Europe, see A.J. Easson, ‘Tax Competition Heats Up in Central Europe,’ (1998) 52 *Bulletin for International Fiscal Documentation* 192.

¹⁷⁹ Mintz, *supra* note 161, at 99.

welfare. Tax competition or, more precisely, harmful tax competition¹⁸⁰ arises when a country deliberately exploits the unintentional mismatches which arise from the interaction of different tax systems in order to erode the tax base of another country.¹⁸¹ The net effect of tax competition is that 'higher taxes in one country cause the tax base to flee to neighbouring jurisdictions with more favourable tax systems.'¹⁸² In order to attract FDI, many countries are more willing to create a favourable climate for investors by further liberalising their economic environment and providing other incentives in order to influence the locational decision of TNCs. Thus the phenomenon of 'dowry chasing' whereby TNCs 'play off national and regional authorities against one another to gain the largest possible investment incentive.'¹⁸³ An investment incentive has been defined as 'any government measure designed to influence an investment decision, or having the effect of increasing the profit accruing to the potential investor or altering the risks attached to it.'¹⁸⁴ Although such incentives may take several forms, including financial measures, assistance with infrastructure, or preferential government contracts, this thesis is only concerned with the effects of fiscal or tax incentives, which may take the form of tax exemptions, tax holidays, reduced rates or special deductions, or credits.¹⁸⁵

The major threat of harmful tax competition is that it may lead to the adoption of a least common denominator in the taxation field as governments jostle for scarce capital.¹⁸⁶ Given that governments generally attempt to cover their public spending through taxation, a reduction in tax revenue must necessarily result in a reduction of its public spending capacity.¹⁸⁷ This may in turn bring about a reduction in overall national welfare.¹⁸⁸ A reduction in tax revenue also means that private economic operators are less able to improve their economic welfare, thus

¹⁸⁰ OECD (1998), *supra* note 132.

¹⁸¹ *Supra* note 132, at 15 para. 28

¹⁸² Mintz, *supra* note 161, at 99.

¹⁸³ J. Stopford & L. Turner, *Britain and the Multinationals* (London: John Wiley & Sons, 1985), at 238.

¹⁸⁴ OECD, *Investment Incentives and Disincentives: Effects on International Direct Investment* (Paris: OECD, 1989), at 9.

¹⁸⁵ Easson (1992b), *supra* note 178, at 390.

¹⁸⁶ A. Easson, 'The Tax Competition Controversy' (25 January 1999) 18 *Tax Notes Int*'1371.

¹⁸⁷ As shown by the KPMG's annual survey of corporate tax rates around the world, corporate tax rates are constantly falling; see News, 'Global tax Cuts Ease the Pressure' (March 1999) *International Tax Review* 5.

¹⁸⁸ Tanzi, *supra* note 160, at 70.

adversely impacting on economic efficiency and on the equity of the national tax system.¹⁸⁹ This process of fiscal degradation is more likely to hurt countries with high tax ratios.¹⁹⁰

Tax competition is not limited to a race to the bottom as far as tax rates are concerned. In fact, tax competition may also come from changes in the tax bases of various countries. Such changes are less visible and more difficult to assess. The burden of taxes on enterprises is also dependent on the bases on which tax rates are applied. The lack of harmonised methods between countries for determining the corporate tax base no doubt creates arbitrage opportunities for TNCs. In addition, tax competition may also entail changes in the elements that are relevant to the determination of the tax base, for example, depreciation allowances. Thus, it is the relationship between tax rates and tax bases that result in effective tax rates which has 'the greatest influence on where real investment goes.'¹⁹¹

It can also be argued that high tax rates are inefficient, damage economic performance, and reduce the standard of living of future generations.¹⁹² Nonetheless, competition tends to equalise tax rates at low levels resulting in significant revenue loss for some countries. Such depletion of their revenue indubitably impedes their public-spending program.¹⁹³

Tax competition is further complicated with the intervention of tax havens.¹⁹⁴ Tax competition provides incentives to some countries to become low-tax countries or even tax havens. Such countries are usually small but are strategically located in the right time zones and in the proper geographic area. By attracting transient financial capital and taxing it a modest rate they are able to increase their tax revenue without increasing the tax burden of their own residents. In fact, the proliferation of tax havens is such that they are required to compete with each other for capital. According to Vito Tanzi there is ample evidence of:

¹⁸⁹ *Supra* note 160, at 70.

¹⁹⁰ There is no consensus as to whether such results are intrinsically bad. See, for example, Viewpoint, 'A Business view on Tax Competition', (1 July 1999) 19 *Tax Notes Int'l* 281; Wright, *supra* note 159, at 461; M. Gaffney, 'Competition: More Harm Than Good?', (December/January 1999) 10 *International Tax Review* 46.

¹⁹¹ Tanzi, *supra* note 160, at 110.

¹⁹² *Supra* note 160, at 7. See also Slemrod, *supra* note 173, at 381.

¹⁹³ See K. Messere, '20th Century Taxes and their Future', (January 2000) 54 *Bulletin For International Fiscal Documentation* (No. 3) 2. See also K. Messere, 'Half a Century of Changes in Taxation', (August/September 1999) *Bulletin For International Fiscal Documentation* 340.

¹⁹⁴ In order to offer a united front in face of the OECD's assault on their practices, the World Association of International Financial Centres (WAIFC) was formed in October 1998. In April 1999, it held its inaugural meeting in Vancouver, Canada. The WAIFC aims 'to present a united front to lobby on behalf of offshore centres in the face of the concerted moves by the G-7, the European Union, and the OECD to curb their freedom.' See Anonymous, 'International Centres to taken OECD', Institute of Chartered Accountants in England & Wales, at <<http://www.dialogweb.com/cgi/>>.

intensified competition among tax haven countries in providing tax advantages to those who invest in them. This competition may largely neutralize the effects of the intensified campaign against tax evasion.¹⁹⁵

The above discussion shows that international cooperation in the taxation area is essential if an optimal allocation of world capital is to be achieved. In this regard, two initiatives need to be examined given that they aim at dealing with the problem of tax competition by advocating the harmonisation of certain tax fundamentals. The first is the adoption of the European Community (EC) Code of Conduct at the European Council of Economic Finance Ministers (ECOFIN) meeting of 1 December 1997,¹⁹⁶ and the second is the OECD report on harmful tax competition (hereinafter the Guidelines).¹⁹⁷ Both aim at removing distortion and unfairness stemming from harmful tax competition rather than penalising countries striving to modernise and rationalise their tax structures.¹⁹⁸

The Code of Conduct in business taxation is the first aspect of a package of measures designed to eliminate harmful tax practices among EU Member countries.¹⁹⁹ The second element of this strategy deals with the taxation of savings income,²⁰⁰ and the third is a draft directive concerning withholding taxes on interest and royalty payments.²⁰¹ Following the Code of Conduct, the ECOFIN established a 'Code of Conduct Business Taxation Group' in March 1998 with Dawn Primarolo, the U.K. Paymaster General, as chairwoman and members from 15 EU Member States. The group (Primarolo Group) in a report to ECOFIN made public in February 2000 identifies 66 measures in the EU and dependent territories that have harmful effects on competition. As part of the Code of Conduct, EU Members are required to eliminate these practices by the end of December 2002.²⁰²

¹⁹⁵ Tanzi, *supra* note 160, at 137.

¹⁹⁶ For the text of the EC Code of Conduct see 'EC Update', (January 1999) 38 *European Taxation* 2, at EC-5-8.

¹⁹⁷ OECD (1998), *supra* note 132.

¹⁹⁸ For a comparison of the EU and the OECD initiatives, see M. Nettinga, 'Conference Discusses Initiatives to Curb Harmful Tax Competition' (January 1999) 39 *European Taxation* 37.

¹⁹⁹ Whether the efforts at eliminating harmful tax competition will yield the promised benefits is debateable at least within the EU; see J. Weiner, 'News Analysis: Institute for Fiscal Studies Reports on EU Corporate Tax Harmonization', Tax Analysts Document Number: Doc 2000-14053 (15 May 2000).

²⁰⁰ In this regard, after serious divergence as to the proper taxation regime of savings, the EU finance ministers have agreed, on 20 June 2000 at Santa Marie de Feira, Portugal to adopt a 'co-existence' model which would allow countries to adopt either a withholding tax or provide greater exchange of information on income earned by non residents within the European Union. See J. Weiner, EU Ministers Agree on Savings Taxation: EU Hearing and Summits Address Other EU Tax Issues, Tax Analysts Document Number: Doc 2000-17204 (21 June 2000).

²⁰¹ J. Weiner, 'Consortium of EU -Based Law Firms Discusses EC Law's Direct Impact on Direct Taxation' (10 April 2000) 20 *Tax Notes Int'l* (No. 15) 1629.

²⁰² *Id.*, at 1630. See also, R. Goulder, 'Primarolo's Group Report Identifies 66 Harmful Tax Regimes', (20 March 2000) 20 *Tax Notes Int'l* (No. 12) 1283.

The OECD views harmful tax practices as those which are tailored to erode the tax base of other countries. In order to eliminate such practices, the Guidelines established a Forum on Harmful Tax Practices to coordinate national and treaty responses to harmful tax practices whilst encouraging Non-Member countries to associate themselves with the effort.²⁰³ During the first two years of its existence, the Forum on Harmful Tax Practices will be required to review countries' tax practices in order to locate any harmful practice.²⁰⁴ The Forum on Harmful Tax Practices 'is responsible for undertaking an ongoing evaluation of existing and proposed preferential tax regimes in Member and non-member countries, analysing the effectiveness of counteracting measures, including non-tax measures, and examining whether particular jurisdictions constitute tax havens.'²⁰⁵ Several criteria are used to define a tax haven. These are:

- No, or only nominal, effective tax rates,
- lack of effective exchange of information,
- lack of transparency, and
- absence of a requirement of substantial activities.

After the initial period of review, where a country believes that a measure in another country may constitute a harmful tax practice, it may request the Forum to examine that measure and determine if indeed it is a harmful tax practice. Whilst the opinion of the Forum is non-binding, 'nonetheless, the existence of an opinion by an international body that a domestic measure is in violation of important political commitments undertaken by a Member country should have a strong impact.'²⁰⁶

It is to be noted that the Guidelines on harmful tax practices incorporate a standstill and a rollback provision. Under the standstill provision, Member countries are required to abstain from adopting new measures, and extending the scope of, or the strengthening of, existing measures that constitute harmful tax practices.²⁰⁷

²⁰³ E. Osterweil, 'OECD Report on Harmful Tax Competition and European Union Code of Conduct Compared' (June 1999) 39 *European Taxation* 198 at 199. As for the effectiveness of the proposed measures, see E. Troup, 'EU Initiatives on Tax Harmonization: Do as I Say, Not as I Do?' (12 October 1998) 17 *Tax Notes Int'l* 1081; M. Ellis, 'Are Measures to Curb Harmful Tax Competition Necessary?' (March 1999) *European Taxation* 78.

²⁰⁴ M. van Herksen, 'What's in a Definition? On Defining Harmful Tax Competition' (24 August 1998) *Tax Notes Int'l* 525.

²⁰⁵ See OECD, 'Harmful Tax Practices', at <http://www.oecd.org/daf/faharm_tax/harmtax.htm>.

²⁰⁶ See J. Weiner & H. Ault, 'The OECD's Report on Harmful Tax Competition', (September 1998) 5 *National Tax Journal* (No. 3) 601, at 606.

²⁰⁷ OECD, *supra* note 205.

The rollback provision, for its part, requires the elimination of the harmful features of preferential regimes before the end of five years.

The advent of the Guidelines has undoubtedly put pressure on some countries to adopt best practices in the field of taxation. Indeed, it was widely publicised that the OECD would release at a ministerial meeting its *Report on Progress in Identifying and Eliminating Harmful Tax Practices* on 26 June 2000.²⁰⁸ This Report would contain a list of jurisdictions that are tax havens under the criteria to be found in the Guidelines.²⁰⁹ In a scramble not to appear on this list, by 19 June 2000 six countries made specific commitments to the OECD to eliminate whatever harmful tax practices that they may have promoted by the end of 2005.²¹⁰

In June 2000, the OECD published a list of what it calls ‘uncooperative’ tax havens.²¹¹ It also recommended to its Members a series of ‘defensive tax measures’ to be taken against these tax havens. However, it has delayed the implementation of these measures until 31 July 2001 in order to enable those appearing on the list that wish to do so to roll back these harmful practices.

The OECD’s action may be viewed as one directed towards major TNCs operating in these tax havens.²¹² Unfortunately, the governments of these relatively poor countries are now being caught in the cross-fire,²¹³ and one needs to acknowledge that the Organisation is slowly and

²⁰⁸ See OECD, *Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (Paris: OECD, 2000).

²⁰⁹ Thus, 47 preferential tax regimes in the OECD area have been publicly identified as potentially harmful while 35 jurisdictions were identified as meeting the criteria used to define tax havens. These are invited to enter into a dialogue with the OECD with a view to making whatever changes necessary to meet the international standards of transparency and fairness as determined by the OECD. See OECD, News Release, ‘Ministers promote fair tax practices at global meeting’, (Paris: OECD, 29 June 2000) at <<http://www.oecd.org/media/release/bercy.htm>>.

²¹⁰ That is, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino; see OECD, *supra* note 205.

²¹¹ See R. Goulder ‘OECD Still Plans to Release Tax Haven List, but May Delay Call for sanctions’, (1 May 2000) 20 *Tax Notes Int’l* (No. 18) 1919; R. Goulder, OECD Releases Tax Haven Blacklist, Tax Analysts Document Number: Doc 2000-17613, (26 June 2000).

²¹² It is to be noted that the Business and Industry Advisory Committee (BIAC), a private-sector group that has a long-standing cooperative relationship with the OECD, has issued a report criticising the latter’s report on harmful tax competition. The core of BIAC’s argument is that some tax competition among nations is beneficial given that it attracts business and investments; see BIAC, ‘A Business View on Tax Competition’, (19 July 1999) 19 *Tax Notes Int’l* (No. 3) 281. In response, it would appear that the OECD has taken note of the divergent views between the two organisations and has conceded that a mutual reconciliation needs to be reached; see R. Goulder, ‘OECD Takes Exception With BIAC’s Exception to OECD Tax Haven Report’, (19 July 1999) 19 *Tax Notes Int’l* (No. 3) 227.

²¹³ For a reaction of those countries, see B. Zagaris, OECD ‘Report on Harmful Tax Competition: Strategic Implications for Caribbean Offshore Jurisdictions’ (1998) 17 *Tax Notes Int’l* 1507. The move against tax havens is gaining momentum even in political circles. Thus, for the first time, a finance minister of the G-7 countries launched an attack against these jurisdictions labelling their action as modern-day piracy; see B. Zagaris,

surely achieving a certain status as a major tax organization with enough power to sanction those jurisdictions which refuses its injunctions. Indeed, it is moving towards a strong organization as suggested in this thesis albeit in a more consensual way. The creation of the Forum on Harmful Tax Practices is a crucial development on the road to the setting of an international tax agency. Indeed, the Guidelines provide that Member countries should use the Forum to coordinate their national and treaty responses to harmful tax practices. Until recently, an embryonic form of cooperation had been achieved via the exchange of information provision present in most tax treaties. A step towards the OECD achieving some form of policing powers was taken with the establishment of peer review in the transfer pricing area. It is suggested that the creation of the Forum is a most important achievement to date. Whilst it may well be that its powers are symbolic, the important point is that countries are examining whether it is feasible to allow an international organisation to exercise certain tax policing powers. Indeed, it has been argued that the Guidelines is really a Trojan horse for harmonisation, an argument strongly denied by Frances Horner, head of the OECD Tax Competition Unit.²¹⁴

Whilst the efforts of the OECD may be regarded as aiming to achieve a certain coordination of the tax systems of its Members, one needs to keep in mind that its membership is limited to the 29 most industrialised countries in the world. Therefore, the vast majority of countries have no direct influence on its decisions. Well aware of this limitation, the OECD has in recent years made significant overtures towards Non-Member countries including countries of the former Soviet Bloc, Latin America, and the newly industrialised nations. As the OECD's efforts unfold in the next few years and the world sees the emerging direction in harmful tax practices, the challenge to the OECD will be to gain worldwide legitimacy for its actions as well as for its very existence. Indeed, while the reason for the attack on the harmful tax practices of certain countries, notably in the Caribbean, is on balance a laudable effort, the fact remains that for some poor countries losing to the forces of globalisation, turning to financial services as a legitimate economic alternative is often seen as the solution of last resort. It is submitted, therefore, that international cooperation must go beyond isolated measures, such as curbing harmful tax competition, and embrace a structural overhaul of the international taxation system by the creation of an international tax organization which would administer the sharing of the tax pie in a more equitable way.

'Skirmishes and Jockeying Ensure Over Harmful Tax Competition Measures', (26 June 1999) 19 *Tax Notes Int'l* (No. 4) 325.

²¹⁴ See F.M. Horner, 'Fighting for Balance, not Harmony', (February 2000) *International Tax Review* 11, at 12.

ii *The Control of Tax Avoidance*

The least that can be said is that globalisation facilitates tax avoidance.²¹⁵ Recently, it has been argued that today ‘tax avoidance, if present, is at the margins, not at the centre’ of TNCs’ preoccupations.²¹⁶ However, there is little reason to believe that TNCs are only marginally concerned with such a universal phenomenon. In fact, recent work by the U.S. Internal Revenue Service tend to show that TNCs are not reluctant to resort to tax avoidance in order to minimise their overall tax burden.²¹⁷ Moreover, quite apart from elaborate tax avoidance schemes, there is also the problem of tax evasion. In fact, it has been said that ‘tax evasion is universal,...[it] takes place in all societies, social classes, all professions, all industries, and all economic system.’²¹⁸

It may well be that an international organisation would be in a much better position to deal with the problem. Such an organisation would need to have access to adequate tax information about various TNCs including access to their banking operations if there was any suspicion that they were using national banking secrecy provisions for tax avoidance purposes.²¹⁹ Tax information, especially in the new globalised economic environment, is an essential prerequisite for the prevention of tax avoidance as the OECD has admitted in its recent report on the question.²²⁰ Following this report, the OECD has considered ways of improving international cooperation with respect to the exchange of information in possession of banks and other financial institution for tax purposes. Clearly, ‘access to bank information can greatly improve

²¹⁵ OECD (1998), *supra* note 132, at 14 para. 23.

²¹⁶ J. Pagan & S. Wilkie, *Transfer Pricing Strategy in a Global Economy* (IBFD Publications, 1993) 16.

²¹⁷ U.S. Department of the Treasury, Internal Revenue Service, *Report on the Application and Administration of Section 482* (Washington, D.C.) April 1992.

²¹⁸ V. Tanzi and P. Shome, ‘A Primer on Tax Evasion’, International Monetary Fund Staff Papers v 40 n 4 807ff (December 1993) in K.R. DialogWeb Doc No 00450154/9. See also M.G. Allingham & A. Sandmo, ‘Income Tax Evasion: A Theoretical Analysis’ (1972) 1 *J Public Econ*, at 323-38 in Binh Tran-Nam, *supra* note 76 n 2.

²¹⁹ According to the OECD, ‘[A] major problem encountered by tax administrations for the processing of foreign-source tax information exchanged automatically is that it lacks the TIN (Tax Identification Number) of the beneficiary of the income and this makes it difficult, costly or even impossible to identify the beneficiary. A great improvement would be that the source country would provide tax information together with the TIN of the beneficiary. This would make it mandatory for non-resident taxpayers to provide their residence country TIN.’ OECD, Proceedings, *Tax Treaties: Linkages Between OECD Member Countries and Dynamic Non-Member Economies*, prepared by Richard Vann, (Paris: OECD, 1996), at 134. Accordingly, an international TIN may be ascribed to TNCs and administered by an eventual international tax institution.

²²⁰ OECD, Committee on Fiscal Affairs, *Tax Information Exchange Between OECD Member Countries: A Survey of Current Practices* (Paris: OECD, 1994), at 10. See also C. Gnaedinger, ‘U.S. Treasury Secretary Describes Battle Against Tax Evasion and Money Laundering’, (14 February 2000) 20 *Tax Notes Int’l* (No. 7) 708.

the ability of tax authorities to effectively administer the tax laws enacted in their parliaments.²²¹

The numerous problems arising from globalisation whether economic or social are ‘difficult to address on a unilateral basis’.²²² Whilst recognising this limitation, especially in the field of international taxation, this thesis does not propose the creation of an international organisation with extended membership to deal exclusively with the problem of harmful tax competition or unacceptable tax avoidance practices. What is intended is an international organisation capable of dealing with such problems indirectly. Indeed, its main purpose is to implement a global formulary apportionment system which directly confronts the problem of international tax competition that free trade exacerbates.²²³ It is submitted that once this substantial question is resolved then the incidentals such as tax avoidance would be dealt with within the same cooperative structures.

2 The Evolution of Transnational Operations

One result of the gradual liberalisation of national economies over the last two decades has been a significant change in the way in which TNCs conduct their business. This change maximises efficiency in the emerging global markets. As noted by Professor Galbraith:

capitalism as it matures is basically an international system. Not only are its products traded across national frontiers, its enterprises also extends its plant and employment to other countries as a matter of course. Thus is born the transnational or international corporation. And thus diminished is its identification with any one country or government.²²⁴

The evolution of the private sector must, it is contended, be matched by a relatively similar evolution of the public sector, or at least some sectors of the public sector, such as the revenue. Such an evolution is essential because, without it, the utility of the public sector itself is at risk. Thus, if the basic purpose of government is to be maintained, then it must be given adequate financial means, through efficient taxation, to do so.

A A New Corporate Environment

The conclusion reached when the theory of the transnational firm was examined earlier was that the separate accounting/arm’s length standard is not readily applicable to TNCs. TNCs, relying on their inherent strengths, are expanding to an optimum level. Until recently many

²²¹ OECD, *Improving Access to Bank Information for Tax Purposes* (Paris: OECD, 2000), at 8 para. 4.

²²² *Id.*, at 13 para. 19.

²²³ McIntyre, *supra* note 2, at 785.

²²⁴ J.K. Galbraith, *The World Economy Since the Wars: A Personal View* (Mandarin Paperback, 1995), at 167.

TNCs consisted of a relatively large number of theoretically independent legal entities each enjoying a relatively large autonomy in the conduct of its business. These subsidiaries, whilst controlled by a local or regional holding company, were individually managed and served their respective markets independently. A flow of products from manufacturing subsidiaries to sales centres characterised inter-company transactions. Finance, licensing arrangements, or management services, were provided for by specialised vehicles or by the parent.

This structure is rapidly being replaced by the fully integrated multinational. TNCs are currently undergoing significant restructuring processes in order to achieve the status of globally integrated businesses. The case of the manufacturing industry illustrates this transformation. Formerly, a TNC organised its production facilities to service specific markets. Thus, production facilities were designed to satisfy the North American, the Japanese, or the European markets separately, but this kind of market segmentation is now disappearing. Manufacturers are concentrating on the production of standardised products saleable in all three markets concurrently. This system avoids duplication in the conception, design, and engineering processes, and therefore achieves substantial economies of scale.

In order to achieve this objective, TNCs engaged in the manufacturing industry are deliberately merging their European and North American operations into single operating units.²²⁵ Regional independent companies are fast disappearing. The new entities are reorganised along global product lines with centres for research and engineering achieving preponderance for the whole manufacturing operation regardless of their geographical location. The importance of these research centres is thus explained:

[T]hey do basic engineering and integration of components and subsystems in one country, engineering of components in other countries and the logistics of the development is provided by video conference systems and supercomputers allowing simultaneous engineering in various countries.²²⁶

This evolution is not restricted to the manufacturing sector either. Similar developments are occurring in the fields of telecommunications and banking, as companies jostle for a share in the global market. Each and every significant player in various industries is remodelling itself into global companies, sharing technology across the group or even with competitors by way of strategic alliances involving technology transfers and cost-sharing agreements in the field of research and development as well as fixed costs.²²⁷ All this remodelling activity aims at achieving economies of scale and consistency in products. Consequently, the traditional legal

²²⁵ H. Müller, 'Integrated Multinationals - The Manufacturing Industry Challenges the Global Tax System', (1995) 22 *Tax Planning International Review* 3, at 3.

²²⁶ *Ibid.*

²²⁷ See Chapter 2, Section III, 1, B, at 79.

categories through which TNCs operate are quickly becoming obsolete. H Müller, quoting a recent survey, finds that TNCs:

- re-engineer independent subsidiaries into dependent parts of a global business;
- develop virtual rather than legal organisations breaching geographies and legal boundaries; and
- integrate the resources of all group companies to develop global products.²²⁸

An integrated company is basically one where all group members have access to all the resources of the group. As a result, subsidiaries lose their independence and become part of a global machinery whose ultimate objective is the efficient production of a global product or service.²²⁹ The outcome of these developments is a substantial increase in intra-firm trading involving not only goods, but also intangibles, as well as an increase in the demand and supply of specialist management services. The emergence of global trading, especially in the financial sector, is really an amplification of this process. In this environment, it is especially difficult to construct ‘a transfer pricing regime based on the identification of “inputs” to the productive process and the association of profit with particular inputs’.²³⁰

TNCs constitute vast assemblages of companies comprising wholly owned subsidiaries and several dozens of branches all in different parts of the world. The production of a TNC’s final product is often the result of inputs originating from those foreign branches or subsidiaries.²³¹ The growth of such intra-group trade both in terms of goods and services²³² puts an extra strain on the present systems of international taxation.²³³

International taxation must, in its principles and methods, match those used by international business.²³⁴ A new international tax organisation would replicate the integrated policy approach pursued by TNCs. It would permit the efficient management of vast resources, now

²²⁸ *Ibid.*

²²⁹ United Nations Conference on Trade and Development, *World Investment Report 1996, Overview*, *supra* note 175, at 13.

²³⁰ S.I. Langbein, ‘A Modified Fractional Apportionment Proposal for Tax Transfer Pricing’, (10 February 1992) *Tax Notes* 719, at 724.

²³¹ J. Morgan & N. Teunon, ‘Tax Issues Feature Prominently in Organizing Multinational Groups’, (17 February 1997) 14 *Tax Notes Int’l* 625.

²³² United Nations Conference on Trade and Development, *World Investment Report 1996, Overview*, *supra* note 175, at 13.

²³³ R.Y.W. Tang, *Transfer Pricing in the 1990s* (Westport: Quorum Books, 1993).

²³⁴ The management techniques used by TNCs, that is, the promotion of the enterprise as a whole as opposed to purely sectorial consideration, has been seen as providing a useful model applicable by an eventual world government formed to promote trade and the general well being. See L.M. Salter, ‘The Dynamics of the Multinational Enterprise: An Exemplar for World Government?’, (1974) 8 *The International Lawyer* 11.

immobilised with separate sovereign tax authorities which are so often seen as marginally effective. Indeed, it would promote an internationalist culture based on higher productivity measured in relation to its ability to achieve its object. If such an organisation is able to mirror the operational performances of TNCs, then it is arguable that it would also generate synergetic advantages that would flow to the revenues of its members. Finally, if politically controversial decisions were to be taken by such an organisation, politicians may even view this as an advantage. Indeed, they would always be able to claim that their margin of action is constrained by a power centre outside their control. Thus, for example, when confronted by their constituents, politicians in the EU have been able to escape criticism arising from the jurisprudence of the European Court of Justice by shifting the blame to the Court, although, clearly, the Court's powers are subject to a certain political control through, for example, the appointment of the Court's judges, or the power to amend the treaties instituting the Court.²³⁵

One of the main arguments for the creation of an international tax organisation is premised on the claim that since there has been an evolution in the way international business is done, the taxation of such cross-border operations must also evolve in the same direction. Such an organisation is most likely to suit a world increasingly characterised by economic integration. TNCs now face dozens of different tax authorities each with its peculiar legal and administrative tax rules. If these TNCs were to face one central authority, it is obvious that their cost of compliance with that authority's rules would be far less than those they face now. Thus valuable resources would be released from their present unproductive assignment.

Moreover, with the advent of electronic commerce and the constant interaction of trade and taxation, tax administration must sooner or later embrace an international dimension. Today, trade is carried out by several thousand TNCs. A system that aims at taxing the gains arising from these international activities, while remaining national in nature, is simply not viable. To adequately solve an international problem, one requires an international response. This response must necessarily take the form of an international administrative agency. It is submitted that if countries were to leave the design of a tax system to competitive forces, then it is probable that the system of present corporate taxation would disappear and with it the method by which governments today are given the means to finance the stock of public goods. Whilst this may be seen by some as a positive development, the fact is that 'governments have gotten larger rather than smaller in the face of globalization'.²³⁶ In such circumstances, in order to continue with the level of funding commensurate with their size, governments have but one

²³⁵ This option is difficult though because of the need to obtain the unanimous agreement of the 15 Member States. See Anne-Cécile Robert, 'Ce juge méconnu de Luxembourg', *Le Monde Diplomatique*, May 1999, at 14.

²³⁶ Mintz, *supra* note 161, at 103.

alternative: to improve the coordination of tax policies at the international level by making country tax systems similar to each other. In other words, they need to:²³⁷

- harmonise their taxes,
- decide on a minimum and maximum rate of tax,
- implement adequate measures to prevent double taxation,
- monitor transfer pricing activities of TNCs, and
- achieve an acceptable level of exchange of information and prevent harmful tax competition.

An adequate response to the objections as to the representative character of existing organisations dealing with tax matters is to set up a tax organisation open to all nations.

B The Need for International Coordination

The radical changes examined require the migration of revenue-raising from the national to the international domain.²³⁸ It may seem alien in the current economic climate, based on deregulation, to consider regulating on a worldwide basis the taxation of international business activities.²³⁹ Thus, it would appear that ‘the formally commonplace notion that taxation is the price we pay for civilization’²⁴⁰ is no longer applicable in a free market. It is submitted, though, that a free market is based principally on the notion of efficiency and not specifically on the absence of any regulatory power. In reality, what is unacceptable is the lack of accountability in the use made of that ‘price’ which taxpayers pay for civilisation.²⁴¹

Regulation to safeguard the tax base cannot be seen as a hindrance to the development of business. On the contrary, it aims at creating the necessary framework destined to prevent

²³⁷ *Supra* note 161, at 103.

²³⁸ J. Ralph, ‘Ralph Sets His Sights on Tax in Cyberspace’, *Sydney Morning Herald*, 7 October 1999, at 8, where ‘the architect of the Federal Government’s business tax revamp’ said that ‘issues such as the source [of income] and residency are all going to be very difficult out there in cyberspace. The only way that is going to be addressed is through more co-operative international arrangements and countries coming together more than they have in the past. A more integrated system across jurisdictions will be needed.’

²³⁹ Proponents of smaller governments and free market have attacked the OECD initiative in the field of tax competition as an intolerable restraint on the free market. See B. Zagaris, ‘The Assault on Low Tax Jurisdictions: A Call for Balance Debate’, (13 August 1999) 28 *Tax Management International Journal* (No. 8) 474.

²⁴⁰ Frankman, *supra* note 158, at 641.

²⁴¹ In this regard, note the correlation between low tax jurisdictions, bank secrecy and money laundering; see Zagaris, *supra* note 239.

anarchic behaviour from both national governments and TNCs competing for revenue on the one hand, and for investment on the other.²⁴²

Whilst tax competition might be a serious reason to contemplate the creation of an international organisation to deal with taxation, it is suggested that the most compelling reason for doing so arises from the constant erosion of the revenue base and the resulting inequities that it brings about, for example, in the heavier taxation of immobile labour.²⁴³ Moreover, by engaging in transfer pricing, TNCs effectively undermine the taxation policy of several national governments. Moreover, the manipulation of transfer prices within TNCs not only reduces their total tax liabilities, it also brings about a reallocation of the overall tax revenue among relevant countries with some gaining and some losing. Is it then acceptable that the worldwide allocation of revenue is to be made dependent on the commercial policies of TNCs? It is submitted that TNCs should have no say as to how the total tax revenue is to be distributed on a worldwide basis. Their major concern should be limited to ensuring that any policy initiative does not end up with their business operations being subjected to double or multiple taxation or unnecessary compliance costs.

Finally, if the fiscal sovereignty of various nations is most likely to be undermined in a globalised world, then it is suggested that countries would be better off surrendering part of their fiscal sovereignty to an international organisation charged with resolving the allocation process. Indeed, countries would still have control of such an organisation and would, therefore, ease the control that the higher management of about 39,000 global enterprises maintain on world development.

Various international bodies have endeavoured to find an adequate model for regulating and coordinating TNCs.²⁴⁴ The United Nations (U.N.) have established the U.N. Commission on Transnational Corporations. The OECD has been at the forefront of this effort, publishing, in the transfer pricing area, its Guidelines for Multinational Enterprises, the latest version having been released in 1995.²⁴⁵ It has also pioneered the development of rules pertaining to the

²⁴² See M.A. Sullivan, 'The Luck of the Irish? Profits and Taxes of U.S. Multinational Abroad', (3 June 1996) 12 *Tax Notes Int'l* 1765, at 1767. See also J. Stopford & L. Turner, *Britain and the Multinationals* (New York: John Wiley and Sons, 1985), at 238-41 for an earlier study of the phenomenon of tax competition and dowry chasing.

²⁴³ Mintz, *supra* note 161, at 103.

²⁴⁴ For an analysis of the efforts of the U.N., the OECD and the ICC, see C.D. Wallace, 'International Codes and Guidelines for Multinational Enterprises: Update and Selected Issues', (1983) 17 *The International Lawyer* 435.

²⁴⁵ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) [updated regularly].

disclosure of information by TNCs.²⁴⁶ In addition, the Committee on Fiscal Affairs of the OECD, through a Special Session, is conducting useful consultations on global trading in financial instruments with the view to producing its own guidelines in this expanding market. Finally, it is to be noted that the Multinational Agreement on Investments sponsored by the OECD and the Council of Europe, which attempts to regulate cross-border investments,²⁴⁷ is still under negotiation.²⁴⁸ It is time that all these efforts, as far as the measuring and apportioning of the income of TNCs is concerned, be handled by one organisation.

The complexity and interconnectedness of contemporary economic conditions arising from the globalisation of the world economies is such that the pressures for the emergence of a new international tax order built around a central coordinating institution are increasing.²⁴⁹ Justice Brennan in *Container Corp.* alluded to the necessity of such a coordinating authority in the purely American state context when he noted that:

[I]n the absence of a central coordinating authority, absolute consistency, even among tax authorities whose basic approach is quite similar, may just be too much to ask.²⁵⁰

²⁴⁶ OECD, *Guidelines for Multinational Enterprises* (Paris: OECD, 1976); OECD, Committee on International Investment and Multinational Enterprises, *Disclosure of Information by Multinational Enterprises: Survey of the Application of the OECD Guidelines* (Paris: OECD, 1988) which is followed by a survey on the application of the guidelines therein proposed.

²⁴⁷ R. Couzin, 'Taxation and the Multilateral Agreement on Investment', (24 June 1996) 12 *Tax Notes Int'l* 26, 2049. It would appear that because negotiations on the MAI have stalled, the leaders at the London EU-U.S. Summit of 18 May 1998, have adopted a joint statement on the Transatlantic Economic Partnership (TEP) identifying a series of elements for an initiative to intensify and extend multilateral and bilateral cooperation and common actions in the field of trade and investment.

²⁴⁸ As a result of sharp grassroots opposition to the MAI, the OECD Council of Ministers announced on 28 April 1998 'a period of assessment and further consultation between the negotiating parties and with interested part of their societies.' OECD *Ministerial statement on the Multilateral Agreement on Investment (MAI)* (28 April 1998), at <http://www.oecd.org/news_and_events/release/nw98-50a.html>. For a general discussion as to the advantages and disadvantages of the MAI, see Cornell International Law Journal Symposium, *Regulating Foreign Direct Investment: Institutional Arrangements*, (1998) 31 *Cornell International Law Journal* (No. 3), at 455ff.

²⁴⁹ This thesis proposes the creation of an international tax organisation to administer the taxation of cross-border income taxes on a worldwide basis. There have been, however, far more radical proposals dating as far back as 1884 for global taxes to finance the global governance of mankind; see, for example, the work of J. Lorimer, 'Book V. The Ultimate Problem of International Jurisprudence', in *The Institutes of the Law of Nations; A Treatise of the Jural Relations of Separate Political Communities*, (Edinburgh & London: William Blackwood & Sons, 1884) mentioned in M.J. Frankman 'International Taxation: The Trajectory of an Idea from Lorimer to Brandt', (May 1996) *World Development* 807-820. Moreover, in 1995 the Commission on Global Governance identified the following as potential global revenue sources to finance global governance: foreign exchange transactions (Tobin Tax), profits on TNCs, and use of common global resources (including flight lanes, sea-lanes, ocean fishing areas, geostationary orbit, and the electromagnetic spectrum; see Report of The Commission on Global Governance *Our Global Neighborhood* (Oxford: Oxford University Press, 1995), at 217-121.

²⁵⁰ Per Brennan J. in *Container Corp. v Franchise Tax Board* 463 U.S. 159 (1983), at 192.

Obviously, Justice Brennan was concerned with the lack of a central coordinating authority to administer the U.S. state taxation system based on the formulary taxation of the unitary enterprise. If the need for such an agency has been felt in the U.S. state tax context, then arguably its creation is of fundamental importance if that system of corporate taxation were to be expanded from its relatively limited application, as in the U.S. states' context, and made applicable on a worldwide basis.

Professor Hellerstein has canvassed the creation of such a central coordinating agency in the U.S. state taxation context. It is submitted that Hellerstein's arguments are readily transposable to strengthen the case for an international tax organisation²⁵¹ because these arguments revolve around the advantages that such an international tax agency would provide. An international tax agency is necessary in order to systematically deal with tax matters instead of having these problems considered by the many and various organisations as examined earlier. Indeed, while such organisations have had varying degree of success in carrying out their objects, the fact is that they often act in isolation and, above all, none may claim to legitimately represent the interests of all nations as far as taxation questions are concerned.

This thesis proposes the creation of an international tax organisation by means of a multilateral treaty to act as a central coordinating agency in the field of international taxation. The most salient functions of the organisation must now be studied.

²⁵¹ J. Hellerstein, 'Allocation and Nexus in State Taxation Interstate Businesses' (1964) 20 *Tax Law Review* 259, at 283.

Intertax: Its Role and Functions

A world government may well be the most effective way of dealing with the various emerging global problems. However, in its absence, there are three possible ways to confront these issues:

- (i) relying on spontaneous market solutions;
- (ii) solutions through international agreements; and
- (iii) the creation of international institutions charged with the responsibility of dealing with the problems created by the above-described developments.¹

This thesis focuses on the third alternative identified above. Section I examines, in general terms, the functions and powers of an eventual international tax organisation, (referred to as Intertax).² Section II concentrates on the need for harmonised accounting standards in order to facilitate the operation of the organisation. Finally, Section III explores the problems inherent to determining an international tax base for the purposes of allocation between different countries.

Section I Intertax's Mandate

How Intertax should operate may be analysed from both an idealistic and realistic point of view. The creation of such an organisation operating from an idealistic perspective is impossible in the current economic and political climate. Therefore, a more appropriate alternative needs to be considered. The realistic view, while still proposing the creation of Intertax, is more modest in its objective. What is claimed is that given the proper impetus the present system could evolve into one which is more appropriate to the current economic environment. The centrepiece of this alternative is an international organisation competent to deal with international tax matters in a coordinated way. It is therefore argued that the proposed model which is based on an integrated format, is superior to the dysfunctional approach that characterises the present system.

¹ V. Tanzi, 'The Impact of Economic Globalization on Taxation', (August/September 1998) 52 *Bulletin for International Fiscal Documentation* (No. 8/9), at 341.

² This appellation is taken from J.V. Surr, 'Intertax: Intergovernmental Cooperation in Taxation Matters', (1966) 7 *The Harvard International Law Club Journal* (No. 2) 179.

1 An Idealistic View

In spite of claims to the contrary, especially at the peak of an economic cycle, ‘free market needs governance’³ since competition, for various reasons, often engenders instability. Thus, for example, such a local hazard as the recent Thai crisis achieved global status after having been transmitted, through fully deregulated financial markets and international commodity trade, to other parts of the world.⁴ Self-regulation is often proposed as a method of control. However, this alternative has its limitations given that it is frequently disregarded for short-term gains. It is therefore imperative that existing regulatory bodies be maintained and their operation coordinated with that of other organisations to be created on a needs basis in order to channel competition and initiate corrective actions when necessary.⁵

A The Aims of Intertax

The advantages of a multilateral treaty that deal with the core problem of the allocation of the international tax base have already been explored. One of the central themes of this thesis is that if a multilateral tax treaty similar to the General Agreement on Tariff and Trade (GATT) is to be established, then a new international institution similar to the World Trade Organisation (WTO) may be required for its administration. Vito Tanzi sums up the functions that would be entrusted to it:

[T]here is no world institution with the responsibility to establish desirable rules for taxation and with enough clout to induce countries to follow those rules. Perhaps the time has come to establish one.⁶

Basically, therefore, the primary objective of such an international tax organization as herein proposed is to establish and promote principled tax allocation rules and to ensure that these are followed.⁷ Indeed, the creation of Intertax would synthesise the actions of various international organisations such as the WTO, the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) in the taxation area⁸ thus providing a neutral and non-discriminatory tax environment in which TNCs would operate to

³ W. Hutton, ‘Free Market Needs Governance’, *Sydney Morning Herald*, 29 October 1997, at 15.

⁴ United Nations, Department of Economic and Social Affairs & United Nations Conference on Trade and Development, *World Economic Situation and Prospects for 1999*, at <<http://www.un.org>>.

⁵ See, for example, J. Slemrod, ‘Tax Principles in an International Economy’, in Boskin & McLure, eds., *World Tax Reform* (San Francisco: ICS Press, 1990), at 11-23.

⁶ V. Tanzi, *Taxation in an Integrating World* (Washington D.C: The Brookings Institution, 1995), at 140.

⁷ Surr, *supra* note 2, at 179.

⁸ A. Weiss & F. Molnar, ‘International Cooperation Is Possible’, in H. Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley & Sons, 1988), at 103.

the optimum of their efficiency. The following may be considered the main functions of Intertax.

i Global Tax Administration

The present international organisations dealing with tax matters have never been required to focus exclusively on taxation issues. In order for Intertax to achieve its main objective, which is the provision of the necessary impetus for the creation of international tax allocation rules, it should be endowed with sufficient legal powers together with an adequate mechanism to police the application of its decisions. In this regard, the question arises as to whether Intertax should be an organisation of the ‘weak’ type like, the former GATT, or a ‘strong’ one, like the IMF.

An organisation of the ‘weak’ type is one that has very little power to coerce its members into adopting its decision. In essence, an organisation of the ‘weak’ form is one whose mandate is limited to giving advisory opinions and to recommending actions with the view to furthering its objects. It may also be charged with resolving disputes among its members. A ‘strong’ model, on the other hand, is one with enough powers to impose its decisions on its members. An organisation of this type is adequately staffed, its dispute-settling mechanisms are binding and, in general, it has the necessary authority to initiate and require its members to abide by major policy initiatives, as is the case, for example, with the European Union (EU) institutions.

Writing in 1991 Professor Vann favours the first type because of the inherent reticence of nations to forgo their fiscal sovereignty. However, it is arguable that given the entrenchment of the principle of fiscal sovereignty in the national psyche, and the likely defence of localised tax advantages, an organisation of the ‘weak’ type may not be as effective as required. Consequently, instead of aiming at achieving consensus on a worldwide basis for a ‘weak’ organisation, it may well be that the most viable option is for the major industrialised countries to create a tax organisation as between themselves, and then after solving its teething troubles open it to accession to the rest of the world. Moreover, a strong organisation, such as the IMF, could easily impose its views on weaker nations through a series of rules, for example, the linking tax reform to economic aid. But more significantly, depending on the political will of its members, an eventual international tax organisation would need to be able to deal with powerful nations. Such a strong organisation is also more likely to have enough credibility to place greater constraints on stronger nations to abide by their international obligations. However, in the current situation, an eventual tax organisation of this type is not likely to eventuate in the near future.

ii The Implementation of Worldwide Formulary Apportionment

Although Intertax would ultimately be concerned with the management of the tax consequences of all cross-border transactions, this present thesis is restricted to the examination of its action as far as the taxation of TNCs is concerned. Intertax would be required to manage the change from the application of the separate accounting principle to a formulary apportionment methodology in the international field.

In order to achieve this fundamental objective, Intertax would need to concentrate most of its efforts on two main areas; first, the determination of the worldwide income of TNCs; and second, the construction of a formula, or formulas, for the apportionment of that income to those countries entitled to it.

B Intertax: The Institution*i The Sovereignty Question*

The major obstacle to the creation of an international tax institution is based on the argument that nation-states are unlikely to forsake their sovereignty in taxation matters. The principle of sovereignty is one of the most enduring principles in international law.⁹ The notion of sovereignty connotes the idea of autonomous and absolute political, military and economic power embodied in a ruler or governmental body. In the taxation field it is epitomised by the principle that 'one nation does not take notice of the revenue laws of another.'¹⁰

The concept of sovereignty was formally articulated at the Treaty of Westphalia in 1648 and it has come to be regarded as the basis of the nation-state. However, it has never been considered as an immutable principle. Modern international law has modified the notion of absolute sovereignty as originally conceived. Thus, the United Nations (U.N.) has the legal power to check the sovereign pretensions of nations. Moreover, nation-states have always accommodated themselves with voluntary adjustments to their sovereignty when they perceived an immediate advantage for doing so. This is especially true in the field of economic policies where there is ample evidence of such abandonment of the sovereignty principle. An example may be found in U.S. history:

[C]ertainly from the very beginning of U.S. history, with the treaty that in effect, created us, the Jay Treaty gave away fishing rights to Canada, or as it was then called, Nova Scotia in return for other English concessions. And no one blinked an eye that somehow we were sacrificing our sovereignty

⁹ In 1576, Jean Bodin published one of the earliest and most interesting theories of sovereignty; see J. Bodin, *On Sovereignty*, edited and translated by J.H. Franklin (Cambridge: Cambridge University Press, 1996).

¹⁰ Great Britain, *Planche v Fletcher* 99 Eng Rep 164 at 165. See also *Government of India v Taylor* [1955] A.C. 491.

as part of a deal. So there has always been a long tradition in the economic sphere of people just going off and making deals because they made sense, and not bothering themselves too much with the sovereignty issue. It comes up all the time, but it has not been a major issue.¹¹

Most certainly, the whole notion of sovereignty is undergoing a profound mutation with the recognition of the principle of intervention on humanitarian grounds following the excesses in certain countries, for example, in Somalia, the former Yugoslavia, and East Timor. On a purely economic basis, the internationalisation of global financial markets over the past quarter century and the constant expansion of free trade has sharply reduced national capacities for self-government.¹² It may well be that economic peril on a globalised scale could in the near future be regarded as sound justification for the waning down of the sovereignty principle. Indeed, severe and sudden decrease in the economic well-being of nations have the potential to cause widespread misery and civil unrest which could, in certain circumstances, lead those affected to more serious actions of belligerence. Thus, Professor Galbraith rightly suggests that:

one of the enemies of economic development, indeed of civilized society, has been the notion that national sovereignty is sacrosanct even when it protects the internal conflict that destroys the economy and the people themselves. The community of nations, however reluctantly, is coming to recognize that this is so; action by the United Nations to intervene against civil conflict, if still uncertain and exiguous, is achieving a certain acceptance.¹³

In sum, however sacrosanct the notion of sovereignty is, powerful strategic forces tend to ignore this principle forcing a 'growing number of sovereign nations [to subordinate] some of their national policies and goals to regional agreements.'¹⁴ Nation-states, as the creation of the EU suggests, often choose to negotiate away sovereign rights, albeit with strong reluctance, when, as a result, everyone stands to gain some economic advantage. The same may be said of the North American Free Trade Agreement (NAFTA) which has been described as 'an attempt to manage economic interdependence without a great deal of concern for sovereignty.'¹⁵

Is fiscal sovereignty capable of accommodation as in other areas of economic life? There is a tremendous history of international cooperation in the tax area. However, one is forced to admit that nation-states remain fiercely attached to the notion of fiscal sovereignty. Thus, for

¹¹ G.N. Horlich, 'Sovereignty and International Trade Regulation', (1994) 20 *Canada-United States Law Journal* 57.

¹² H. Stretton, *Inefficiencies of Global Capital Markets*, (December 1998) United Nations, Department of Economic and Social Affairs, Discussion Paper No. 2 ST/ESA/1998/DP.2, at <<http://www.un.org/esa>>. See also E.L. Jenkins, *Address on Global Financial Reporting and the Global Financial Markets*, 1999 Financial Executive Summit, Vancouver, B.C., Canada, 28 May 1999, at <<http://www.isac.org.uk>>.

¹³ J.K. Galbraith, *The World Economy Since the Wars: A Personal View* (Mandarin Paperback, 1995), at 182.

¹⁴ Jenkins, *supra* note 12, at 3.

¹⁵ Horlich, *supra* note 11, at 58.

instance, when in 1989 the Soviet Union imploded, the immediate result, in the taxation field, has been the creation of 15 or so taxing jurisdictions which are now all in competition with each other.¹⁶

Nevertheless, it is arguable that since both the economic and the political worlds are shrinking, the adherence to the notion of sovereignty in the taxation area cannot be maintained ad infinitum, although 'when it comes to taxation, countries jealously guard their independence'.¹⁷ Internationalisation is seriously limiting the ability of national governments to effectively protect their tax base. To do so effectively governments need to enhance their cooperation through multilateral action as recommended by the OECD.¹⁸ The very notion of cooperation in this environment requires that participants dilute their claim to total fiscal sovereignty. What is required of them is that they agree to transfer part of that fiscal sovereignty to an international organisation. As will be seen further below, the result of this arrangement would be that countries would retain full sovereignty with regard to some crucial issues of fiscal policy but would confer comprehensive authority to an organisation in certain specific areas of international taxation. The dilution of fiscal sovereignty is not synonymous with its abandonment given that, in sum, no fiscal power is lost. Some aspect of Member countries' fiscal power is merely transferred to an international tax organisation in order to enhance their ability to obtain a fair share of revenue. Moreover, the notion of fiscal sovereignty needs to be put into perspective. Fiscal sovereignty must be distinguished from political sovereignty. It consists of four distinct elements:¹⁹

- the choice of taxes to be levied,
- the definition of tax base(s), including in this context the choice of an apportionment formula(s),
- tax rates and credits, and
- tax administration.

As Professor McLure and Joann Weiner argue, the most important element of fiscal autonomy is the choice of tax rates (and tax credits). It is a nation's ability to choose its tax rates which

¹⁶ D.H. Rosenbloom, 'Sovereignty and the Regulation of International Business in the Tax Area', (1994) 20 *Canada-United States Law Journal* 267.

¹⁷ J. VanderWolk, 'Direct Taxation in the Internet Age: A Fundamentalist Approach', (April 2000) 54 *Bulletin for International Fiscal Documentation* (No. 4) 173, at 174.

¹⁸ OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998), at 52 ff.

¹⁹ C.E. McLure, Jr., & J.M. Weiner, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Taxation', paper prepared for presentation to the International Seminar in Public Economics/Research Center for Economic Policy Conference on Reform and Harmonization of Company Taxes in the European Union, at The Hague, 3-5 April 1997, at 37.

primarily determines the amount of revenue that nation will collect and thus the size of its public sector.²⁰

It is important to acknowledge that of all the elements of fiscal sovereignty, as mentioned above, the only one not exercisable by Intertax relates to the determination of tax rates which is, significantly, the one that happens to be the most important to any sovereign nation. Therefore, the devolution of the least important elements of fiscal sovereignty to Intertax can in no way be regarded as a complete abdication of the notion of fiscal sovereignty so characteristic of the nation-state.

Clearly, the creation of an international institution to deal exclusively with the technical aspects of cross-border income flows would only mean that national sovereignty is exercised indirectly. The success of any international organisation depends on the collective will of its members, that is, nation-states. An international organisation dealing with taxation will, as is the case with any other organisation, coordinate policies adopted by a majority of members rather than create and impose a policy of its own which is disconnected with the will of its members. Therefore, the advent of such an international organisation would mean a transfer, rather than a loss, of sovereign fiscal power.

The question of sovereignty is arguably a vexing one. While the cooperation of the most powerful states may be open to doubt when it comes to relinquishing their economic and political powers, it is submitted that the fear of losing ultimate control over potent economic forces unleashed by the globalisation process may be the prime mover in this area. Indeed, there are several indications that countries may accept the transfer of some of their sovereign power to international organisations with a mandate to control and harness the globalisation phenomenon on the express condition they maintain ultimate control over such organisations.²¹ Thus, for example, in response to the Asian financial crisis which threatened the whole global financial system, the G-7 countries, at their meeting on 3 October 1998 in Washington D.C., were quick to call for the institution of standards and codes of best practices with, most importantly, a surveillance role to be attributed to the IMF and other international organisations.²²

²⁰ *Ibid.*

²¹ T.S. Adams, arguably the most U.S. influential tax policy expert at the beginning of the twentieth century, believed that 'nations would surrender tax jurisdiction only so long as they could do so without incurring significant harm: we shall eliminate, in the long run, only that measure and degree of multiple taxation which competing jurisdictions believe harmful to themselves.' See T.S. Adams, *Interstate and International Double Taxation*, in Lectures on Taxation 101, at 102 (Roswell Magill, ed., 1932.) in M.J. Graetz & M. O'Hear, 'The 'Original Intent' of U.S. International Taxation' (1997) 46 *Duke L.J.* 1021, at 1102.

²² Anonymous, 'Declaration of G7 Finance Ministers and Central Bank Governors', (30 October 1998) reproduced in *Notable Quotations about IASC*, at <<http://www.iasc.org.uk>>.

At this stage, however, there is no point in being over-prescriptive about the details of the rights and duties of Intertax's members. What is important is that the broad criteria for the proper operation of the organisation are met. For the moment the concept is more important than the design. One of the first principles of Intertax is that it would work in conjunction with the Bretton Woods institutions,²³ the OECD and the WTO, in order to secure consistency of goals and promote consensus-building dialogue between governments.

ii The Structure of Intertax: An Overview

In the ideal, Intertax's structure and methods of operations should be such that political resistance is kept to a minimum. The likelihood of Intertax successfully furthering its objects would be enhanced if its actions were perceived as being totally independent of vested national interests.

The following is a hypothetical model based on an idealistic view of the world. The model speculates on the optimum structures that would enable Intertax to achieve its goals. To start with, the task of formulating rules for the taxation of cross-border income flows is to be entrusted to an organ composed principally of technical experts chosen in such a way as to equitably represent both capital-exporting and capital-importing countries. Care should be taken to achieve an equitable representation of various economic interests rather than promoting an elitist group.

The formulation of the decision-making mechanism within Intertax would probably present the most serious difficulties. This is because nations will tend to look suspiciously at each other for fear of losing any significant amount of revenue if they do not control this decision-making process themselves. In the end, therefore, it would be of critical importance for the success of the organisation that it is viewed as being totally impartial in its decision-making process. In the case of the GATT, which has been suggested as a model to be emulated in the field of international taxation, one finds that although nominally all parties are regarded as equal, the fact is that the whole negotiating process is dominated by the major powers.²⁴ In an ideal world, this situation is unacceptable. New and more democratic arrangements should be found in order to compensate less powerful countries for the loss of part of their fiscal sovereignty. There arises, therefore, the question of voting power which is crucial to the eventual success of the organisation. The question of voting power or, in other words, the decision-making

²³ The Bretton Woods Conference held in Bretton Woods, New Hampshire, USA, in July 1944 resulted in the creation of the International Bank for Reconstruction and Development and the International Monetary Fund. See Chapter 2, Section III, 1, A, at 77.

²⁴ The Report of The Commission on Global Governance, *Our Global Neighbourhood* (Oxford: Oxford University Press, 1995), at 147.

process, is at the very heart of the distinction between the U.N., a relative failure in economic matters, and the IMF where the prevailing system of weighted voting rights has probably been responsible for its relative success in achieving its mandate.²⁵

The Report of the Commission on Global Governance shows that if the purchasing power parity basis is taken as the reference point, then the world's 10 biggest economies are, in descending order, Russia, Brazil, the U.K., India, Italy, France, Germany, Japan, China, and the U.S.²⁶ In fact, Mexico, Indonesia and the Republic of Korea are not far behind in these statistics. At the same time the share of output accounted for by Members of the OECD shrinks to barely half once the underlying purchasing power of economies measured at comparable prices is taken into account.²⁷ This new reality must be taken into consideration when allocating voting rights within Intertax because, as already argued, countries are more likely to cling to the concept of sovereignty if they believe that, in any international 'deal', their interests are ignored.

In performing its major obligation, that is, the administration of a multilateral taxation treaty and the application of formulary apportionment for the allocation of income derived by TNCs, Intertax will necessarily be confronted with inevitable disputes, which will need to be solved. It is therefore important to determine, at least in the broad terms, an acceptable mechanism for the settlement of these disputes. It is suggested that arbitration would be the ideal solution to deal with disputes arising in either the management of the organisation, or in its application of the provisions of the multilateral treaty it is supposed to administer. The crucial aspect of the procedure is that all parties must compulsorily submit to the award of the court of arbitration.

The idea for a court of arbitration in purely financial matters is not new. The International Centre for the Settlement of Investment Disputes (ICSID) was created as far back as 1965 by the Convention on the Settlement of Investment Disputes in order to promote the settlement of disputes relative to investments. Each Contracting State, whether or not it or any of its nationals have been party to the proceedings, is obliged to recognise an ICSID award and take the necessary steps to ensure that any pecuniary obligations imposed by the award are met as if it were a final judgment of one of its own courts.

The ICSID is by no means the only case where nation-states have voluntarily accepted to forgo some of their sovereign powers in monetary matters. At the European Council meeting in

²⁵ The recent difficulties faced by the IMF in dealing with the Asian crisis are however symptomatic of the inability of the organisation to deal with the consequences of globalisation with classical economic management tools which it has used since its inception.

²⁶ The Report of The Commission on Global Governance, *supra* note 24, at 148.

²⁷ *Supra* note 24, at 148.

Maastricht in 1991 an agreement was reached on a Treaty on Economic and Monetary Union (Treaty on EMU) which includes provisions for a central EU monetary authority whose objective is to formulate and implement a single monetary policy for the EU.²⁸ Although the scope of the Treaty on EMU is restricted to the EU, the point is that sovereign states are ready, in appropriate circumstances, to forgo some of their prerogatives even in such crucial areas as monetary policy. Consequently, if the necessary safeguards as to equitable and non-discriminatory treatment are afforded by Intertax under the control of a court of arbitration, then there are reasons to believe that compliance of the member states would be forthcoming.²⁹

2 A General Agreement for Taxes: A Realistic View

The idealistic view of the world that transcends national barriers has no chance of being implemented. Cooperation in the formulation of fiscal policy, more especially in the field of direct taxation, is still in its infancy even among countries within the EU. If the experience of the EU in the area of direct tax harmonisation is used as a guide, then, clearly, the task of trying to find a solution to the allocation problem that would be applicable on a worldwide basis is a practical impossibility.³⁰ Yet, the difficulty for most countries to determine their fair share of taxes arising from cross-border transactions is nonetheless real, as evidenced by the increasing complexity of international taxation legislation in most industrialised countries. What is therefore needed 'to stem the erosion of the capital income tax base - and preserve the income tax - is vastly increased multilateral cooperation among tax authorities, perhaps along the lines of the...GATT.'³¹

What are the prospects of creating a General Agreement on Tariffs, Trade and Taxes, to use an expression of Professor Slemrod?³² Is it more realistic to propose a worldwide tax institution of the 'weak' type akin to the GATT as proposed by Professor Vann?³³

²⁸ C.A. Whytock, 'Eurofed: Toward a European System of Central Banks and a European Central Bank', (1991-92) 23 *Law and Pol. Int'l Bus.* 469. The European Central Bank has now been created; see at <<http://www.ecb.int/>>.

²⁹ For a proposal to create an international tax court, see J. Azzi, 'Tackling Tax Treaty Tensions: Time to Think About an International Tax Court', (August/September 1998) 52 *Bulletin for International Fiscal Documentation* (No. 8/9) 344.

³⁰ For the latest thoughts on the problem of tax harmonisation in the EU, see S. James, 'Can We Harmonise Our Views on European Tax Harmonisation?', (June 2000) 54 *Bulletin for International Fiscal Documentation* (No. 6) 263.

³¹ J. Slemrod, 'What Makes a Nation Prosperous, What Makes it Competitive, and Which Goal Should We Strive For?', (1992) 9 *Australian Tax Forum* 373, at 384.

³² *Ibid.*

A A Reinforcement of the IMF/OECD Axis

Since taxation consumes a significant part of both the OECD and the IMF's resources, it may be argued that these two organisations should at least coordinate their action in this area. Lack of political will and inertia, however, may be such that 'the present will be the future'.³⁴ In other words, the status quo will be maintained so that the OECD will remain concerned with international taxation and the IMF will continue to provide expertise in domestic tax policy and tax administration to developing countries.

However, for several reasons, this immobility is unlikely to last. First, there is the magnitude of change occurring in all fields of human endeavour, particularly in computer technology and communications and the Internet.³⁵ If the case of global trading in financial instruments is taken as an example, it is clear that change in this area is impacting very significantly on the way such instruments are traded. Electronic commerce has tax consequences that are still being analysed by various institutions including the OECD and the U.S. Treasury with the view to offering a coherent system for the tax treatment of gains and losses thereon.³⁶

Second, as already noted, in many instances, former capital-importing countries are now exporting capital. In other words, and most significantly, capital flows are no longer totally unidirectional.³⁷ In addition, the traditional distinction between developed and less-developed countries (LDCs) cannot be applied to former Eastern bloc countries. Indeed, contrary to LDCs, the existing industrial capacity of these countries, though obsolete in many respects, is nevertheless real. As a result of all these mutations, the very premises of the present institutional arrangements are constantly being challenged.

Third, the emerging economic environment requires innovative solutions to double taxation, and protection of the tax base, obtaining a fair share of the tax pie, which are concerns relevant to all countries. In spite of this, the OECD continues to maintain a firm control of all developments in the area of tax treaties, which still remains the primary mechanism to

³³ R.J. Vann, 'A Model Tax Treaty for the Asian-Pacific Region?', (April 1991) 45 *Bull Int'l Fiscal Documentation* 151, at 156.

³⁴ R.J. Vann, 'The Future of International Tax Treaty or Institution? Small Step or Great Leap?' (1996), unpublished paper, at 55.

³⁵ See I. Barkan, 'Virtual Permanence: Consideration of the Virtual Office in International Income Tax Treaties with the United States', (Nov 1997) *Taxes* 648; I. Lejeune et al., 'Does Cyber-Commerce Necessitate a Revision of International Tax Concept?', (February 1998) *European Taxation* 50.

³⁶ See, for example, U.S. Department of Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce*, at <<http://www.fedworld.gov/pub/tel/internet.txt>>. See also, The Australian Taxation Office, *Tax and the Internet*, at <<http://www.ato.gov.au/ecp.htm>>.

³⁷ United Nations Conference on Trade and Development, *World Investment Report 1996, Overview*, (New York & Geneva: United Nations, 1996) (UNCTAD, Sales No. E. 96.II.A.14), at 6-8.

accommodate these pursuits. The IMF, for its part, has been forced in its dealings with the former Eastern bloc countries, to abandon its traditional insistence on the separation of technical assistance and conditionality in the tax area.

There are different ways in which these two major international organisations could react to this state of affairs. They may expand their commitments and re-examine their operating principles. This has already occurred, for example, with the OECD which is becoming more open to non-member countries. In addition, its 1995 Guidelines, whilst remaining international in its outlook, contains recommendations, which are quite prescriptive in the domestic area. It also contains provisions for peer review of their application, a critical development that will be examined further below. Furthermore, the OECD has a formal ruling function under the Convention for Mutual Administrative Assistance in Tax Matters; its mutual agreement procedure is being reinforced; and arbitration as a viable option for the settlement of tax disputes is being studied.

As already implied, the IMF is not directly concerned with international taxation issues. It has, however, encouraged the development of standardised fiscal mechanisms through the provision of uniform training packages to tax and treasury officials of its members. In addition, it has mounted a huge effort to modernise the tax administration capabilities of the former Eastern bloc countries. In fact, its action has informally produced a certain harmonisation of the tax systems being implemented in those jurisdictions.

It would seem, therefore, that both the OECD and the IMF are deliberately opting for preserving each other's precinct without engaging in open competition, although the reality of such competition can be seen in the activities of both organisations in Eastern and Central Europe. Competition with other institutions, such as the WTO, is also a substantial risk as direct taxation becomes the focus of trade measures.

Nevertheless, these two organisations may well consider more seriously the option of entering into cooperative arrangements, or to use a fashionable expression, a strategic alliance, to facilitate their work.³⁸ To start with, it would be advisable if they were to carve up their respective spheres of influence in order to avoid wasteful competition which indeed is damaging to both. In the long run, however, these organisations could seek a merger of their fiscal affairs divisions into an international organisation dealing exclusively with taxation.

Formal cooperative mechanisms between the IMF, the EU, the OECD and the WTO are already in place. The OECD has pledged to work with non-OECD member countries and other tax organizations such as CIAT, CATA, IOTA, and the United Nations ad hoc group of

³⁸ See Chapter 2, Section, III, 1, B, at 79.

experts on international tax matters.³⁹ Thus, for example, apart from the Joint Vienna Institute, or the Joint Africa Institute, representatives of the EU and the IMF routinely attend the meeting of the OECD's Committee on Fiscal Affairs. A conceivable solution could well be the formation of an international organisation designed to deal exclusively with international taxation, incorporating those features of the OECD and the IMF, which have already proved their usefulness. Such an institution may even be set up by the combined efforts of these two organisations. More remotely, what if they were to merge into a new organisation given that their complementary functions would probably facilitate that operation? The complementarity of these organisations has been recognised recently. Indeed, as mentioned earlier, the G-7 countries are much in favour of the setting up of codes and standards with:

the Fund [IMF], World Bank, OECD and the international regulatory and supervisory organisations to work closely together to provide advice and, where necessary, assistance to countries to help them meet these internationally agreed codes and standards.⁴⁰

B A Conceivable Institution

Embryonic institutions designed to harness the globalisation process are therefore already in gestation. As will be shown further on, others are being contemplated, for example, in the field of accounting or, more broadly, in the financial sector.

In the words of Vito Tanzi:

[A] keen observer must have noted the growing role that international institutions (such as DJF, the OECD, the WTO, YMO, the World Bank, the BIS, the UN, and so on) are playing in connection with issues with international ramifications. Such a role is at times controversial but most observers seem to accept the legitimacy of these institutions even though they may criticize some of their actions or policies.⁴¹

Notwithstanding this trend to deal with international economic affairs through specialised international institutions:

[T]he keen observer must also have noted that there is now no international institution responsible for dealing with the cross-border externalities or spillovers created by tax systems.⁴²

³⁹ See C. Gnaedinger, 'OECD Announces New Measures for Easing Tax Authorities' Access to Bank Information' (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1725, at 1726.

⁴⁰ Declaration of G-7 Finance Ministers and Central Bank Governors, (30 October 1998) reproduced in *Notable Quotations about the IASC*, *supra* note 22, at 4.

⁴¹ Tanzi, *supra* note 1, at 338.

⁴² *Supra* note 1, at 338.

i The Progress Towards an International Tax Institution

The passing of tax jurisdiction from national to international jurisdiction is, in the words of Professor Vann, a multifaceted process.⁴³ Most international organisations concerned with economic matters are also required to deal with taxation. Consequently, a certain convergence of these heterogeneous efforts is necessary. The objective meeting point for this convergence may well be some special forum designed to coordinate the various informal working arrangements, which already exist among current international organisations.

An example of a coordinating body, which might exercise quasi-supranational powers in the future, is already in place in the tax administration field. This is the coordinating body established by the Convention on Mutual Administrative Assistance in Tax Matters (MAATM) sponsored by the OECD and the Council of Europe.⁴⁴ The Convention provides, as already discussed,⁴⁵ for the multilateral exchange of information and mutual administrative assistance in recovering tax claims in participating countries. Significantly, the Convention marks a real departure from bilateral tax treaties in that it provides for international cooperation in recovering taxes. Articles 24(3) and (4) of the Convention provide for a coordinating body to 'monitor the implementation and development of this Convention, under the aegis of the OECD.'⁴⁶ The body is to be made up of representatives of signatories. Pursuant to Article 24(4), if one of the signatories so requests, the coordinating body needs 'to furnish opinions on the interpretation of the provisions of the Convention'.⁴⁷ The coordinating body is at this stage a sub-set of Working Party No. 8 on Tax Avoidance and Evasion of the OECD Committee of Fiscal Affairs.⁴⁸ However, if in the future non-OECD Members become parties to the Convention, this coordinating body may well take on an independent life whilst being closely tied to the OECD. This possibility for the coordinating 'body becoming a quasi-judicial forum is acknowledged in the Commentary on Article 24.'⁴⁹

The evolution in proposed solutions to the problem of compliance and administration in international taxation from a bilateral to a multilateral level is also significant in the more specific

⁴³ Vann, *supra* note 34, at 55.

⁴⁴ 'Convention on Mutual Administrative Assistance in Tax Matters', (1988) 27 *International Legal Materials* 1164.

⁴⁵ See Chapter 3, Section I, 2, A, ii, at 105.

⁴⁶ 'Convention on Mutual Administrative Assistance in Tax Matters', *supra* note 44, Article 24(3), at 1172.

⁴⁷ *Supra* note 46, at 1172.

⁴⁸ Vann, *supra* note 34, at 21.

⁴⁹ A. Fletcher, 'International Agreements - *The Convention on Mutual Administrative Assistance in Tax Matters*', (1989) 30 *Harvard International Law Journal* 514, at 518.

area of transfer pricing. The point of reference in this sector is the OECD 1995 Guidelines.⁵⁰ While the Guidelines deal basically with transfer pricing issues and other related tax issues with respect to multinational enterprises,⁵¹ ‘what may prove to be of most importance in the future is the public agreement of OECD countries to subject themselves to a process of peer review in the transfer pricing area.’⁵² Although this was already happening on an informal basis, the point is that the role of the OECD as an arbiter in the taxation area is gradually being strengthened. This process of a gradual surrender of tax jurisdiction from the national to the international level is thus being achieved in a gradual way within the existing treaty domain.⁵³

The influence of broad international economic principles on international taxation principles has already been examined.⁵⁴ This interaction is becoming increasingly significant and may lead to a new international order in the field of taxation. When one considers the trend set by standards such as the most favoured nation (MFN) principle, the national treatment (non-discrimination) obligation, or other trade and investment agreements prohibiting expropriations, for example, the Multilateral Agreement on Investment (MAI), although now on hold, one may perceive a steady movement towards the creation of an embryonic tax organisation. However, to accelerate this process, it may well be that a carve out of the taxation measures contained in these international economic principles should first be agreed upon and then transferred to an organisation specifically designed to deal with the numerous issues arising from the encounter of international business taxation and international economic principles. After all, the WTO, and especially GATS, deal, *inter alia*, with tariffs which are basically a special kind of tax on commodities so that now, in a world where trade in services, in ideas and in other intangibles is growing, the need for a multilateral treaty dealing with the taxation issues arising from this type of trade has become a fundamental necessity.⁵⁵

There are other strands now being explored in the present system of international taxation that may ultimately be considered as a prelude to the formation of a more conventional international tax organisation, for instance, the availability of the simultaneous tax examination, defined as ‘an arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or

⁵⁰ OECD, *Transfer Pricing Guidelines For Multinational Enterprises and Tax Administrations* (Paris: OECD 1995), (OECD 1995 Guidelines).

⁵¹ *Id.*, at P-4.

⁵² Vann, *supra* note 34, at 23. See also, the OECD 1995 Guidelines, *supra* note 50, Revised Recommendation of the Council Recommendation in the Appendix, at A-3.

⁵³ Vann, *supra* note 34, at 23.

⁵⁴ See Chapter 3, Section III, at 127ff.

⁵⁵ Slemrod, *supra* note 31, at 384.

related interest with a view to exchanging any relevant information which they so obtain.⁵⁶ A simultaneous examination is a form of mutual assistance that allows countries to cooperate in tax investigations. The procedure is authorised pursuant to Article 26 of the OECD Model Tax Convention.⁵⁷ Article 8 of MAATM also authorises the conduct of simultaneous tax examinations.⁵⁸ Furthermore, pursuant to Article 9 of the Convention, a country requesting a tax examination to be carried out by another may also request that its representatives be allowed to be present in the other country when the examination is being conducted. Acceptance by the requested state is optional rather than imperative. Nonetheless, if such a request is accepted, it is arguable that the requested state, by allowing foreign fiscal representatives on its territory, is agreeing to limit its sovereignty in fiscal matters.⁵⁹ Given that this convention is multilateral and that its implementation is to be coordinated by a body composed of the representatives of the competent authorities of the parties pursuant to Article 24 of the Convention, it is arguable that it provides yet more evidence of a subtle move towards the creation of an international organisation to which its members will devolve some of their fiscal sovereignty.

In recent years, there has been a widespread use of Advance Pricing Arrangements (APAs) as a method of cooperation between tax administration and taxpayers in the transfer pricing area.⁶⁰ In 1994, anticipating a wider use of this procedure, the Pacific Association of Tax Administrators (PATA), grouping Australia, Canada, Japan and the U.S., agreed to a standardised process in handling the competent authority aspects of bilateral APAs involving its members.⁶¹ As for the OECD, its 1995 Guidelines admit that APAs could aid in resolving transfer pricing disputes and avoid double taxation,⁶² and it recommends that APAs be concluded on a bilateral or multilateral basis. In 1999, in order to harmonise standards in regard to APAs, the OECD released its guidelines thereon.⁶³ In the words of Jeffrey Owens,

⁵⁶ OECD, *Model Agreement for the Undertaking of Simultaneous Tax Examinations* (Note by the Secretary-General [C(92) 81 (Final)] in R. Vann, OECD Proceedings, *Tax Treaties: Linkages Between OECD Member Countries and Dynamic Non-Member Countries* (Paris: OECD, 1996). See also, the OECD 1995 Guidelines, *supra* note 50, at 4.84-4.93 for an examination of the procedures to be followed for a simultaneous examination in the transfer pricing context and the advantages thereon.

⁵⁷ OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and Capital* (OECD: Paris 1992) looseleaf (1997 update), at M-49. (Note: A 2000 update is now available.)

⁵⁸ 'Convention on Mutual Administrative Assistance in Tax Matters', *supra* note 44, at 1167.

⁵⁹ V. Morgan, 'Mutual Administrative Assistance in Tax Matters', (1988) 36 *Can. Tax J.*, 974, at 985.

⁶⁰ See Chapter 3, Section, I, 2, B, ii, at 109.

⁶¹ *Id.*, at 572.

⁶² OECD 1995 Guidelines, *supra* note 50, at 4.146.

⁶³ OECD, Committee on Fiscal Affairs, *Guidelines for Conducting Advance Pricing Arrangements Under the Mutual Agreement Procedure* (Paris: OECD, 1999), DAF/CF/WP6(99)1.

the head of the Fiscal Division of the OECD, these guidelines are meant to propose ‘some type of international APA standards’.⁶⁴ However, one must keep in mind that whilst the APA is a practical solution to transfer pricing issues, it is nonetheless a time-consuming process and ‘is certainly not optimal from a policy perspective.’⁶⁵

Moreover, again in the field of international tax administration, and in relation to the mutual agreement procedure (MAP) of Article 25 of the OECD Model Tax Convention on Income and Capital,⁶⁶ there is renewed interest in the development of arbitration as a means of dealing with tax disputes. The MAP is an example of how cooperation between fiscal authorities is managed in order to reach an acceptable outcome for all parties concerned, including a taxpayer. The MAP may be considered as the most significant effort to deal with transfer pricing and other allocation questions that ‘are by far the most important source of international disputes’.⁶⁷ The MAP has, however, some important shortcomings.⁶⁸ Consequently, the OECD has sought to strengthen Article 25. Thus, for example, the OECD 1995 Guidelines⁶⁹ propose certain recommendations designed to address these concerns. Recently, two other difficulties have arisen relative to the MAP. First, there is the emerging use of secret comparables in competent authority cases which, in the words of the former U.S. Competent Authority (CA), ‘poses an immediate threat to competent authority procedures’.⁷⁰ Indeed, the release of ‘secret comparables to third parties to support tax adjustments would violate the tax return confidentiality provisions of section 6103 of the U.S. Internal Revenue Code.’⁷¹ The second threat to the MAP comes from the uncertainty resulting from the lawsuits initiated by Tax Analysts, the publisher of *World Tax Daily* and *Tax Notes International* under the U.S. Freedom of Information Act (FOIA) seeking access to advance pricing agreements, the records of the Pacific Association of Tax Administrators, and field service advice. The

⁶⁴ Anonymous, ‘A Global Review of Advance Pricing Agreements’, (14 August 1996) 5 *Tax Management Transfer Pricing Special Report, Report No. 22*, at 5.

⁶⁵ J. VanderWolk, ‘Direct Taxation in the Internet Age: A Fundamental Approach’, (April 2000) 54 *Bulletin for International Fiscal Documentation* (No. 4) 173, at 174.

⁶⁶ OECD (1992), *supra* note 57, at M-47.

⁶⁷ G.K. Kwatra, ‘Arbitration in International Tax Disputes: A New Approach’, (1988) 5 *Journal of International Arbitration* 151, at 153.

⁶⁸ *Id.*, at 155-57. See also I.P.A Stitt, ‘International Tax: Avoiding Parochialism’, [1997]1 *BTR*9, at 30, where the author suggests that in his personal experience, and because of limited available evidence, ‘the Mutual Agreement Procedure (or Competent Authority) procedures do not provide an acceptable or satisfactory answer, and are very costly both in terms of time and money.’

⁶⁹ OECD 1995 Guidelines, *supra* note 50, at para. 4.40-4.66.

⁷⁰ A. Fernandez & T.F. Field, ‘Canadian Tax Foundation Holds First World Tax Conference’, (6 March 2000) 20 *Tax Notes Int’l* (No. 10) 1056, at 1057.

⁷¹ *Ibid.*

provision of information by a foreign jurisdiction is made on the assumption that such information should remain confidential. If the U.S. were to disclose this information, the confidence of foreign tax officials in the MAP procedure would be severely curtailed and would give rise to serious disputes between various CAs.

Such disputes have always arisen in the past, so much so in fact that, since 1972 at least, there have been discussions in various forums, for example, the OECD, the International Fiscal Association, and the International Chamber of Commerce, to find other acceptable methods for settling international tax disputes.⁷² Arbitration in tax matters has been proposed as a possible solution. It has, however, been argued that the availability of arbitration, rather than arbitration itself, may be a powerful incentive for parties to reach a resolution under the MAP in order to prevent the intervention of third parties.⁷³ A potent example where use of arbitration is provided for is the EU Convention on Arbitration⁷⁴ in transfer pricing which came into effect on 1 January 1995 for a period of five years.⁷⁵ It expired but was extended for a further five-year period from 1 January 2000.⁷⁶ The Convention provides for a mandatory arbitration procedure whose mechanics have already been examined.⁷⁷ The OECD, for its part, notes in its 1995 Guidelines that, as 'trade and investment have taken on an increasingly international character, the tax disputes that, on occasion, arise from such activities have likewise become increasingly international.'⁷⁸ Therefore, in order to deal with these disputes, the OECD Committee on Fiscal Affairs has agreed to undertake a study on the topic of arbitration in the context of transfer pricing, which will eventually be incorporated in the Guidelines.

Recently, those welcome but as yet incomplete moves towards enhancing cooperation between countries through institutional means have been boosted by the OECD's bold move against what it terms harmful tax competition. Basically, the major effect of the OECD's intervention is that it has initiated an evolution of the present system of international

⁷² For a brief historical account of these efforts, see Kwatra, *supra* note 67, at 158-61.

⁷³ Vann, *supra* note 34, at 21.

⁷⁴ There is a debate as to whether the convention should be known as the 'EC Arbitration Convention' or the 'EU Arbitration Convention'. See J.H.J Bourgeois, 'EC or EU: More than a Question of Semantics' [1995] EC Tax Review 188.

⁷⁵ For an analysis of the EU Convention, see F.J. Kolb, 'Pros and Cons of the EC Arbitration Convention', (22 July 1996) 13 *Tax Notes Int'l* 241, and L. Hinnekens, 'The European Tax Arbitration Convention and its Legal Framework-I', [1996] 2 *BTR* 132 & [1996] 3 *BTR* 272.

⁷⁶ Anonymous, 'Extension of the E.C. Arbitration Convention', [1998] *BTR* 389.

⁷⁷ Basically, the Convention is a mechanism to ensure that the signatory states do not end up causing double taxation when they initiate transfer pricing adjustment. See Chapter 3, Section I, 2, B, i-iii, at 106ff.

⁷⁸ OECD 1995 Guidelines, *supra* note 50, at para. 4.167.

cooperation from a purely monitoring role into one characterised by intervention, albeit indirectly, through peer pressure. This novel approach is illustrated by the mechanism set up to deal with the most blatant cases of harmful tax competition. At present, countries no longer compete with one another through the use of tariffs, non-tariff barriers, or quantitative restrictions. Rather, competition is often driven by such measures as tax incentives, decreases in tax rates, or the abandonment of some types of taxes, for example, withholding taxes. Whilst competition often maximises welfare, clearly when these methods aim at securing an advantage at the expense of another country's tax base, then it seems logical that intervention is required. The OECD's determination to deal with such harmful tax competition has already been mentioned.⁷⁹ However, what is really significant for the present discussion is the means by which the OECD intends to use to deal with the problem. In its endeavour to phase out harmful tax measures by 31 December 2005,⁸⁰ perhaps the most important of the 19 detailed recommendations proposed by the OECD⁸¹ is the establishment of the Forum on Harmful Tax Practice. This Forum 'is the first broadly mandated international institutional structure directly responsible for the evaluation and coordination of existing and proposed tax measures.'⁸² The operational aspects of the Forum, it is submitted, come very close to what an international tax organisation of the 'weak' type ought to be doing, as mentioned earlier. For an initial period of two years the Forum will carry out cross-country reviews designed to determine which countries use preferential tax regimes and in what instances these regimes become harmful. Once this information is available, countries that do have these regimes will be requested to remove them. After the review process, a country may request the Forum to examine any measure taken by another country which it considers to be harmful. If the Forum does find that a tax measure is indeed a harmful practice, then the country at fault will be requested to remove the offending measure though the Forum's recommendations are not binding. However 'the existence of an opinion that a domestic measure is in violation of important political commitments undertaken by a Member country should have a strong impact.'⁸³

Moreover, since the OECD intends to associate non-member countries to this process, it is reasonable to infer that the Forum may well have a significant impact on the fiscal policies of all major economies in the coming years. The real test for this initiative will be whether both

⁷⁹ See Chapter 5, Section III, 1, B, at 226ff.

⁸⁰ B. Zagaris, 'The Assault on Low Tax Jurisdictions: A Call for Balance Debate', (13 August 1999) 28 *Tax Management International Journal*, (No. 8) 474, at 486.

⁸¹ J. Weiner & H. Ault, 'The OECD's Report on Harmful Tax Competition', (September 1998) 51 *National Tax Journal*, (No. 3) 601, at 605.

⁸² *Id.*, at 606.

⁸³ *Id.*, at 607.

OECD and non-OECD countries are prepared to commit to a program that significantly reduces their sovereignty in fiscal matters.⁸⁴

To sum up then, it is clear that, as a result of both intrinsic and extrinsic pressures on the existing principles of international taxation, a variety of avenues are now being explored in order to enhance international cooperation in tax matters. There also arises the question of the relationship between proposed solutions and, most significantly, the cumulative impact of these developments on the future of international taxation. The fact that ‘international taxation is moving to a higher plane cannot be understated.’⁸⁵ The conclusion is that the newly found cooperation between the existing various international organisations concerned with taxation on the one hand, and the emergence of new rules, practices, and dispute resolution which need to be coordinated by various institutions on the other, already amount to an embryonic tax organisation. However, as Professor Vann observed, ‘it remains an open question whether and how the new developments can be given recognition as amounting to an international tax institution.’⁸⁶

ii. The Operational Aspects of Intertax

The creation of Intertax under a multilateral treaty would free the principles of international taxation from the constraints of the current bilateral structure into which they are forged. Thus, for example, under a multilateral approach, the strict reciprocity that characterises bilateral treaties could be abandoned. This means that countries would be able to adopt different tax ceilings applicable to TNCs operating within their jurisdiction and ‘those rates would automatically be extended to all parties to the treaty irrespective of whether other countries adopted the same or different rates.’⁸⁷ This arrangement is particularly important in the proposed model where, as will be examined later, governments would be free to apply to their allocated share of the tax base whatever tax rate they think fit in order to achieve their economic objectives.

Furthermore, the flexibility of a multilateral convention is such that parties could opt out of certain parts provided these are not the core provisions instituting the proposed model. These core provisions should be minimal with progressively more binding undertakings as Intertax

⁸⁴ S.M. Lyons, ‘OECD Initiates Crusade Against Harmful Tax Competition’, (June 1998) 25 *Tax Planning International Tax Review* (No. 6) 12, at 13. The Forum is also required to draw a list of tax havens given that the OECD Report on harmful tax competition recommends certain measures designed to strip them of their attractiveness in tax minimisation schemes. See Chapter 5, Section III, 1, B, I, at 226ff.

⁸⁵ Vann, *supra* note 34, at 23.

⁸⁶ *Supra* note 34, at 47.

⁸⁷ Vann, *supra* note 33, at 157.

moves slowly towards becoming a stronger institution. Again, the analogy with the GATT is appropriate. Over the years the number of binding commitments under the GATT have increased although countries still have much latitude in deciding which part of the agreement would bind them. It is arguable that uncertainty in international taxation might emerge if countries are allowed to avail themselves of too many flexible rules in the convention. After all, in the transfer pricing area, the whole purpose of APAs is to achieve certainty of outcome for both the taxpayer and the taxation authorities. Certainty is achievable if Intertax were to provide authoritative binding determinations on the contents of the rules it is required to administer. Thus, the presence of an interpretative body charged with producing an increasingly detailed jurisprudence relative to the agreed rules makes it possible, in the multilateral context with an international tax institution, to assist in achieving a certain uniformity of tax systems. Obviously, an organisation of the 'weak' type may find it particularly difficult to impose such rules unless they are particularly flexible. However, rather than adopting positive prescriptions whose success could be uncertain, Intertax could proceed by way of negative rules, or what has been called 'negative harmonisation'.⁸⁸ Reliance on negative rules implies that Intertax would regulate what tax systems cannot do, rather than what they should do. Countries would thus be able to maintain an appearance of control on their tax systems. Any factual surrender to an external body could be presented to the nation as merely being in the nature of a peer review rather than a capitulation to a supranational body.

In providing for authoritative binding determinations, Intertax would stand as an arbiter between the competitive interests of its members. A more formal aspect of this function would be the presence of some kind of dispute resolution mechanism exercisable by the institution. As already suggested, arbitration would be an adequate way to resolve any disputes that would arise between Intertax member states. It is inevitable that arbitration would become a standard practice in international taxation because of the evolution of ideas and the pressures from other economic sectors where the procedure is prevalent. Thus, the presence of an international tax institution will also tend to satisfy the desire of tax officials to retain the right to resolve tax disputes through the MAP as expressed in the 1995 update of the OECD Model.⁸⁹

The consolidation of corporate group accounts for taxation purposes, by eliminating intra-group transactions, would identify an indisputable tax base.⁹⁰ Once this is achieved, the second

⁸⁸ Vann, *supra* note 34, at 40.

⁸⁹ OECD (1992), *supra* note 57, Commentary on Article 25, at paras 44.1-44.7.

⁹⁰ See S. Plasschaert, 'An EU Tax on the Consolidated Profits of Multinational Enterprises', (January 1997) 37 *European Taxation* 2, at 10.

step requires that Intertax determines each country's share of that base. To do so, an appropriate formula will need to be used. Once each country's share is established, that country would be free to apply whatever tax rate it believes is conducive to achieving its fiscal objectives provided these rates remain within an agreed band. The residence country would then decide how to tax its share of the income.

C The Advantages of the Proposed Institutional Approach

The proposed institutional approach would deal simultaneously with several of the most acute problems identified with the present system of international business taxation. First, the recharacterisation of income under the proposed system loses its effectiveness within a TNC. This is because of the elimination of intra-group transactions resulting from the consolidation process. Similarly, it would lose its attractiveness outside the group as a result of the division of the tax base by means of an appropriate formula and the application of single-source country taxation.

Second, the choice of a formulary apportionment methodology over the arm's length principle has often been demonstrated as being theoretically correct. Thus, according to Professor Peggy Musgrave:

[F]ormula apportionment under the unitary approach...recognises the integrated nature of the related parts of the modern business enterprise and avoids the arbitrariness inherent in intra-firm pricing. Most important, it allows the application of a formula designed to be consistent with equity principles, that is, to conform with 'fair share' standards.⁹¹

Formulary apportionment applied on worldwide consolidated profits of TNCs administered by Intertax is therefore a viable method to capture the synergy profits arising from the interdependence of various entities forming part of a TNC.⁹² This holistic method also bypasses the problem of defining a unitary enterprise.⁹³

Third, consolidation eliminates treaty shopping which is often used to either recharacterise income or divert it to more favourable jurisdictions.⁹⁴ Under the proposed system, treaty shopping is effectively dealt with since a share of the international tax base is allocated to a particular country only if it has effectively contributed to the derivation of that base. This is

⁹¹ P.B. Musgrave, 'Tax-Base Shares: The Unitary Versus Separate Entity Approaches', (1979) *Thirty-First Tax Conference, International Intercompany Pricing* 445, at 447.

⁹² P.B. Musgrave, 'International Tax Base Division and the Multinational Corporation', (1972) *27 Public Finance* 394, at 407.

⁹³ It would appear that TNCs might be favourable to the consolidation of profits, at least in the EU context; see, for example, the arguments of Tabaksblat of Unilever in M. Tabaksblat, 'The Harmonisation of Corporation Tax in the EC: The views of a Multinational', (1993) *Intertax* (No. 1) 16-19.

⁹⁴ Plasschaert, *supra* note 90, at 11.

achieved by the formula that encapsulates all the factors which would have contributed to that derivation.

Clearly, a tax haven, where most conduit companies are situated, does not contribute to the tax base because these conduit companies do not carry any real operation in the jurisdiction. Consequently, the apportionment formula would apportion nothing to the tax haven.

Fourth, thin capitalisation ceases to be a concern because interest payments between members of the TNC are ignored, just as any other intra-firm remuneration. Interest payments by the TNC to third parties would still have to be considered but only for establishing the total tax base subject to division.⁹⁵

Fifth, controlled foreign corporation (CFC) legislation would become obsolete because the consolidation function on which it is based would be carried out for the purpose of defining the corporate group's international tax base. This would then provide the residence country with a comprehensive tax base which it could tax. Consolidation eliminates the problem of deferral, that is, the postponement of tax on foreign income of a resident taxpayer until it is repatriated.

Sixth, with a single tax authority to police the allocation to each country of its fair share of the tax base, the risk of international double taxation is eliminated. Thus 'the allocational efficiency of the new system would also score better than the present highly contorted roundabout procedures under the separate entity paradigm.'⁹⁶

Finally, foreign exchange transactions and finance leases within TNCs would also be effectively dealt with. However, as shown below, it will be necessary to have consistent rules regarding currency translations, that is, the conversion of the currency used for tax accounts by various TNCs into the currencies of the various countries sharing the tax base.

The consolidation approach through a multilateral effort subject to the surveillance authority of Intertax will result in a dramatic improvement of the present international tax scene, but in order for Intertax to achieve its objective, agreement on certain technical points needs to be achieved. How is the tax base to be defined? In this regard, it is important to note that what Intertax needs to achieve is not strictly speaking the definition of each country's tax base. Rather, it only needs to determine the accounting profits of TNCs using a set of international accounting standards, and then to apportion this 'base' to each country entitled to tax by means of certain reasonable apportionment formulas.

⁹⁵ Back-to-back loans involving third parties which have to be identified for effective thin capitalisation rules in the current tax environment would only create timing problems under the consolidation approach. Such timing problems arise because of mismatches of interest paid and corresponding income received. However, these could, according to Professor Vann, be disregarded. See Vann, *supra* note 33, at 159.

⁹⁶ Plasschaert, *supra* note 90, at 11.

Section II Implementing Harmonised Accounting Standards

In order for a global formulary approach to be properly and equitably applied on a worldwide basis, TNCs must be required to lodge with Intertax accounting and other financial records kept in a standardised fashion, disclosing comparable information. Therefore, the need to determine the commercial profits of TNCs on the basis of standardised international accounting principles is of paramount importance for the success of the system.

1 The Need for the Harmonisation of Accounting Principles and Policies

One of the numerous consequences of the emergence of a global market economy and new information technologies is the perception that in order to maximise efficiency a certain degree of harmonisation of financial reporting and disclosure standards is essential.⁹⁷ Several organisations are at the forefront of the harmonisation of accounting standards movement. The International Accounting Standards Committee (IASC), the International Organisation of Securities Commissions (IOSCO), the U.N., the OECD, and the EU are all interested in the issue. Whilst it is arguable that harmonised accounting and disclosure standards would facilitate business taxation, it must be borne in mind that such harmonised standards would first and foremost ‘help market forces to impose discipline and thus improve financial stability’.⁹⁸ Indeed, the inherent feature of financial transactions is that they all involve a degree of credit risk. Therefore, it is crucial for counterparties to reasonably determine the extent of this risk by accessing transparent and harmonised accounting data.

A The Advantages of a Harmonised Accounting System

The laws of various nations may be brought closer together by three methods: unification, standardisation, and harmonisation.⁹⁹ The first two are more readily relevant when political union is contemplated, for example. Harmonisation, which has been described as ‘a movement away from total diversity of practice,’¹⁰⁰ may be viewed from two distinct viewpoints: formal

⁹⁷ Australia, Corporate Law Economic Reform Program, *Policy Framework* (Canberra: AGPS, 1997), at 2.

⁹⁸ W.R. White, *International Agreements in the Area of Banking and Finance: Accomplishments and Outstanding Issues* (Basle: Bank for International Settlements, October 1996), at <<http://www.bis.org/publ/work38.pdf>>.

⁹⁹ R.J. Vann, ‘Improving Tax Law Improvement: An International Perspective’, (1995) 12 *Australian Tax Forum* 193, at 206.

¹⁰⁰ J.S.W. Tay & R.H. Parker, ‘Measuring International Harmonisation and Standardisation’, (1990) 26 *Abacus* (No. 1) 157-69, in A. Tarca, ‘The Measurement of International Harmonisation in Financial Reporting’, (1998) 8 *Australian Tax Forum* (No. 1) 13.

and material harmonisation. Formal harmonisation is defined as ‘the degree of similarity existing among the sets of financial standards of various nations,’¹⁰¹ whereas material harmonisation is defined as ‘the degree of similarity among financial reports of enterprises’.¹⁰² In the present context, if formal harmonisation is achieved on an international level, then material harmonisation is likely to follow in practice. For Intertax to operate efficiently it is essential to achieve the harmonisation of accounting principles and policies including the harmonisation of consolidation methods.

Much has been said about the enormous expansion in foreign investments made by TNCs both in developed and developing countries. In fact, many governments are truly incapable of monitoring foreign investors on the basis of information available through the use of present accounting standards. This defect has not gone unnoticed in the U.S. where Congress, in legislation passed in 1996, recognised that:

a high-quality comprehensive set of generally accepted international accounting standards would generally facilitate international financing activities and, most significantly, would enhance the ability of foreign corporations to access and list in the United States Markets.¹⁰³

The potential revenue loss arising from the dysfunctionalities of different accounting standards interacting with each other in one global market is enormous as shown by figures published by the U.S. General Accounting Office (GAO).¹⁰⁴ On the other hand, it is arguable that a rationalisation of accounting standards is likely to have beneficial consequences for TNCs, given that ‘disclosure requirements increase the confidence of individual investors in the

¹⁰¹ L.G. Van der Tas, ‘Measuring Harmonization of Financial Reporting Practice’, (Spring, 1988) *Accounting and Business Research* 157-69, in H.I. Wolk & P.H. Heaston, ‘Toward the Harmonization of Accounting Standards: An Analytical Framework’, (1992) 27 *The International Journal of Accounting* 95, at 96.

¹⁰² *Ibid.*

¹⁰³ P. Pacter, ‘International Accounting Standards: The Worlds Standards by 2002’, (July 1998) CPA Journal, at <<http://www.iasc.org.uk/>>.

¹⁰⁴ United States, General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* Report to the Ranking Minority Member, Committee on Foreign Relations, U.S. Senate GAO/GGD-92-89 (1992). Although these findings have been disputed, work by the U.S. Internal Revenue Service tends to support them. See U.S. Department of the Treasury, Internal Revenue Service, *Report on the Application and Administration of Section 482* (Washington, D.C.) (April 1992). Moreover, in a report to the Honorable Byron L Dorgan, U.S. Senate published in March 1999, GAO updated its findings on ‘the nonpayment of U.S. income taxes by foreign-controlled corporations (FCC) and U.S.-controlled corporations (USCC).’ The report (1999 GAO Report) confirmed the earlier findings given that ‘between 1989 and 1995, the latest years for which data were available...a majority of corporations, both foreign- and U.S.-controlled, paid no U.S. income tax.’ See United States, General Accounting Office, *Tax Administration: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95*, (23 March 1999) GAO/ GGD-99-39, at <<http://www.gao.gov/>>.

fairness and integrity of financial markets and, by fostering confidence, encourage investments.¹⁰⁵

The objective of financial statements, as recognised by the U.N. Working Group of Experts on International Standards of Accounting and Reporting, is 'to provide information about the financial position, performance and changes in financial position of an enterprise, which is useful to a wide range of users in making decisions...'¹⁰⁶

The primary source of information on TNCs is their general purpose annual report. The diversity of users of general purpose reports is great and consists, for example, of creditors, suppliers, investors, employees, government bodies, and the general public. If the focus is maintained on the need of governments, then it is fairly obvious that governments require more specific data in order to elicit specific information relevant to their revenue collection function as well as for other policy decisions. In addition, as a result of the internationalisation of capital markets, market operators worldwide are becoming more aware of the need for one common business and accounting language.¹⁰⁷ Such uniformity would promote greater confidence in both the financial and non-financial information in TNC reports enabling investors to properly assess the risks of particular investment opportunities.¹⁰⁸

In general, the range of information disclosed in TNC financial accounts needs to be broadened in order to provide relevant, reliable, neutral and comparable information.¹⁰⁹ To achieve these objectives, agreement on a worldwide basis 'on a body of information necessary to form such a nucleus and to harmonise the differing methodologies used to quantify those data'¹¹⁰ is essential.

Currently, there are fundamental differences in the ways in which financial information is presented around the world. For example, consolidation of accounts is by no means a universal practice, even in certain industrialised countries.¹¹¹ In some countries there is an

¹⁰⁵ Australia, Corporate Law Economic Reform Program, *Policy Framework*, *supra* note 97, at 3.3.

¹⁰⁶ United Nations, 'Conclusions on Accounting and Reporting by Transnational Corporations', *The Group of Experts on International Standards of Accounting and Reporting* UNCTAD/DTCI/1 (New York and Geneva: United Nations, 1994) 5.

¹⁰⁷ See F.D.S. Choi, 'Global Consequences of International Accounting Diversity', (October 1998) *Accounting and Business* reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁰⁸ Australia, Corporate Law Economic Reform Program, *Policy Framework*, *supra* note 97, at 3.2.

¹⁰⁹ For an analysis of these requirements, see Australia, Corporate Law Economic Reform Program, Proposal for Reform: Paper No. 1, *Building International Opportunities for Australian Business* (Canberra: AGPS, 1997) 14.

¹¹⁰ B.S. Thomas, 'International Accounting and Reporting - Developments Leading to the Harmonization of Standards', (1983) 15 *New York J Int'l L and Politics* 517, at 520.

¹¹¹ *Id.*, at 520-25. In this regard, the Ralph Committee's report on the reform of business taxation in Australia arguing for the adoption of a comprehensive consolidation states that: '[The] Committee sees consolidation as

actual or practical linkage between income tax and financial reporting, which results in a clash between the needs of fiscal authorities and the needs of other users. Again, in such areas as leases, or foreign currency translations, significant differences exist. The periodicity of financial statements also varies widely. In some jurisdictions a statement as to the source and application of funds is not required. Finally, there are wide variations as to the standard qualification of independent auditors and audit examinations of financial statements.

B Efforts to Harmonise

Calls for more uniformity in the accounting laws, albeit in the American context, were made as far back as at the first International Congress of Public Accountants held in September 1904 in St Louis, Missouri.¹¹² President John F Kennedy's address to the Eight International Congress of Accountants held in New York in September 1962 clearly demonstrates that at the political level, at least at that time, the advantages of achieving uniformity on a worldwide basis were clearly understood. The President said:

[Y]our Congress, meeting at the invitation of the American Institute of CPAs, offers an excellent opportunity for the exchange of information and ideas. As we gain confidence in each other's policies of economic disclosures, accounting can indeed become an international language of business. As a result, capital will flow more freely and the international exchange of goods and services will increase more rapidly. Many of the problems with which you will concern yourselves during your meeting will, I am sure, bear directly on the ability of all of us to strengthen the spirit of international economic confidence.¹¹³

A pioneer in the search of accounting uniformity is the International Accounting Standards Committee (IASC). The IASC, an independent private sector body, was founded in 1973 by the accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the U.K., Ireland and the U.S.¹¹⁴

The primary objectives of the IASC are:¹¹⁵

offering major advantages to entity groups – in terms of both reduced complexity and increased flexibility in commercial operations (driven by intra-group transactions being ignored for tax purposes). Associated short-term transitional costs are well worth the long-term benefits from this reform. See Australia, *Review of Business Taxation, A Tax System Redesigned, (Ralph Report)* (Canberra: AGPS, 1999), at 518.

¹¹² G.R. Barrett, 'Preparing for October's XIV World Congress of Accountants', (January 1992) *Journal of Accountancy* 41, at 42.

¹¹³ *Id.*, at 43.

¹¹⁴ Australia, Canada, the U.S., and the U.K. are widely considered to be at the forefront of standard setting in financial reporting. These countries collectively known as the G4+1 have established a concerted work program in this field. See Australia, Corporate Law Economic Reform Program, Proposal for Reform: Paper No. 1, *Building International Opportunities for Australian Business*, *supra* note 109, at 20.

¹¹⁵ B.T. Curran, *A Comparative Study of Australian & International Accounting Standards- Challenges for Harmonisation*, (Sydney: Coopers & Lybrand, 1996), at 7. The IASC has a current membership of more than

- to formulate and publish accounting standards to be observed in the presentation of financial statements, and to promote their world wide acceptance and observance; and
- to work generally for the improvement and harmonisation of regulations, accounting standards, and procedures relating to the presentation of financial statements.

The IASC is not alone in its ambition to implement harmonised accounting standards on a worldwide basis. For example, in 1982 the International Federation of Accountants (IFAC) held its XII International Congress where it was resolved that a formal relationship be established between the IFAC and IASC. As part of the agreement, the IFAC resolved to promote the worldwide acceptance of IASC standards. In addition, as from 1 January 1996, a representative of the International Association of Financial Executives Institutes (IAFEI) is on the IASC Board.¹¹⁶

The OECD is also concerned with the formulation and promotion of international accounting standards. It formally recognised the need for better quality information when it published its first Guidelines for Multinational Enterprises in June 1976.¹¹⁷ In 1978, the OECD Committee on International Investment and Multinational Enterprises established an ad hoc working group on accounting standards and a permanent group in 1979. The group developed recommendations destined to harmonise international accounting and reporting standards. In addition, with the view to promoting international comparability of accounts and identifying 'possible solution for greater harmonization' of the different approaches of its Members regarding tax accounting, the OECD published recommendations relative to the harmonisation of accounting standards in 1987.¹¹⁸

Likewise, the European Union is actively involved in the process of harmonising the conditions in which business is done within Member countries. The Fourth Directive adopted in 1978 sets forth requirements governing the form and content of financial statements for limited liability companies. This involves the harmonisation of company financial reporting, while the Seventh Directive relates to the consolidation of group company accounts. In November 1995, the European Commission released a policy statement entitled *Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation* where the Commission decided to

142 professional accounting bodies from more than 100 countries. *Annual Review 1998: Accounting Standards Converging*, excerpts reproduced in *Notable Quotations about the IASC*; see *supra* note 22.

¹¹⁶ Curran, *ibid.*

¹¹⁷ In 1976, the OECD Member countries adopted a Declaration on International Investment and Multinational enterprises, one of the principal components of which is the OECD Guidelines for Multinational Enterprises. See OECD, *The OECD Guidelines for Multinational Enterprises*, (Paris: OECD, 1986), at 3.

¹¹⁸ OECD, Working Group on Accounting Standards, *The Relationship Between Taxation and Financial Reporting, Income Tax Accounting*, Accounting Standards Harmonization No. 3 (Paris: OECD, 1987).

associate the EU with the efforts undertaken by the IASC and IOSCO to achieve a broader international harmonisation of accounting standards rather than amend existing directives dealing with the question.¹¹⁹

The U.N., too, has been part of the harmonisation process. In 1973 the Secretary-General appointed the Group of Eminent Persons to study the impact of TNCs on development and international relations. In its report, the Group deplored the serious lack of useful financial and non-financial information on the activities of TNCs as well as limited comparability of corporate reports.¹²⁰ According to the Group, the solution to the problem resides in the creation of an international system of standardised accounting and reporting system. It recommended the convening of a group of experts under the auspices of the newly created Commission on Transnational Corporations to formulate such a system. The Secretary-General then appointed a group of experts to study the question of information disclosure. In July 1977 the experts issued a list of what they considered to be the minimum requirements in the field of information disclosure, but the Commission on Transnational Corporations did not approve that list. The Commission then advocated the creation of an ad hoc inter-governmental group of experts. In 1979 the Economic and Social Council created the ad hoc Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting. After several interim reports, the Intergovernmental Working Group published its final report in 1994.¹²¹

Finally, while not participating directly in the harmonisation efforts, there has been support for these efforts from various sectors, both private and public, comprising the U.N. Conference on Trade and Development, the then Prime Minister of Russia, Victor Chernomyrdin, and various national accounting bodies including those of Australia, New Zealand, and Canada, to name but a few.¹²² In December 1996, even the WTO stated that it encourages the successful

¹¹⁹ B. Howieson, 'International Harmonisation: He Who Pays the Piper Calls the Tune', (1998) 8 *Australian Accounting Review*, (No. 1) 3, at 5.

¹²⁰ United Nations, *The Impact of Multinational Corporation on Developments and International Relations* UN Sales Doc No. E/74/II/A.5, in B.S. Thomas, *supra* note 110, at 529.

¹²¹ Conclusions on Accounting and Reporting by Transnational Corporations, the Group of Experts on International Standards of Accounting and Reporting, UNCTAD/DTCI/1 (New York and Geneva: United Nations, 1994). There is at the moment a certain cooperation between the various organisations concerned with these problems. Thus, the IASC Board meets regularly with an international Consultative Group 'which includes representative of users and preparers of financial statements, standard-setting bodies and observers from Intergovernmental organisations such as the International Chamber of Commerce, the International Organisation of Securities Commissions (IOSCO), The World Bank, the Organisation for Economic Cooperation and Development (OECD), and the United Nations Centre on Transnational Corporations.' See Curran, *supra* note 115, at 7.

¹²² See the IASC web page, at <<http://www.iasc.org.uk>>.

completion of international standards in the accountancy sector by the IASC, IFAC and IOSCO.¹²³

Moreover, recognising the efforts made by the IASC in this area, the European Commission established a committee, named the Contact Committee, to examine the conformity between the international accounting standards produced by the IASC with the European Accounting Directives.¹²⁴ In order to facilitate the application of International Accounting Standards (IASs) by European Companies for the 1998 financial reporting term, the Contact Committee examined the conformity between all applicable IASs and the European Accounting Directives. This examination covered not only all IASs, but also the interpretations of the Standing Interpretations Committee (SIC)¹²⁵ applicable to accounting periods prior to 1 July 1998. The objective of this examination was to determine whether and, if so, to what extent conflicts subsist between IASs applicable to accounting periods beginning prior to 1 July 1998 and the European Accounting Directives. The purpose of the exercise was reassure European companies wishing and able to apply relevant IASs in their consolidated accounts that in doing so they were not acting contrary to European legislation.¹²⁶

The Contact Committee concluded that there are no significant conflicts between the Directives and those IASs and the interpretations of the SIC that have been issued and are currently applicable. However, one minor conflict between IAS 27 and the relevant Directives remains. IAS 27 deals with consolidated financial statements and accounting for investments in subsidiaries. It would appear that some of its provisions conflict with Article 14(1) of the Seventh Directive. However, the Contact Committee questioned whether this conflict would have any serious effect in practice.¹²⁷

Following the views of the Contact Committee, five EU Member States have already introduced dispensations allowing major corporations to use IASs rather than comply with

¹²³ Howieson, *supra* note 119, at 5.

¹²⁴ European Commission, Contact Committee on the Accounting Directives: *An Examination of the Conformity Between the International Accounting Standards and the European Accounting Directives* (Luxembourg: Office for Official Publications of the European Communities, 1996).

¹²⁵ In 1997 the IASC Board created a Standing Interpretations Committee (SIC) to consider 'on a timely basis, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance...The SIC reviews accounting issues and [develops] interpretations [in close cooperation] with similar national committees; see at <<http://www.iasc.org.uk>>.

¹²⁶ This examination did not deal with IASs that have been finalised and published, but that are not yet in force.

¹²⁷ European Commission Directorate General XV, Examination of the Conformity Between International Accounting Standards and the European Accounting Directives, (Brussels) (27 April 1999), reprinted in *Notable Quotations about the IASC*, see *supra* note 22.

national standards implementing various mandatory accounting Directives for their consolidated accounts.¹²⁸

The need for harmonised accounting standards for taxation purposes is also one of the major preoccupations of the OECD. The current view within the organisation is that, in order to obtain consensus on international accounting standards, a separation of tax and financial reporting must be achieved. Once this outcome is reached, then a substantial effort to harmonise the various prevailing financial accounting systems could be made.¹²⁹ Comparability of financial accounting systems, that is, comparability in the methods of computing company profits, is therefore viewed by the OECD as essential in order to achieve a harmonised system in the taxation of cross-border transactions. It would seem that this is also the view of the Ruding Committee on the question.¹³⁰

Demand for harmonised accounting information does not originate exclusively from those operating in sophisticated capital markets around the world. Many developing countries have adopted accounting standards produced by the IASC since they do not have the resources to develop their own methods.¹³¹ Notwithstanding the constant expansion in the use of its standards, the IASC still needs to obtain the approval of the major economies, especially the U.S., if it hopes to see its standards achieve undisputed international status.

To further this acceptance process, in 1995 the IASC agreed with IOSCO to complete a core set of 40 International Accounting Standards. Recently, IAS 39, Financial Instruments: Recognition and Measurement, has been approved. This means that all 40 topics have been addressed. The IOSCO is now required to consider endorsing IASC standards for acceptance by its members for (at a minimum) cross-border listings. At the same time, individual IOSCO members are formulating their plans for evaluating the core standards based on their domestic requirements.

A key IOSCO committee, Working Party No. 1, has already begun a detailed standard-by-standard review of the IASC core standards package. Working Party No 1. focuses on multinational accounting and disclosure issues. It is required to make a recommendation

¹²⁸ Frank Harding, the President of the International Federation of Accountants, while a staunch advocate for the use of IASs nevertheless warns that a problem may occur if there is a conflict between the international and national requirements. See F. Harding, 'Corporate Credibility - Why A Harmonised Global Accountancy Framework Matters', reprinted in *Notable Quotations about the IASC*, *supra* note 22.

¹²⁹ Plasschaert, *supra* note 90, at 21.

¹³⁰ European Communities -Commission *Report of the Committee of Independent Experts on Company Taxation* (Luxembourg: European Communities -Commission, 1992) 50.

¹³¹ L.J. Herbert, 'Developments in Harmonization of Accounting Standards', (1981) *3Journal of Comparative Law and Securities Regulations* 175, at 177.

regarding endorsement to IOSCO's Technical Committee. The latter is composed of 16 regulatory agencies from countries with the world's largest securities markets, including, obviously, the U.S. Securities and Exchange Commission (SEC). If the Technical Committee endorses the standards, the next step would be for these to be considered at individual national levels.

In April 1996, the SEC released a statement in support of the efforts of the IOSCO and the IASC to develop a core set of accounting standards that could become a framework for financial reporting in cross-border securities offerings. The SEC's statement indicated that, if the IASC successfully completes the work plan agreed with the IOSCO, the SEC would consider accepting the core standards in securities offerings by cross-border issuers in the U.S. if those standards satisfy the following criteria for acceptance. To do so, the SEC is required to make its own independent assessment of the acceptability of the completed core standards for use in the U.S. markets. In Australia, the view shared by both the government and the accounting profession is that while at this point in time the level of international acceptance of IASs is far too low to enable Australia to simply adopt them:

[T]he development of a high quality set of IASC standards, and their adoption by major capital markets, offers the best prospect for the establishment of globally accepted accounting standards.¹³²

The Australian Securities and Investments Commission (ASIC) has for its part indicated that it supports the harmonisation of Australian accounting standards with the IASs produced by the IASC. Indeed, ASIC has contributed financially to the development of these IASs.¹³³ Moreover, the Australian Government, in its Corporate Law Economic Reform Program announced by the Treasurer in March 1997, contemplates a fundamental review of key areas of regulation which affect business and investment activity. Measures proposed include the complete revamp of the accounting standards setting body with instruction to begin issuing IASC exposure drafts and standards as its own from 1 January 1999, unless advice from the proposed Financial Reporting Council (FRC) indicates that it would not be in the interest of Australia to do so. In the interim, Australia would continue to harmonise its standards with those of the IASC so that compliance with the IASC's IASs would automatically result in

¹³² Plasschaert, *supra* note 90, at 24.

¹³³ *Supra* note 90, at 25.

compliance with the Australian standards.¹³⁴ Clearly, therefore, the onus is with the IASC to improve the standard of its work if the latter is to gain international acceptance.¹³⁵

2 The Relative Failure of the Harmonisation Effort

The harmonisation effort has been substantial, and a number of countries, including China and other emerging countries in the South East Asian region such as Malaysia and Hong Kong, 'have moved to substantially adopt IASC accounting standards'.¹³⁶ In addition, Germany, Italy and France, together with Australia,¹³⁷ are contemplating harmonising their standards with those of the IASC.¹³⁸ In spite of these successes, there are still no uniform accounting principles applicable to all TNCs regardless of their geographical location.¹³⁹

The greatest challenge to the harmonisation of accounting standards arises from a significant difference in the approach of the IASC and that of the U.S. While the former addresses the substance of a particular subject matter in its IASs, leaving room for the exercise of professional judgement on the part of the users, the latter has opted for an extensive body of detailed financial reporting requirements. The U.S. position cannot be ignored because of the strength of its securities market. Consequently, as will be examined later, in order to win U.S. approval, the IASC has initiated a process whereby its standards are being subjected to a rigorous revision procedure.

¹³⁴ R. Picker, 'International Harmonisation – The Future is Now and Yes, It does Affect You!' *Paper Presented at Victoria ICAA PD Forum, Session 3a*, (18 May 1998).

¹³⁵ A.R. Wyatt & J.F. Yospe, 'Wake-Up Call to American Business: International Accounting Standards are on the Way', (July 1993) *Journal of Accountancy* 80, at 85.

¹³⁶ Australia, Corporate Law Economic Reform Program, Proposal for Reform: Paper No. 1, *Building International Opportunities for Australian Business*, see *supra* note 109, at 20.

¹³⁷ For a critique of the Australian Government Corporate Law Economic Reform Program's effort to adopt international accounting standards, see S.A. Zeff, 'An American View of CLERP', (1998) 8 *Australian Accounting Review* (No. 2) 3.

¹³⁸ For a review of the progress made towards the international acceptance of the IASC's standards, see R.K. Larson & S.Y. Kenny, 'The Harmonization Of International Accounting Standards: Progress in the 1990s?' (Spring 1999) 7 *Multinational Business Review* (No. 1) 1.

¹³⁹ To illustrate, Daimler Benz reported a profit under German accounting rules but a loss under U.S. accounting rules. See B Carsberg, 'Global Issues and Implementing Core International Accounting Standards: Where Lies IASC's Final Goal?', (23 October 1998), remarks of Sir Bryan Carsberg, Secretary-General, IASC, 50th Anniversary Dinner, Japanese Institute of CPAs, reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

A The Causes of the Apparent Failure

The official reason for the slow progress towards adopting the IASC standards are summarised by the Australian Corporate Law Economic Reform Program¹⁴⁰ The main concerns are that the IASC allows for too many options in the preparation of financial reports, and that its standards contain insufficient explanatory material and guidance on use, or are incomplete.

However, the fundamental problem is that each industrialised country believes that its own set of accounting rules are the best in the world. In 1991, Arthur R Wyatt, the then Chairman of the IASC, commented that resistance from the U.S. to the adoption of international standards that deviate from American practice is notable. In an interview, Professor Wyatt even suggested the proper course of action to take in order to achieve the desired outcome:

[M]ost of the advice I get from my colleagues in the United States is to fight for the conclusions we have reached [in] our [own] way...We have to be willing to concede on some issues if we expect others to do the same...the dynamics of the process are difficult to envision if you haven't participated, but the bottom line is we must be willing to concede some existing U.S. practices aren't supportable worldwide.¹⁴¹

In order to fully appreciate the difficulties in arriving at harmonised accounting standards on a worldwide basis, it is important to consider the political and financial consequences of harmonisation. It would appear that there is, at this stage, little available research demonstrating the full range of benefits likely to accrue from harmonisation. The question may be asked as to how an eventual elimination of the accounting diversity is likely to impact on share market activity. It has been suggested that in the event of substantial harmonisation some small stock exchanges, for example, the Australian Stock Exchange, are likely to lose out to the big overseas exchanges.¹⁴² Such uncertainties are not likely to induce acceptance of harmonised accounting standards in some sectors. What is certain is that important exchanges, such as the New York Stock Exchange, are more likely to derive substantial benefits from harmonisation. Hence the pressure the latter is currently exerting in order to influence the adoption of the IASC's standards.

The key obstacle to the worldwide adoption of IASC's standards is the reluctance of the U.S. to endorse them. The U.S. finds support from Canada and Japan. Canada holds the view that its proximity with the U.S. requires it to support the U.S. Generally Accepted Accounting

¹⁴⁰ Plasschaert, *supra* note 90, at 21.

¹⁴¹ P.D. Fleming, 'The Growing Importance of International Accounting Standards', (September 1991) *Journal of Accountancy* 100, at 106.

¹⁴² P. Brown & G. Clinch, 'Global Harmonisation of Accounting Standards: What Research in the Capital Markets Tells Us', (1998) 8 *Australian Accounting Review*, (No. 2) 21.

Principles (GAAP).¹⁴³ Japan does not have a national independent standard setter. The Ministry of Finance carries out this activity and sometimes the process of setting Japanese accounting standards has been politicised. Japan, therefore, fears if it were to support the IASC it would lose its sovereign powers in this area.¹⁴⁴ The attitude of the U.S. is understandable. If the U.S. were to support the IASC's standards, then 'the real brand loser would be the U.S. GAAP.'¹⁴⁵ Indeed, while the IASs are often very close to the U.S. GAAP, they are more in the tradition of the U.K. GAAP. Thus, the U.K. recently released a discussion paper canvassing the possibility of U.K. companies adopting IASs.¹⁴⁶

Until recently, the harmonisation project was not considered as achievable even in such a relatively homogeneous market as prevailing in the EU where the harmonisation of accounting standards has been significantly delayed. The doubt about the effectiveness of the provisions of the Maastricht Treaty, as well as, for example, the uncompromising attitude of Germany in this area, together with the uncertainty on the political front, have combined to hinder progress towards the adoption of harmonised accounting rules.¹⁴⁷ However, as will be explored further below, the European Commission is now committed to adopting IASC's standards.

B The Decisive Battle for Harmonised Accounting Standards

Although conventional wisdom holds that global capital is driving the need for one set of international standards, until 1998, the quest for international accounting standards had been carried out at a very slow pace. Then, a series of events precipitated the countdown to harmonisation. Among those, undoubtedly the Asian financial crisis had the most pervasive effect. Starting in Thailand, the crisis spread to other Asian countries, Russia and Brazil and other developed countries through the global financial markets and international commodity trade.¹⁴⁸ Thus was forcefully demonstrated the intensive trade and financial linkages among world economies. As lenders reacted to the perception of increased risk, credit availability

¹⁴³ This position is by no means unanimous. For a contrary view, see GGA-Canada, *The Case for International Accounting Standards in Canada: A Report by the Certified General Accountants Association of Canada*, reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁴⁴ See C. Matten, *Managing Bank Capital: Capital Allocation and Performance* (Chichester: John Wiley & Sons, 1998). See also Pacter, *supra* note 103, at 2.

¹⁴⁵ J. Kelly, 'A Standard Brand in Accounting', (March 1999) *Accounting and Business*, reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁴⁶ U.K., Modern Company Law For a Competitive Economy: U.K. Discussion Paper Inviting Comment on the Possibility of U.K. Companies Adopting IAS, (25 February 1999) as mentioned in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁴⁷ J. Hegarty, 'Accounting Integration in Europe—Still on Track?', (May 1993) *Journal of Accountancy* 92, at 94.

¹⁴⁸ United Nations (1999), *supra* note 4, at 2.

decreased, world trade slowed, and output per capita plummeted in spite of the fact that most of these countries had strong macroeconomic fundamentals.¹⁴⁹

What has emerged from these events is that because investors and lenders have gone global, financial reports need to be written in a common accounting language, which is understood globally. In other words, the definition of assets and liabilities and the methods of defining profits and losses must be the same across political boundaries.¹⁵⁰ In the absence of such a common lingua franca it is reasonable to infer that lenders and investors are more likely to panic at the slightest tremor hitting global markets, given that they would have committed funds based on economic data which, at best, is fragmentary or inadequate. Panic reaction, needless to say, could easily bring about the failure of the current financial system, thus the increased demand for accounting standards comparable across national borders in order to avoid risk.¹⁵¹ As already mentioned, this demand was heeded by the G-7 Finance Ministers and Central Bank Governors who, in October 1998, agreed to intensify co-operation among member countries in order to strengthen the international financial system. The G-7 ministers also stated that, in order to achieve this objective, a key part would be to render capital less expensive by identifying risk through greater transparency of accounting standards. The G-7 then expressed support for the IASC, which it believes should be supported by business corporations and financial institutions.¹⁵²

However, the momentum towards achieving market-driven harmonised accounting standards remains stalled by the hesitations of the U.S. In the U.S., the Financial Accounting Standards Board (FASB) establishes accounting standards, while the SEC 'retains the authority to promulgate accounting principles for SEC registrants and to prescribe the form and content of financial statements filed with the Commission.'¹⁵³ Both institutions feel that some of the IASC standards 'are not tough enough and that others need more tinkering.'¹⁵⁴ The general feeling is that while the SEC may yield to pressure and accept IASC standards, it may well require

¹⁴⁹ *Supra* note 4, at 1.

¹⁵⁰ Pacter, *supra* note 103, at 1, shows how American investors have gone global given that 'since 1991 holdings of non-U.S. equities by U.S. residents increased from \$200 million to well over \$1 trillion.'

¹⁵¹ IASC, Annual Review 1998, *supra* note 115.

¹⁵² Declaration of G-7 Finance Ministers and Central Bank Governors, (30 October 1998) reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁵³ M.B. Tokar, 'What is Going to Happen in the U.S.?' Remarks of Mary B Tokar, Senior Associate Chief Accountant, U.S. Securities and Exchange Commission, at the 2nd International Accounting Standards Conference, Brussels March 10, 1998 reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

¹⁵⁴ L Berton, 'Countdown to Harmonization', (June 1999) 33 *Institutional Investor*, (No. 6) 1.

numerical reconciliation of at least some of the latter to the U.S. GAAP.¹⁵⁵ In this regard, the SEC faces a dilemma. On the international scene it may find itself accused of rejecting a movement towards international accounting standards and, on the domestic front, it may be accused of granting an unfair advantage to foreign firms over U.S. corporations by agreeing that the former use more flexible accounting standards.¹⁵⁶ The shift to international accounting rules is inevitable although strong SEC and FASB resistance may hold the shift for a while yet. It is now believed that if agreement is not reached within a reasonable time frame 'such international economic bodies as the IMF, the World Bank or the Basle Committee on Banking supervision of the Bank for International Settlements (BIS) may step in to break the impasse.'¹⁵⁷

C The Shift towards an International Accounting Body

There is every indication that the question of international accounting standards will be resolved in the next few years. The progress towards a solution has also uncovered the need to deal with the problem in ways that go beyond the mere task of harmonising present accounting standards.

In December 1998, the IASC released a paper outlining its plan to 'bring about the convergence between national accounting standards and practices and high-quality global accounting standards.'¹⁵⁸ The document canvasses changes to the structure of the IASC which would be implemented by July 2000. The purpose of the proposed changes is to create the necessary environment for the emergence of a 'partnership' between national standard setters and the IASC, with the view to accelerating the convergence between national standards and the IASC's own international standards. What is envisaged is the creation of a Standards Development Committee (SDC) composed predominantly of national standard setters. The SDC, working in close cooperation with national standard setters of various countries and subject to the rules of due process and accountability, would be required to prepare exposure and final drafts of international accounting standards. Then, these standards would be simultaneously approved nationally and by the IASC. Such an arrangement, it would seem, satisfies the need to preserve the sovereignty of each nation given that acceptance of IASC standards would be achieved on a country-by-country basis. Moreover, the IASC Board

¹⁵⁵ D.S. Ruder, 'Developing High Quality International Accounting Standards', (1999) *Financial Reporting Journal* reprinted in *Notable Quotations about the IAS*, see *supra* note 22.

¹⁵⁶ *Ibid.*

¹⁵⁷ Berton, *supra* note 154, at 2.

¹⁵⁸ International Accounting Standards Committee, *Shaping IASC for the Future* (IASC: London 1998), at <<http://www.iasc.org.uk>>.

would be expanded to 25 members. Whether the Board should have the power to delay or reject the publication of drafts or the adoption of standards is still not decided. This power of veto has proved to be the most controversial recommendation in the discussion paper.¹⁵⁹ The U.S. FASB does not approve of the SDC being ‘an autonomous and independent decision making body.’¹⁶⁰ The same reservations have been expressed by the American Institute of Certified Accountants which ‘contemplates an independent standard setting board, not directly associated with any professional organization, country or national standard setter.’¹⁶¹

An examination of the arguments as to how a revamped IASC should operate anticipates the debate that would occur if an international tax organisation is to be set up. Controversy is bound to occur when considering how such an organisation is to derive its legitimacy. Some believe that legitimacy for the IASC standards should arise from the competence and independence of the SDC members.¹⁶² Others hold the view that ‘legitimacy should come through approval by a relatively large and geographically diverse group of carefully selected and informed persons.’¹⁶³ In other words, one can see the tensions between those who favour legitimacy through competence and independence and those who favour it through the political process. It may well be that a compromise would be reached by reconciliation of both views.

In any event, the point to note is that the IASC is slowly emerging as an international organisation to which would be devolved the power to set international accounting standards.¹⁶⁴ In its bid to become such an organisation, the IASC is probably preempting other organisations. One must keep in mind that whilst the G-7 ministers and central bank governors have, in their Declaration of the 30 October 1998, called the IASC to finalise a proposal for a full range of internationally agreed accounting standards, they have also required the IMF, in close cooperation with standard setting bodies such as the Bank for International Settlements, the OECD, and the World Bank, to monitor the application of these standards and to publish the results of its surveillance activities.¹⁶⁵

¹⁵⁹ Ruder, *supra* note 155, at 8.

¹⁶⁰ FASB letter to Sir Bryan Carsberg, IASC dated 10 March 1999, at 4, in Ruder, *supra* note 155, at 8.

¹⁶¹ AICPA letter to Sir Bryan Carsberg, IASC dated 21 April 1999, at 3, in Ruder, *supra* note 155, at 8.

¹⁶² See ‘IASC, Annual Review 1998’, at the IASC Web page, *supra* note 115.

¹⁶³ Ruder, *supra* note 155, at 9.

¹⁶⁴ See B. Carsberg, ‘Global Issues and Implementing Core International Accounting Standards: Where Lies IASC’s Final Goal?’, (23 October 1998), remarks of Sir Bryan Carsberg, Secretary-General, IASC, 50th Anniversary Dinner, Japanese Institute of CPAs, *Notable Quotations about the IAS*, see *supra* note 22, at 4.

¹⁶⁵ Declaration of G-7 Finance Ministers and Central Bank Governors, (30 October 1998) reproduced in *Notable Quotations about the IASC*, see *supra* note 22.

To sum up, it would appear that the demand for international accounting standards is irresistible. When such standards are in place, which it would seem likely to be achieved in a matter of a few years, then, arguably, the architecture would have been set to enable an international tax organisation to adequately compute the tax base resulting from TNC operations and to allocate it to countries with a legitimate claim to it.

Section III Problems in Determining an International Tax Base

The tax base refers to the taxable income of a taxpayer. It consists, therefore, of that figure to which relevant tax rates are to be applied in order to determine gross tax liability.¹⁶⁶

There are fundamental differences in the determination of the corporate income tax base as between countries depending upon whether those countries favour a policy of tax conformity or not. Tax conformity implies the adoption of a general presumption that taxable profit is computed on the basis of generally accepted accounting principles.

In other countries, while the starting point is profit before tax as determined by commercial accounting, there is no further reliance on accounting principles but reliance on specific tax accounting rules to arrive at taxable income. This solution is premised on the belief that accounting principles per se are inadequate, as the sole determinants of taxable profit, since they lack sufficient precision and often permit wide variations in the practical aspects of drawing up company accounts.¹⁶⁷

Whether a country favours conformity as opposed to another that does not, there exists a common denominator between their respective systems. Indeed, if Country A equates taxable profit with accounting profit while Country B determines taxable profit by making adjustments to accounting profit, the constant between the two systems is the notion of accounting profit.

In this environment, to achieve uniformity in the determination of TNCs' tax base, it is submitted that a two-step process is essential. First, if accounting profit is computed pursuant to harmonised international accounting standards, then uniformity in tax base calculations would have been achieved for those countries favouring conformity. The second step would then be to move towards adopting measures designed to favour, in the long run, a certain convergence between accounting and taxable profit.

¹⁶⁶ R.L. Hamilton & R. Deutsch, *Guidebook to Australian International Taxation* 4th Student Edition, (Sydney: Legal Books, 1996), at para. 1.80.

¹⁶⁷ P. McCourt & G. Radcliffe, 'Les Relations Fiscalité-Comptabilité' in France: A Model for Europe? [1995] 5 *BTR* 461.

1 A Further Step towards Achieving Uniformity in Tax Base Calculations

The need to have general accounting standards for the determination of accounting profit has already been examined. However, TNCs, by definition, operate in various jurisdictions by means of numerous legal vehicles which together constitute the group. It is therefore essential, for equity purposes, for example, that these TNCs use harmonised consolidation and currency translation methods.

A The Need for Harmonised Consolidation Methods

When an enterprise forms part of a large and complex network of companies commonly referred to as a group, it has long been accepted that the accounts of individual members are meaningless if a full view of the economic and financial position of the group is to be ascertained.¹⁶⁸ In the U.S., consolidated statements for group companies came to be regarded as the ideal solution as far back as 1900.¹⁶⁹ Consolidated statements were introduced in the U.K. in the 1920s, and by the 1940s consolidated statements had become customary in most jurisdictions worldwide.

Although the IASC has published two IASs on the question of consolidation,¹⁷⁰ there is in this area no standardised methodology applicable on a worldwide basis. It is generally agreed that consolidated statements are required in the case of a group of companies consisting of a parent and subsidiaries that are under the parent's control. Basically, consolidation aims at presenting a group's financial statements as if it was a single entity. The process, therefore, disregards the separate legal personalities of the group of enterprises.¹⁷¹ There are different consolidation rules prevailing in different countries. The need for a comprehensive harmonisation effort is therefore evident in, for example, the decision to include or to exclude a particular company from the consolidation process. How then is a consolidation policy formulated? Are there any prospects for such policies to be harmonised in order to facilitate the task of Intertax?

¹⁶⁸ Recommendation 15.1 of the *Ralph Report* on the reform of business taxation in Australia proposes the taxation of entity groups (comprising companies) on a consolidated basis. See Australia, 'Consolidated Groups': Taxing Entity Groups on a Consolidated Basis', *Ralph Report*, *supra* note 111, at 515ff. For a critique of this proposal, see C.J. Getz & D. Van Horn, 'Ralph's corporate panacea', (February 2000) *The Tax Specialist* (No. 4) 170.

¹⁶⁹ R.G. Walker, 'An Evaluation of the Information Conveyed by Consolidated Statements', (1976) 12 *ABACUS* 77.

¹⁷⁰ IASC, IAS 27 & IAS 22. For a comparison with Australian standard AASB 1024, see Curran, *supra* note 115, at 135ff.

¹⁷¹ OECD, *Consolidated Financial Statements* (Paris: OECD, 1988) 9.

i The Origins of Consolidation

Modern corporation law hinges on the principle that ‘upon incorporation a new legal entity comes into existence which is separate and distinct from its creditors and shareholders.’¹⁷² The House of Lords’ decision in *Salomon v Salomon & Co*¹⁷³ effectively enshrined the concept of separate personality in the common law tradition. That concept was quickly exported to other legal systems and eventually gained universal recognition.

However, necessity required that at times the separate personality concept be ignored. There are many instances where this occurs so that the corporate veil is lifted. Specific tax law may so dictate, for example, with the CFC legislation, or in the case of blatant tax evasion arrangements. In relation to financial disclosure, the separate entity principle needs to be ignored if a fair view of the overall position of a group is to be presented. To achieve this objective, group accounts rather than individual accounts of members of that group are required, and they generally take the form of a consolidated balance sheet and a consolidated profit and loss account.¹⁷⁴

The evolution of the law and professional regulation in this area has been slow. Ultimately, however, there emerged the concept of consolidated accounting which was the legal expression of the need to recognise the existence of the ‘economic group’ concept.¹⁷⁵

ii The Objectives and Methods of Consolidation

Consolidated financial statements disclose the financial affairs of a consolidated group of companies united for economic activity by common control.¹⁷⁶ The main criterion for determining the consolidation of any group is control. In general, it is admitted that the usual condition for a controlling financial interest is ownership. When a parent has a 100 per cent ownership in a subsidiary, the consolidation process is relatively simple: the assets, liabilities, revenues and expenses of the group entities are aggregated on a line-by-line basis.¹⁷⁷ Difficulties arise when the parent has either directly or indirectly less than 100 per cent of

¹⁷² A. Herzberg, ‘Insolvent Trading’ (1991) 9 *C&SLJ* 285.

¹⁷³ [1897] AC 22 H L.

¹⁷⁴ L.C.B. Gower, *Gower’s Principles of Modern Company Law*, 5th ed., (London: Sweet & Maxwell, 1992) 118.

¹⁷⁵ It would appear, according to Walker, that ‘early texts described consolidated statements as depicting the affairs of a holding company and its subsidiaries *as if* they were a simple organization or *as if* the subsidiaries were merely branches of the parent; see F. Clarke & G. Dean, ‘Law and Accounting-The Separate Legal Entity Principle and Consolidation Accounting’, (1993) 21 *Australian Business Law Review* 246, at 277.

¹⁷⁶ P. Rosenfield & S. Rubin, *Consolidation, Translation, and the Equity Method: Concepts and Procedures* (New York: John Wiley & Sons, 1985) 5.

¹⁷⁷ OECD (1988), *supra* note 171, at 10.

ownership. According to the OECD report on the question of consolidation, there are three different approaches, as explained below.¹⁷⁸

a. The proprietary approach

Under this approach only the parent's portion of the assets, liabilities, revenues and expenses in the subsidiary together with the parent's own assets, liabilities, revenues and expenses are included in the consolidated financial statement. Therefore, the interests of other investors, for example, minority interests, are excluded. This results in partial, rather than, full consolidation.

b. The parent company approach

In this instance, the first step is to allow full consolidation, that is, all the assets, liabilities, revenues and expenses of subsidiaries as well as those of the parent are included in the consolidated statement. However, the focus is on the parent's interest, since equity and net income represent those of the parent company. The interest of other investors is disclosed as 'a separate item outside equity and in arriving at net income. Only the parent's company's interests in any intra-group profit, transactions or balances are eliminated.'¹⁷⁹

c. The entity approach

The entity approach starts with full consolidation, that is, all assets, liabilities, revenue and expenses of the subsidiary are included in the consolidated statement along with those of the parent company. However, equal emphasis is given to the interests of both the parent and that of other investors such as minority interests. Equity and net income reflect those of both groups, although they are disclosed separately. The total amounts of intra-group profit, transactions or balances are eliminated.

If one company does not have control over a particular entity but is capable of exercising a significant influence over the latter, the equity method is often used. In this case, 'the proportionate interests of the company exercising such influence in the assets, liabilities, revenues and expenses of entities in which it has investments are presented as a single-line item in the component financial statements.'¹⁸⁰

The difficulties of achieving international comparability are due to the various practices prevailing in the field of consolidation. A number of initiatives designed to achieve a certain uniformity have been proposed. The OECD has long provided that enterprises should, at least once a year, publish 'financial statements and other pertinent information relating to the

¹⁷⁸ *Supra* note 171, at 10.

¹⁷⁹ *Supra* note 171, at 10.

¹⁸⁰ *Supra* note 171, at 10.

enterprises as a whole.¹⁸¹ The OECD guidelines also discuss, in certain instances, the question of consolidation. However, the guidelines are only meant to be indicative of what is reasonably to be expected from TNCs in the field of information disclosure.

In reality, the major obstacle to achieving a harmonised system in the preparation of consolidated financial accounts arises because the various entities forming part of a TNC, depending on where they operate, are each subject to accounting laws and standards which, as noted earlier, differ from one country to another. For example, for the purposes of consolidation, national prescriptions relative to the criterion for control differ widely ranging from a 100 per cent ownership to unified management.¹⁸² Yet, if the relevant principles set forth by the OECD were to be followed by TNCs, a certain uniformity could be achieved. But as usual, the OECD's rules are not prescriptive and, therefore, relatively ineffective.

The IASC initially formulated a definition of control which rested entirely on ownership. It now advocates a new definition of the word pursuant to which control means 'the power to govern the financial and operating policies of the management of the enterprise so as to obtain benefits from the activities of the enterprise.'¹⁸³ This definition effectively recognises that while control usually results from ownership, it may also be achieved through various other means. For example, it may be granted by the constitutive documents of the enterprise, or from a long-term agreement, or it can result from the ability to appoint a majority of directors.

In the EU, the 7th Directive also attempts to provide certain guiding principles relative to the preparation of consolidated accounts within Member States.¹⁸⁴ However, it was thought that its numerous exceptions and other exclusions do not really favour the emergence of a truly European system of consolidation. It would appear though that the concerns expressed when the Directive was issued 'that the many options and loopholes that coloured the text of the seventh company law directive on consolidated accounts would cause a lot of practical problems were unfounded.'¹⁸⁵

¹⁸¹ OECD (1986), *supra* note 117. See also OECD (1988), *supra* note 171, at 5.

¹⁸² OECD (1988), *supra* note 171, at 10, for a comprehensive list of the different bases for consolidation as practised around the world.

¹⁸³ IASC, Exposure Draft issued 1 September 1987 (E30). For comments thereon see OECD (1988), *supra* note 171, at 12. The standard arising from the Exposure Draft, that is IAS 27 maintains this criterion whereby the controlling entity is able to obtain benefits from its activities. See Curran, *supra* note 115, at 139.

¹⁸⁴ See M. Petite, 'The Conditions for Consolidation Under the 7th Company Law Directive', (1984) 21 *Common Market Law Review* 81-121. See also News-International, 'New Areas of European Accounting Expected', (December 1994/January 1995) *World Accounting Report*, at 10-11, where it is reported that a survey of the FEE has disclosed a trend within European groups of companies to adopt the consolidation principles of the 7th Directive.

¹⁸⁵ News/Europe, 'Consolidated Options Working Well', (May 1996) *World Accounting Report*, 4.

Finally, whilst the benefits of consolidation cannot be ignored, it has been claimed that it defeats its own purpose, and in the end, provides a distorted picture of group operations.¹⁸⁶ Notwithstanding this, consolidation is justifiable at both the theoretical and practical levels. It first enables TNCs to be treated as they should be, that is, as fully integrated businesses carried out in a legal form that reflects reality. Second, it is a prerequisite for the creation of a register for TNCs, which could then be realistically monitored.¹⁸⁷ Finally and most importantly, from the perspective of this thesis, consolidation paves the way for a more effective application, on a worldwide basis, by Intertax, of the formulary apportionment of profits derived by each of the TNC branches.

B The Need for Harmonised Currency Translation Methods

One of the perennial issues in consolidation accounting is the question of currency translation. Translation is the process by which the currencies in which financial statements of foreign subsidiaries of a group of companies whose financial statements are to be consolidated, are changed from the domestic currency into the currency of the parent company's country so that those statements can be consolidated with the financial statements of the parent and other domestic subsidiaries.

The financial statements of a parent company are stated in the domestic currency of its situs, for example, Australian Dollars (AUD) for Australian parent companies. In the same way the financial statements of a foreign subsidiary of the Australian parent are stated in the currency of the place where it operates. In order for the Australian parent to achieve the consolidation of the group's financial position it must first change the amounts stated in the foreign currency into amounts denominated in its own currency. Changing the amounts from those stated in the foreign currency to those stated in the domestic currency is called translation, an undisguised analogy to the translation from one language to another.¹⁸⁸

The comment in the introduction of the OECD report on foreign currency translation indicates the difficulties encountered on an international level when different translation standards coexist. In this respect it is noted that:

¹⁸⁶ Clarke & Dean, *supra* note 175.

¹⁸⁷ The feasibility of an international register for multinational enterprises has been explored the Institut de Droit International, 'Résolutions adoptées par l'Institut à la Session d'Oslo, 30 août-8 septembre 1977: III. Les entreprises multinationales' (Deuxième Commission), as reproduced in *Institut de Droit International: Annuaire*, Vol. 57 Tome II, Section III: 2(a), at 338-342, in C.D. Wallace, 'International Codes and Guidelines for Multinational Enterprises: Update and Selected Issues', (1983) 17 *The International Lawyer* 435, at 456-57 nn. 89, 93.

¹⁸⁸ Rosenfield & Rubin, *supra* note 176, at 8.

[T]he Working Group on Accounting Standards has identified foreign currency translation as a major issue where considerable benefits could be derived from greater harmonisation of accounting practices. The use of different accounting practices can give rise to substantial variations in the reported amount of net assets and financial results of enterprises. The differences between practices are so great that comparability cannot be achieved by disclosure alone. Consequently, the absence of a common method of translation has been a major obstacle to achieving comparability between financial statements.¹⁸⁹

The two major problems that arise with financial translation relate to the selection of the foreign exchange rate to be used for translation and the treatment of translation differences. There are two methods to select the rate used in translating the various items expressed in foreign currency: the temporal and the closing rate methods of translation. As for the treatment of translation differences, the first option is to include them in the group's income statement in whole or in part, either immediately or later, and the second option is to treat them as a direct charge or credit to the group's equity without first going through the income statement.¹⁹⁰ Recently the 'net investment approach' has been developed. Basically, it combines the temporal and closing rate method in an attempt to gain more precision. This method is favoured by the USA, Canada, the U.K, Australia, and, more importantly, by the IASC, which has issued IAS 21 on the question.

There are different rationales underlying the principal methods of translation. The net investment approach is favoured by the IASC. It distinguishes between a foreign operation whose economic activities are substantially self-contained from one which is highly integrated with those of the parent company. The interesting feature of the net investment approach is that it can readily be applied to highly integrated TNCs without being constrained by legal subdivisions of the group. Thus, a legally separate subsidiary may be classified as an operation integrated with that of the parent whilst a branch may be classified as a foreign entity. Judgement therefore plays an important role in determining the consolidation policy under the net investment approach.

The OECD in its report on foreign currency translation warns that it may be more difficult to achieve international harmonisation as far as the question of currency translation is concerned.¹⁹¹ This arises because some of the points at issue represent conflicting positions on the interpretation of such accounting concepts as prudence and materiality. However, it is submitted that the net investment approach might turn out to be the bridging method among the diverging practices. Indeed, it is particularly suitable for highly integrated operations as those carried out by enterprises trading in the global financial industry.

¹⁸⁹ OECD, *Foreign Currency Translation* (Paris: OECD, 1986), at 6.

¹⁹⁰ *Id.*, at 11.

¹⁹¹ *Id.*, at 21.

2 The Final Step towards Achieving Uniform Tax Base Calculations

The final step towards achieving worldwide uniformity in tax base calculations requires a greater matching of tax and accounting requirements. Indeed, achieving substantial correspondence between tax and accounting income at the conceptual level would mean achieving greater equity in the way TNCs are treated. In addition, this would level the playing field by reducing the compliance cost of those enterprises operating in jurisdictions where such conformity is absent.

A The Conformity Issue¹⁹²

The successful implementation of the model proposed in this thesis depends on achieving three objectives:

- the harmonisation of general accounting standards and policies,
- the harmonisation of consolidation methods, and
- common translation methods.

These three requirements have already been analysed earlier in this chapter. A fourth objective is the need for consensus regarding the ways of achieving a certain degree of convergence between tax and financial accounting. The question of conformity between these types of accounting arises because of the uneasy relationship between accounting and legal principles. The search for a suitable interface between law and accountancy is still being pursued.¹⁹³ In an international context, the power struggle and conflict of interests which arise at the point of contact between the two disciplines are exacerbated. Yet, the growing sophistication and internationalisation of financial markets demands that a reasonable solution be found. In a purely taxation context, it is clear that accounting and law can no longer be juxtaposed.

The purpose of financial accounting is to provide financial information on an enterprise. This information consists of a computation of the profit derived by that enterprise for a given period of time as well as a snapshot of its financial position at a particular date.¹⁹⁴ Financial accounting, therefore, calculates profit and loss, and allocates that profit over an arbitrarily chosen period. In order to achieve this, financial accounting attempts to select the correct period of time for reporting income and expenses (the matching principle) on the assumption

¹⁹² See Special Issue, 'Accounting Standards and Taxable Profits', [1995] 5 *BTR* 433-524.

¹⁹³ See J. Freedman & M. Power, 'Law and Accounting: Transition and Transformation', (1991) 54 *MLR* 769.

¹⁹⁴ B.T. Colditz & R.W. Gibbins, *Australian Accounting*, 3rd ed., (Sydney: McGraw-Hill, 1983) at 16-18.

that ‘there ought to be reporting and recognition of related revenue and expenses coincidentally’.¹⁹⁵

In Australia, for example, tax accounting has one particular goal: the allocation of income and deductions to their appropriate tax period in order to enable the annual assessment of the tax payable by a particular taxpayer to be made. The need to compute taxable income on a yearly basis means that income derived and expenses incurred be calculable and allocatable for that particular period. The tax accountant needs to assert when an item of income is derived and when an item of expense is incurred, which is to be contrasted with the commercial accountant preoccupation with ascertaining when items of income and expense ought to be recognised in the books of the enterprise.

The question of conformity is often debated in the U.S., the U.K., Canada and Australia where accounting principles of the Anglo-American tradition is applicable. In these countries, there is little conformity between financial and tax accounting. Professional bodies regulate financial accounting, while tax accounting is determined by either legislation or the courts. Consequently, there is a lack of correspondence between the concepts of accounting profit and taxable income.¹⁹⁶ The problems of this mismatch have been clearly exposed by various tax reform advocates. Thus, for example, in Australia, the Asprey Committee argued that the two systems ought to have identical rules, more especially in the international tax area, in order to permit a ‘meaningful international comparison of the incidence of tax on business operations’.¹⁹⁷ More recently, the theme has been canvassed in the *Ralph Report*.¹⁹⁸

The problem of conformity is clearly expressed by Professor Graeme Cooper: ‘[T]he merit of conformity or divergence between tax and financial accounting is an issue both perennial and pervasive perhaps even eternal and universal.’¹⁹⁹ Professor Cooper also mentions that, almost without exception, legislators worldwide engaged in the process of tax reform invariably consider such conformity as a major goal.

Basically, the debate about conformity arises because both financial and tax accounting, while purporting to measure income derived by an enterprise, arrive at figures which differ significantly. These disparities arise presumably, inter alia, because each system has different objectives, financial accounting being designed to provide useful information to present and

¹⁹⁵ G.S. Cooper, ‘Tax Accounting for Deductions’, (1988) 5 *Australian Tax Review* 23, at 30.

¹⁹⁶ *Id.*, at 41.

¹⁹⁷ Australia, Taxation Review Committee, *The Asprey Committee Full Report*, (Canberra: AGPS, 1975), at 79 para. 8.2.

¹⁹⁸ *Ralph Report*, *supra* note 111, at 203-205 paras 4.23-4.24.

¹⁹⁹ G.S. Cooper, ‘Some Observations on Tax Accounting’, (1986) 15 *Australian Tax Review* 221.

potential investors, creditors and other users, while the primary objective of a tax system is to raise revenue to fund government programs.

According to the OECD, there are three main methods of reconciling financial accounting and tax accounting.²⁰⁰ Financial statements may be drawn according to accounting principles and methods independent of tax rules. The converse tradition is to permit accounting practices to be largely influenced by tax rules. Finally, there is the method whereby the presentation of financial statements is based on accounting principles and standards with exceptions designed to meet specific tax purposes.

As the OECD has found, all these differences constitute major obstacles to achieving a greater comparability of performance in both the domestic and international context. They further inhibit the harmonisation of accounting practices. However, it appears that there is a general tendency to move away from strict conformity towards a total separation of financial and tax accounting.²⁰¹

Notwithstanding this trend, the issue is whether greater comparability between the two systems is desirable. The benefits of conformity may be analysed relative to the traditional policy objectives of taxation law. Put differently, does conformity satisfy the equity, simplicity, and efficiency benchmarks? As far as the simplicity criterion is concerned, it appears that conformity would reduce complexity. The end result of conformity is the preparation of one rather than two sets of accounts. Accordingly, in countries where conformity is the norm, it would seem that complexity in preparing tax returns is mitigated. With regard to the efficiency criterion, again it seems that conformity is desirable. If the rules of commercial accounting are well defined and consistent, then it is clear that more certainty and efficiency are achieved in determining both profits and taxable income since these two are the same. Finally, 'equity would be increased because conformity would increase certainty and simplicity, and would lead to greater uniformity.'²⁰² The benefits of conformity may also be examined both in terms of administrative convenience and that of taxpayer's compliance. According to one author,²⁰³ the apparent benefits include simplification, greater certainty in the determination of taxable income, and greater confidence in the integrity and equity of the self-assessment process. However, it is also arguable that commercial and tax accounting have different objectives. The quest for conformity between the two inevitably means that one needs to become subservient

²⁰⁰ OECD (1987), *supra* note 118, at 9.

²⁰¹ *Supra* note 118, at 11.

²⁰² T.M. Porcano, et al., 'Alignment of Taxable Income with Accounting Profit', (1993) 10 *Australian Tax Forum* 475, at 502

²⁰³ J.S. Nolan, 'The Merit in Conformity of Tax to Financial Accounting', (1972) 50 *Taxes: The Tax Magazine* 761.

to the other. Basically the question at issue in the conformity debate is whether ‘taxable income should be made to correspond with commercial profits.’²⁰⁴ As already mentioned, in Australia, the Asprey Committee held that such conformity was desirable. The Committee also believed that it was unattainable. In the Committee’s view:

[T]he first and overriding principle...is that income tax should be levied on true profits flowing from the business or professional activity during its whole period of operations. If this is not achieved the rates of tax, be they progressive as for individuals or proportionate as for companies, become meaningless and misleading as an indication of the weight of tax. The true after-tax profits remaining and available for maintenance or expansion of the activity cease to be readily apparent and become distorted.²⁰⁵

In other words, if income tax is levied on a base which is larger than true profits, then such a tax is inherently inequitable. Is ‘true profits’ synonymous to accounting profits? True profits remain an elusive concept. As Professor Cooper points out, the tax base will never coincide with accounting profit in many instances.²⁰⁶ In Australia, amounts that are deductible in financial accounting are often not recognised as allowable deductions for tax purposes. The converse is also true, with the ultimate result that in the first case income for taxation purposes is artificially inflated and in the second it is decreased. The outcome therefore depends on the policy of the government of the day.

Moreover, accounting profit is not determined by a mechanical process similar to a scientific investigation. Rather, it is determined by taking into consideration various parameters and by the exercise of judgement. In reality, there are three distinct branches of accounting, namely enterprise accounting, government accounting, and social accounting.²⁰⁷ Each branch attends to different needs and has different goals. In spite of the basic accounting concepts that underlie all three branches, differences in outcomes are likely to result because consumers in each branch are looking for different data to satisfy their needs.

The need to ‘move tax and accounting treatments of income closer together’ as a way of promoting simplicity and achieving reduced compliance costs is again at the forefront of tax reform both in Australia and in the U.K.²⁰⁸ No doubt this renewed interest in the issue has

²⁰⁴ Cooper, *supra* note 199, at 240.

²⁰⁵ *Asprey Report*, *supra* note 197, at 79 para. 8.2.

²⁰⁶ Cooper, *supra* note 199, at 239.

²⁰⁷ A.J.H. Enthoven, ‘Accounting and Economic Development Policy and Accounting Systems in Third World Countries’, in A. Fouad, ‘Standardization in Accounting Practices: A Comparative Study’, (1986) 21 *The International Journal of Accounting* 161, at 164.

²⁰⁸ See *Ralph Report*, *supra* note 111, at 203-05 pars. 4.23-4.24. See also, The Chartered Institute of Taxation [U.K.], *Budget 2000, Representations on the Form and Administration of the Tax System*, at <<http://www2.tax.org.uk/content/submissions/budgappx.htm>>.

been prompted by the ‘increased global harmonisation of accounting standards, together with the increasing emphasis placed by the courts on accounting figure’.²⁰⁹

While the question of conformity is of significance in certain countries, it is submitted that this not the case when it comes to Intertax exercising its main function, that of the apportionment between relevant countries of the worldwide commercial profit of TNCs. As will be examined further on, the role of Intertax is not to determine the corporate tax base of its members. In the proposed model this remains the prerogative of national governments. Intertax is simply required to determine, from the overall commercial profits of TNCs measured in a standardised fashion, the appropriate share of such profits allocatable to each country with a legitimate claim to tax.

B The European Experience with the Conformity Issue

Efforts to reach this objective of convergence have been expended in the EU in order to enable the internal market to function smoothly.²¹⁰ For its part, the OECD favours the separation of tax and financial reporting.²¹¹

The debate over the issue of tax harmonisation within the EU has been at the forefront of the European Commission agenda for the last 30 years. In 1975 a draft directive was proposed in order to achieve a common partial imputation system of company taxation. It is significant that the draft directive ran into difficulties in the European Parliament:

where it was criticized on the ground that it made little sense to harmonize corporate tax systems and statutory rates as long as differences continued to exist among Member States in the rules for computing taxable company profits, that is, the tax base.²¹²

The *Ruding Report* noted that since 1980 the importance of moving towards a common tax base had been a major preoccupation of the European Commission.²¹³ The Commission is first concerned with promoting efficient methods of allocating resources within the EU through the elimination of distortive pressures stemming from, inter alia, tax regimes in competition with each other. The aim of the Commission is thus to prevent the allocation of capital within the EU based solely on where the highest after-tax returns can be obtained. It follows, therefore,

²⁰⁹ United Kingdom, *Reform of Corporation Tax: Response from CGU plc* (22 October 1999), at <<http://www2.tax.org.uk/content/misc/appx.html>>.

²¹⁰ L. Hinnekens, ‘The Monti Report: The Uphill Task of Harmonising Direct Tax Systems of EC Member States’, (1997) 6 *EC Tax Review* 31.

²¹¹ OECD (1987), *supra* note 118, at 19.

²¹² *Id.*, at 23.

²¹³ The Ruding Committee acknowledged the Report from the Commission to the Council, *Scope for Convergence of Tax Systems in the Community* (27 March 1980), Doc. Com (80) 139 final.

that the Commission is much concerned with the differences among Member States in the rules for the computation of the corporation tax base, in statutory tax rates, and other tax incentives which all result in the effective tax rate on investment varying across countries.

As expected, the Ruding Committee's recommendations reiterated the conviction that differences in the rules which determine the level of taxable income for taxation purposes among Member States create distortions which are incompatible with the efficient operation of the internal market. It also noted that the harmonisation of corporate tax rates 'makes little sense without some minimum degree of harmonization of the corporate tax base.'²¹⁴ The Committee then went on to propose the creation of a group of technical experts to examine, and make firm recommendations for action, the various aspects relating to the calculation of the corporate tax base.

Basically, the Ruding Committee concluded that 'commercial accounts produced for financial reporting purposes should form the starting-point for the computation of taxable income in all Member States.'²¹⁵ One cannot but fully agree with the Committee on this finding. In addition, the Committee further recommended that the European Commission 'take appropriate measures to reduce the differences between commercial accounts and the accounts used for tax purposes.'²¹⁶ The most effective way of achieving this objective is by the application of common accounting standards within Member States.

C The Role of Intertax

It is arguable that Intertax has, at the most, a marginal role in determining the corporate tax base. The question of what the corporate tax base should be, that is, what in the corporate sector one ought to tax is left to the discretion of each member country in the proposed model. Intertax is solely concerned with the allocation of a fair share of commercial profits to each relevant jurisdiction, and is therefore not concerned with what the governments of these jurisdictions do to convert the allocated profits into taxable income. To put it simply: Intertax would have a very limited role in the determination of the tax base of its members, that is, what a particular legislation in a particular country elicits as taxable income. As the OECD report on accounting standards and harmonisation pointed out, in taxation a state has an instrument for achieving two main purposes.²¹⁷ First, taxation enables a state to cover its financial requirements, and second, it enables a nation to achieve its economic policy by dissuasive or

²¹⁴ *Id.*, at 211.

²¹⁵ *Id.*, at 212.

²¹⁶ *Ibid.*

²¹⁷ OECD (1987), *supra* note 118, at 12.

incentive measures. In these pursuits, which basically amount to the forced transfer of resources, a state must still remain sovereign. Therefore, the determination of the tax base is a notion best left to the individual determination of each country.

In order for Intertax to fulfil its role, however, it is imperative that the greatest convergence between the different methods of determining commercial profits be achieved. This would enable the proposed system to operate coherently. Indeed, when computing TNCs' commercial, Intertax would be pursuing accounting standards that clearly reflect the actual performance of an enterprise, as generally perceived by the market. The application of harmonised accounting standards drawn along the principle that companies should pay tax on their commercial profits would go a long way to reducing the complexity which characterises present tax systems. By adhering to this principle, it is submitted that Intertax would promote a system which would provide certainty to taxpayers and would certainly be easier to administer. In addition, in most probability, the neutrality of the system would be enhanced by levelling the playing field for the taxation of TNCs.

Increased conformity between commercial accounting and tax rules, whilst desirable, should not however be achieved at the expense of flexibility. On the national level, it has been argued that conformity could lead to pressure on the standard-setting body to adopt standards that produce tax savings.²¹⁸ If this were to occur, then the value of financial statements to their main users would be reduced, and the ultimate result would be a constraint on the development of accounting standards. This has happened, it would appear, in Germany²¹⁹ and in Japan where authorities are 'now facing the challenge of reducing conformity so as to permit accounting practices to develop and provide reports that are useful to businesses.'²²⁰

In the proposed model this danger is largely mitigated. Indeed, the accounting body responsible for developing these accounting standards is the IASC, an independent body subject to stringent transparency standards, while the task of using them to achieve its stated objective rests with Intertax, another independent body whose influence on the IASC is likely to be marginal. Indeed, Intertax should not, pursuant to its constitutive powers, interfere with the work of the IASC.

The first and primary objective of Intertax, therefore, is to manage the application of worldwide combined reporting for the taxation of TNCs. Consequently, all that Intertax is

²¹⁸ P. Gillies & A. Ryan, *Profit for Accounting and Tax Purposes - Should it Conform?* (April 1998) Australian Society of CPAs; see at <<http://www.cpa.org.au>>.

²¹⁹ G. de Bont et al., *Fiscal versus Commercial Profit Accounting in the Netherlands, France and Germany* (Amsterdam: IBFD, 1996).

²²⁰ *Id.*, at 8.

required to achieve is the sharing of commercial profits between relevant jurisdictions. These commercial profits are determinable by strictly following the complete set of international accounting standards produced by the IASC. Apportionment of these profits is then made by way of an apportionment formula, or formulas, so that each jurisdiction is given a share of the profits based on the contributions achieved by the factors located within its borders, such as capital assets, payrolls, and sales. Once this is achieved, each country would then be free, starting from its share of the commercial profits, to determine the taxable income, and, ultimately, the tax payable within its jurisdiction. In other words, each country, would remain sovereign in determining what it considers as taxable income whether or not such taxable income is in conformity with the share of accounting profits allocated to it by Intertax. Thus, starting from its allocated share of accounting profits, a particular country would be able to independently set whatever depreciation schedules or investment tax credits it chooses, and adopt whatever tax accounting rules it deems fit relative to its policy objectives.

It is convenient to bear in mind that the aims of taxing international income flows, as Professor Bird stressed, is threefold:²²¹

- To allocate tax revenues between jurisdictions in a way recognized by each as fair;
- To neither encourage nor discourage international capital flows; and
- To enable countries, within reason, to impose the domestic tax system of their choice.

Taxable income forms part of a continuum that starts with gross income. The method for the determination of taxable income is a matter of national choice. The evolution from gross income to taxable income is achieved through the operation of national tax accounting rules. Therefore, if the third aim of taxing international flows as determined by Professor Bird is to be achieved, or in other words, if the primacy of national legislation for the determination of the tax base is to be safeguarded, then, it is again submitted Intertax should be exclusively concerned with allocating to each relevant jurisdiction simply the commercial profits or gross income attributable to a particular operation. This attribution is to be carried by means of a formula or formulas and, therefore, constitute a rather minimalist approach which is realistic given that the world is not ready as yet for any supranational body to which countries would surrender their entire fiscal prerogative.

In this particular model, harmonised accounting rules used to determine, on a consolidated basis, the worldwide commercial profits derived by a TNC is therefore of critical importance. This is because if, in the first place, the reality and correct determination of such profits were beyond dispute, then in most probability, if there were to be any further disputes, these would

²²¹ R.M. Bird, 'Shaping a New International Tax Order', (1988) 42 *Bull Int'l Fiscal Documentation*, 292 at 298.

be confined to the apportionment process and would thus not extend to the earlier measurement stage.

A particular country may disagree with the figure allocated to it. If the disagreement arises from the application of the apportionment formula, then that country may invoke the dispute settling mechanism provided for by the multilateral treaty creating Intertax. Basically, as already noted, disputes that are incapable of being solved by agreement would be submitted to arbitration.²²²

It may be argued that such a system imposes an additional burden on TNCs on the ground that apart from the consolidated accounts to be filed with Intertax, it would still be required to satisfy local authorities as far as the domestic operations are concerned. The problem is more apparent than real. Large TNCs operating in many countries already have 'parallel systems of accounting and financial information alongside the official accounting system.'²²³ These systems serve different purposes. Whilst formerly their creation was a source of complication, today the use of computer processing has made it possible to integrate these different systems by the use of special codes and other similar techniques.

Even the language problem has long been solved with large TNCs. Accounts are kept in a local language to satisfy national authorities and are immediately translated into the language that central management is capable of understanding. Had it not been so one wonders how such phenomenon as global round-the-clock trading in, for example, foreign exchange, could have occurred.

Furthermore, from the TNCs' point of view, the determination of commercial profits independently from tax accounting preoccupations has undeniable advantages. Indeed, the independence of financial reporting from the constraints of tax reporting 'substantially reduces the difficulties involved in the international harmonization of the information'²²⁴ thus rendering the disclosure requirements less onerous. The reason for this is that TNCs would follow a set of fully recognised International Accounting Standards and would, to a large extent, be freed from the impediment of having to satisfy a particular category of users of financial accounts, namely different national governments.

The creation of an international organisation to administer the system seems to be an ideal solution in today's global world. Yet, there seem to be a serious divergence of views as to the advisability of this solution. Hence, the Deputy Secretary-General of the OECD speaks

²²² See Chapter 3, Section I, 2, B, iii., at 113.

²²³ OECD (1987), *supra* note 118, at 22.

²²⁴ *Supra* note 118, at 21.

‘facetiously’ of the idea and discards it as a visionary development.²²⁵ On the other hand, the Director of the Fiscal Affairs Department of the International Monetary Fund believes that ‘perhaps the time has come to establish [an international institution that would provide] a kind of “surveillance” function over the developments in tax systems.’²²⁶

There is little doubt that ‘an international tax institution structured like the GATT’²²⁷ would greatly assist in the successful initiation and administration of a multilateral treaty implementing worldwide combined reporting.²²⁸ Nevertheless, if countries cannot reach agreement regarding the transfer of some of their fiscal sovereignty to an international tax organisation, the proposed formulary system may still be implemented on a national basis. The notable difficulty with the proposed system and its formulary apportionment methodology is that it is not considered a viable alternative to the arm’s length principle. As such it is not an international norm. However, given the rapid global integration of certain industries, especially in the financial area, some operators therein are seriously considering it as a viable option. Thus there is anecdotal evidence showing that certain multilateral APA requests have been lodged with various revenue authorities in which the chosen transfer pricing methodology is formulary apportionment.²²⁹ In addition, it has been argued that the APA process is merely a secret method of applying formulary apportionment on a business-by-business basis.²³⁰

A national approach to the implementation of the proposed formulary system is necessarily more onerous. One thing is certain, the system cannot be resorted to by one country unilaterally because of the high risk of double taxation and the likelihood of its trading partners reacting with discriminatory measures. Therefore, the multilateral model remains the most suitable framework for its implementation. The same problems faced by Intertax would have to be solved, namely the delineation of TNCs that would be subjected to the system, coordination in the design and implementation of the regime, and obtaining agreement as to the

²²⁵ See the opening remarks by Ms J.R. Shelton, Deputy Secretary-General of the OECD, at the OECD-APEC Symposium held in Sydney on 30 October 1996 in J.R. Shelton, ‘Emerging Issues in Taxing Business in a Global Economy’, (20 January 1997) *Tax Notes Int’l* 221, at 222.

²²⁶ Tanzi, *supra* note 6, at 140.

²²⁷ Vann, *supra* note 33, at 100.

²²⁸ D. Sandler, ‘Slicing the Shadow-The Continuing Debate Over Unitary Taxation and Worldwide Combined Reporting’, [1994] 6 *BTR*, 572, at 593.

²²⁹ It would appear that while Barclays Bank was challenging California’s use of the WWCR, it negotiated an APA with the IRS that used principles of formulary apportionment. See G.C. Shea, ‘APAs may Effectively Address Income & Expense Allocation Problems Faced by Global Trading Businesses’, (18 May 1992) 4 *Tax Notes Int’l* 1022. Moreover, it would appear that ‘Barclays Bank was the recipient of the global trading ruling addressed in Notice 94-40.’ See letter of M.J. McIntyre to the Editor TNI, ‘McIntyre on APA Report and More’, (17 April 2000) 20 *Tax Notes Int’l* (No. 16) 1775. (Notice 94-40, 1994-1 C.B. 351, issued on 25 April 1994.)

²³⁰ See ‘In Congress’, (16 August 1995) 4 *Tax Management Transfer Pricing Report* 240.

factors that would compose any chosen formula/formulas. Indeed, compromises would have to be reached between nations competing for tax revenue. The next point where consensus would need to be reached is the method for the calculation of the worldwide profits of TNCs to which the formula would be applied.

In view of these difficulties it seems that an international tax organisation remains the most viable option for an orderly application of the proposed formulary system. On the assumption that the Intertax option is chosen, then one of the most crucial functions of the organisation, that of determining an acceptable formula/formulas for the apportionment of the commercial profits derived by TNCs, remains to be examined.

The Search for an Appropriate Formula(s)

The aim of Section I in this chapter is to outline the characteristics of current apportionment formulas used in the American state taxation context. The major limitations of the U.S. states' practice are then studied in Section II. Finally, in light of these findings, tentative solutions aimed at avoiding these limitations in a worldwide system are proposed in Section III.

Section I The Characteristics of Current Apportionment Formulas

The principles at the base of the American State taxation system, especially the Californian Worldwide Combined Reporting (WWCR) method, may be useful in devising a formulary apportionment system applicable by Intertax. Indeed, the experience of U.S. state tax bureaucrats in dealing with this methodology could, with necessary adaptations, serve as a guide for the application of the proposed system on a worldwide basis. By referring to that knowledge and jurisprudence, Intertax is likely to immediately benefit and become fully operational in a shorter period of time rather than submitting itself to undue teething experiences.

1 The Choice of Appropriate Factors

An apportionment formula is composed of certain elements which attempt to attribute a portion of the entire business income to a particular jurisdiction. It assumes that 'the entire income of a business enterprise is the final result of certain income producing factors or elements such as property, payrolls, sales, and costs of manufacturing.'¹ Pursuant to the U.S. Supreme Court's decision in *Container Corp. of America v. Franchise Tax Board*,² it is generally accepted that an apportionment formula should neither be arbitrary in its concept nor unreasonable in its results. In addition, rather than reflecting some sort of scientific precision, the Court held that such a formula is acceptable even though it achieves a rough approximation of attributable income.

¹ P.J. Hartman, 'State Taxation of Corporate Income From a Multistate Business', (1960a) 13 *Vand. Law Review* 21, at 64.

² 463 U.S. 159 (1983).

Two concerns, theory and administrative ease, influence the choice of the elements in an apportionment formula.³ In order to satisfy theoretical considerations, a formula for apportioning business income should reflect the elements that contribute to or measure the processes involved in the earning of that income. In addition, a formula needs to be relatively easy to administer.

A The Basic Economic Rationale of Apportionment Formulas

Formulary apportionment operates along the following principles:

- First, the entire net income of the whole enterprise is computed.
- Second, in the U.S. states' context, income not connected with the unitary business is deducted from the entire net income.⁴
- Third, the residue, considered as net income for tax purposes, is apportioned by way of a relevant formula to the particular taxing jurisdiction. This apportionment is made on the basis of what the average of the factors of the formula within the taxing jurisdiction bears to the average of the total of such factors within and without the taxing state.⁵

An apportionment formula should reflect the elements that contribute to or measure the processes involved in earning business income. How are these elements to be identified? Are they consistently present across the wide range of different businesses operating on a global basis? If so, do they contribute equally in the income generation processes?

An apportionment formula is primarily a compromise. From an economic point of view, there are four factors of production that interact to produce income and wealth, namely land, labour, capital, and organisation. The reward of each group is rent, wages, interest, and profit.⁶ The way these factors interact and their degree of interaction to produce their economic purpose is different depending on industry characteristics. Therefore, it is unrealistic to assume that a single relatively uncomplicated formula would be applicable to any enterprise regardless of where it operates. If a reasonable amount of precision were required, especially on the ground

³ B.F. Miller, 'Worldwide Unitary Combination: The Californian Practice', in C.E. McLure, Jr., ed., *The State Corporation Income Tax, Issues in Worldwide Unitary Combination* (Hoover Institution Press, 1984) 132, at 133.

⁴ For example, capital gains, interest, dividends, etc., which may be subject to specific allocation rules.

⁵ Hartman, *supra* note 1, at 65.

⁶ J. Harvey, *Modern Economics: An Introduction for Business and Professional Students* (London: Macmillan Press, 1969) 96. This analysis, because of certain theoretical weaknesses, is no longer favoured. Modern economists speak of factors of production in a general way, that is, in the sense of resources which cooperate in the production of goods and services wanted by the community. In this regard, a debate arises as to whether 'sales' contributes to the creation of income. The question will be extensively studied further below.

of equity, then different formulas would need to be designed for different industries. At the extreme, since no two businesses are managed in the same way, it would be reasonable for each taxpayer to seek an individualised formula.

The basic economic rationale of apportionment formulas may be apprehended in examining, for example, the efforts of California to devise a formulary system that would broadly satisfy the requirements of a fair system of taxation. The Californian Franchise Tax Board (FTB) has over the years used various formulas to divide the income and franchise tax base of multijurisdictional businesses. Pursuant to the Bank and Corporation Tax Code of 1929, the portion of a taxpayer's net income derived from business carried out in California was apportioned on the basis of sales, purchases, manufacturing expenses, payroll, and value and situs of tangible property, 'or by reference to other factors'.⁷ Notwithstanding this prescription, in general, California applied a three-factor formula comprising tangible property, payroll, and sales factors.⁸ One of the main features of this earlier Californian system was that the FTB did not advocate a rigid application of a single formula across the wide spectrum of businesses operating within the state. It had wide discretionary power to modify the formula ordinarily applied in order to satisfy the needs of various industries.

Other American states applying the formulary apportionment methodology also exercised this discretionary power. As a result, multistate enterprises began encountering problems of compliance and multiple taxation.⁹ As shown in Chapter 4, an attempt was made to remedy the situation with the promulgation of the Uniform Division of Income for Tax Purposes Act (UDITPA) and the advent of the Multistate Tax Compact. It will be recalled that the primary objective of UDITPA is to provide a state level solution to a uniform approach to the division of a multistate enterprises' income.¹⁰

It is often argued that 'the American experience is characterized by features that are specific to it and thus may reduce its value as a guide to future developments in an integrating world with nation-states, frontiers, different currencies, different legal systems, and different rules and regulations.'¹¹ As such, the U.S. system cannot be duplicated on a worldwide basis. Whilst this may be true in terms of value and output, it is clear that most of the developed world, and

⁷ United States, *Bank and Corporation Franchise Tax Act*, s 10, 1929 Cal Stat 19, 24, in E. Coffill & P. Wilson, 'Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?', (24 May 1993) *Tax Notes* 1103, at 1105.

⁸ Miller, in McLure, *supra* note 3, at 133.

⁹ D.M. Hudson & D.C. Turner, 'International and Interstate Approaches to Taxing Business Income', (1984) 6 *Northwestern J Int'l Law & Bus* 562, at 594.

¹⁰ *Id.*, at 563.

¹¹ V. Tanzi, *Taxation in an Integrating World* (Washington D.C.: The Brookings Institution, 1995), at 29.

to some extent the newly industrialised countries as well as the developing countries, mirror with a certain time lag the situation which prevailed in the U.S. when the unit rule was established. Thus the world economy is composed of highly industrialised economies, and less-developed countries whose economies are mainly agricultural with a certain number in a transitional state. A similar division prevailed in the U.S. when the unit rule was implemented. There were mainly industrial and agricultural states, or states where goods were produced and states where they were marketed and consumed. In spite of these large differences, a coherent system of formulary apportionment has been established and, later through the Multistate Tax Compact, that system has, to a certain extent, been harmonised whilst preserving the sovereignty of various state governments in matters of economic policy. This has been achieved through the imposition of certain necessary compromises, especially in the composition of apportionment formulas.

If formulary apportionment is to be implemented worldwide, then these compromises will need to be replicated at the international level. This is indeed a challenging prospect. As an interim measure designed to smooth the implementation of the system, it is submitted that Intertax should promote the use of formulas that would roughly apportion to each member state the level of revenue which it is collecting at the present time. Only when countries realise that the proposed system has some definite advantages likely to be decisive in an increasingly integrated world that finetuning of the system could be attempted.

B Types of Allocation Factors Used

According to the theory of formulary apportionment income is derived by an integrated enterprise as a result of the interaction of complex factors. Formulary apportionment is based on the idea that the determination of the income of one establishment of an enterprise is achieved by dividing total income in the ratio of these factors. Obviously, not all of the latter should be, or indeed are capable of being included in an apportionment formula.¹² All allocation factors used by various American states prior to UDITPA contained items such as property or payroll. These are relatively easy to locate within or without the boundaries of a particular state. Alongside these comparatively direct factors there were others whose presence in an apportionment formula was more controversial. Different types of formulas for different businesses were required. For instance, a particular formula composed of certain

¹² A.D. Lynn, 'The Uniform Division of Income for Tax Purposes Act Re-Examined', (1960) 46 *Virginia Law Review* 1257, at 1261.

elements would be applied to the income of manufacturing corporations, another to the income of mercantile enterprises, and a third type to corporations dealing with intangible property.

As a result of the numerous allocation formulas, a certain classification has emerged. Allocation formulas may be classified as simple or complex.¹³ A simple formula apportions income on the basis of one factor, for example, tangible property, whereas a complex formula includes two or more factors. The most obvious advantage of a simple formula is its easy formulation and administration, especially if the chosen factor is readily capable of being adequately and objectively measured. On the other hand, it displays a number of serious theoretical weaknesses. For example, a simple fraction apportions income on the basis of one activity alone, 'but it can hardly be said that the income of a corporation is derived entirely from manufacturing, or entirely from sales, or even from the ownership of property.'¹⁴ Therefore, the advantages associated with the use of a simple factor may be outweighed by the need to include other factors so as to satisfy a fair segregation of income. The complexity of modern enterprises, especially transnational corporations (TNCs) where income is not derived entirely from one operation alone be it manufacturing, sales, or the provision of services, disqualifies the use of a simple formula by Intertax.

Since simple formulas proved to be inadequate in the U.S. context, complex formulas were introduced to give a more balanced allocation result. Such complex formulas consisted of two, and sometimes up to five, different elements ranging from sales, payroll, property, purchases, cost of manufacture, cost of raw material, and so on.

Complex formulas are often difficult to administer the more so if different weights are given to various factors within the formula. The theory behind ascribing different weights to different factors comprising an apportionment formula is that the factors therein do not contribute equally to the derivation of income. In the U.S., this practice arose as an attempt to increase a state's share of the corporation income under the guise of enhanced precision. Such practices, because of their complexity, not only increased administrative costs but also raised compliance costs. Proper tax administration requires that a balance between simplicity, ease of administration, equity, and low compliance costs be achieved. This objective has broadly been realised by the UDITPA which proposes the use of a common three-factor formula, the so-called Massachusetts Formula.

¹³ J.W. Huston, 'Allocation of Corporate Income for Purposes of Taxation', (1932) XXVI *Illinois L Rev* 725, at 735.

¹⁴ *Id.*, at 736.

2 The Massachusetts Formula

The Multistates Tax Compact, under which a Multistates Tax Commission emerged, promoted the use of the Massachusetts Formula. The Formula evolved as a matter of trial and error over more than 40 years in the U.S. state taxation context.¹⁵ It consists of three factors, property, payroll, and sales assigned on the basis of destination with a throwback rule to ensure 100 per cent taxation.

A The Property Factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible property, owned or rented, and used, or available for use, in one state during the income year. The denominator is the average value of all the taxpayer's real and tangible property owned or rented during the income year.¹⁶

The property factor contains all tangible property used to produce business income as opposed to non-business income. Such property, if owned by the business, is valued at original cost, and if rented it is valued at eight times the rental value. If property is used free of charge, a notional value is included representing a fair rental value.¹⁷

It is arguable that whilst the presence of the property factor in an apportionment formula is reasonable on the basis that it represents the investment of capital, it contains two theoretical imperfections:¹⁸ First, it includes property that is not owned, and second, it does not include intangible property. The absence of intangible property is certainly a serious omission, the consequences of which will be fully examined below. However, the inclusion of rented property or property used for free is fully justified as they both produce income regardless of their ownership status. Thus, regardless of its ownership status, property is included in the formula on the basis of its temporal relationship to the business.

¹⁵ Lynn, *supra* note 12, at 1261.

¹⁶ United States, section 10 of the UDITPA as reproduced in J.R. Hellerstein, *State and Local Taxation: Cases and Materials*, 3rd ed., (St Paul: West Publishing, 1969) 344.

¹⁷ *Id.*, UDITPA sections 11 and 12. Prior to this attempt at uniformity, states used at least six different standards for valuing property owned by a taxpayer as well as a variety of standards for valuing leased property; see House Committee on the Judiciary, *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce* H.R. Rep. No. 565, 88th Cong., 1st Sess., (1965) (*Willis Committee Report*) in Hellerstein, *supra* note 16, at 310.

¹⁸ Miller, in McLure, Jr., *supra* note 3, at 134.

B The Payroll Factor

The use of a payroll factor in the apportionment formula is justified on the basis that labour produces income.¹⁹ The presence of labour as an apportionment factor allocates part of a corporation's income to the state where the services are rendered. Payroll consists of salaries, wages, commissions, and any other form of remuneration paid to employees for personal services rendered to the employer. There seems to be little disagreement as to who is an employee. Generally, an employment relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services both as to the results to be obtained and the means of attaining that result. Nevertheless, recent developments in the labour market may cause a significant problem at this level. In certain sectors, more especially in the computer industry, for example, the trend is to 'employ' software engineers who are referred to as 'contractors' for the production of unique programs for the enterprise. Should these 'contractors' be deemed to be employees, or should the enterprise be considered as purchasing the output of these persons? It is suggested that the first solution may be more acceptable. Indeed, 'contractors' are substitutes for in-house engineers whose formal employment is considered to be less attractive to enterprises. Thus, 'contractors' and in-house engineers are performing equivalent economic activities and should thus be treated in the same way for the purposes of the formula.

The most serious problem involving the payroll factor, if used on a worldwide basis, relates to the fact that productivity and the level of compensation of employees are not the same in different countries. In addition, because of cultural and political differences, the amount paid as compensation for work performed may or may not include social costs. Both direct wages and social costs are part of the measure of labour contributions to the production effort. However, social costs are generally excluded from the payroll factor since they do not constitute taxable income to the employee as determined by U.S. federal rules.²⁰ Therefore, although a business would have made social security contributions on behalf of its employees and paid other insurance contributions depending on the employment philosophy of a particular country, these payments are not included in the factor.

Furthermore, in the labour market the practice is irresistibly moving towards subcontracting and individual contracts which eliminate to a large extent the problem of social costs for TNCs. If this trend continues, it is difficult to predict how a decreasing level of social

¹⁹ Again, prior to the UDITPA there were substantial variations in the attribution rules of the payroll factor. The three basic standards used either separately or in combination were: place of service; place of the business with which the employee is connected; or place of residence of the employee; see *Willis Committee Report* in Hellerstein, *supra* note 16, at 310.

²⁰ R.A. Peterson, 'Comments on Miller', in McLure, *supra* note 3, at 167.

contributions would significantly impact on the payroll factor. Again, the trend is also to compensate employees through their participation in bonus payments or retirement pensions, employee share schemes, or generous superannuation contributions, for example, while keeping salaries to a minimum. Such payments designed primarily to compensate labour for work performed, albeit in a tax effective way should be included in the payroll factor. There are currently manoeuvres destined to delay the derivation of these types of payments by the employees concerned in order to postpone their taxation. A clear distinction must be made between the time at which the payer unconditionally incurs those liabilities and the time when a beneficiary actually derives its share of it. It is submitted that such liability is incurred when the firm irrevocably allocates the funds destined to finance future derivation by its employees. It follows that such funds should be included in the payroll factor in the year where such allocation occurs.

C The Sales Factor

The sales or revenue factor is the third and last of the apportionment factors as proposed by the UDITPA. This factor is a fraction of which the denominator is total overall sales and the numerator is total sales in a particular state during the income year.²¹ The sales factor is not taken to mean mere sales or trade revenues of a taxpayer. Essentially, it includes not only sales of tangible personal property, but also of real and intangible property as well as the performance of services, that is, all gross receipts of the taxpayer giving rise to business income, although certain extraordinary receipts that would be distortive to the sales factor are excluded.

Some economists have questioned the propriety of the inclusion of the sales factor in the Massachusetts Formula by maintaining that wealth is created by the production of goods and the rendering of services rather than by selling.²² The contrary view is that without sales no income would have been generated. As a result, the sales factor, in that instance, has a balancing effect since it provides the market state with an appropriate share of the income base which, but for its presence, would have been unduly apportioned to the manufacturing state.²³ Indeed, the state that provides a market for goods is:

furnishing a key link in the chain of income production; and since the other two factors, property and payroll, weight the apportionment heavily in favour of the manufacturing states, the use of a

²¹ See section 15 of the UDITPA as reproduced in Hellerstein, *supra* note 16, at 345.

²² See, for example, C.L. Harris, 'Economic Aspects of Interstate Apportionment of Business Income', (1959) 37 *Taxes* 327.

²³ See Kust, 'State Taxation of Interstate Income: New Dimensions of an Old Problem', (1959) 12 *Tax Executive* 45.

sales factor and the destination rule of apportionment of sales receipts, is necessary to provide market states which do not have heavy manufacturing industries with an equitable portion of interstate net income.²⁴

Sales has turned out to be the most troublesome of the factors in the various apportionment formulas used in the U.S.²⁵ Professor Musgrave even believes that ‘much of the tension in argument between those who advocate formula apportionment and those who in principle prefer separate accounting is attributable to the inclusion of the sales factor in the formula.’²⁶ In view of these difficulties, the problems relating to the sale factor will be examined in detail further below.

The Massachusetts Formula or certain variations thereof, are almost exclusively used in the U.S. state taxation context. It has certain limitations but is generally regarded as reasonably appropriate.²⁷ These limitations and their likely effect if applied in a global context need now to be examined.

Section II The Limitations of Present Formulas

All formulas used since the inception of the system in the U.S. state taxation context have been criticised on various grounds. The Massachusetts Formula, although approved by the American Tax Association, is no exception. The main criticisms relate to the diversity of factors and to the difficulties inherent in their valuation. Therefore, there is no doubt that if a formulary system were to be implemented on a worldwide basis, specific problems would arise in this environment too. These problems are illustrative of the controversies arising from the inevitable interference of political considerations in the field of taxation.

1 Diversity of Factors and Valuation Problems

A Is a Variety of Factors Necessary?

From the early days of state income taxation the U.S. states have been free to adopt any apportionment formula provided it withstood the constitutional scrutiny of the U.S. Supreme Court. The various states used a variety of factors to achieve their taxation objectives. Property, payroll, and sales were often present in conjunction with other factors, or even on

²⁴ Hellerstein, *supra* note 16, at 341.

²⁵ *Supra* note 16, at 311.

²⁶ P. Musgrave, ‘Principles for Dividing State Corporate Tax Base’, in McLure, Jr., *supra* note 3, at 240.

²⁷ J.R. Hellerstein, ‘Comments on McLure’, in McLure, *supra* note 3, at 130.

their own as a one-factor formula. Among the most prominent factors used at different times within the U.S. states were the following:

- Cost of manufacturing, expressed ‘as a ratio of total cost of manufacturing, collecting, assembling or processing within the state, to the total cost of manufacturing, collecting, assembling or processing everywhere.’²⁸
- Gross receipts, defined as the ratio of gross receipts accruing to business within the state to total gross receipts resulting from business done everywhere.
- Purchase as a factor was used by Arizona alone. Its code merely provided that ‘the numerator of the purchases fraction shall include all purchases resulting from [the] employee buying activity of the taxpayer in Arizona.’²⁹
- Average inventory has also been used as a factor. Thus, in Georgia, it was understood that the factor consisted of the average monthly inventories of all products held in this state for sale, lease, or other business purposes over the average of the total monthly inventories of all products held everywhere else for the same purposes as those inventories held in Georgia.³⁰
- Business done within a state as measured by the amount of payment such as salaries, purchases of inventories, compensation to employees and the amount of sales receipts over those total amounts for the enterprise as a whole.

Such a wide variety of factors contributed to the adverse reputation of state taxation, the most serious objection related to the obvious danger of double, or indeed multiple taxation. There were also concerns about taxpayers’ compliance because of the confusion created by such diversity.³¹

Too great a variety of apportionment formulas lead to inequitable taxation. Apportionment formulas vary not only with regard to the factors used, but also with respect to the definition of each of the factors used therein. Therefore, it seems important that Intertax be well aware of the dangers of yielding to pressure for unrealistic formulas promoted in order to satisfy, in most instances, the political rather than economic aspirations of its various members. However, whilst uniformity is required to satisfy administrative ease and to promote compliance, one must also consider the fact that apportionment formulas need to cater for the needs of different taxpayers operating in different industries. Therefore, a certain relativity in the concept of

²⁸ P.L. Hartman, ‘State Taxation of Corporate Income from a Multistate Business’, (1959) 13 *Vand LR*. 21, at 70.

²⁹ *Ibid*.

³⁰ *Ibid*.

³¹ Hellerstein, *supra* note 16, at 310-11.

uniformity needs to be adopted. This may be achieved by enabling the use of different formulas for different industries as explored further below.

B Formula Apportionment in an International context

A state is entitled to tax its residents as well as non-residents on their in-state income because it provides them with protection and privileges, including the right to receive and enjoy income.³² Thus, the U.S. Supreme Court held that taxing power through formulary apportionment is exercisable by the state if the state has afforded to the taxpayer ‘protection, opportunities, and benefits’.³³ A state must have given something ‘for which it can ask return’.³⁴

It is now argued that the benefit theory as the rationale for taxation must be expanded to fit with the modern theory of the TNC. The protection afforded by a jurisdiction’s legal regime contributes to the worldwide profits of the TNC. Moreover, an enterprise’s profits are the measure of its taxpaying capacity in toto.³⁵ In other words, a jurisdiction’s contribution to a TNC goes beyond the benefits it offers. In reality, a country contributes to the TNC’s ability to pay by providing it with an environment that is conducive for the production and acquisition of wealth. Consequently, these invisible contributions need to be reflected in any formula designed to tax such an enterprise on its worldwide income.

Transposed to the international setting, the starting point in choosing a formula for allocating a TNC’s income among jurisdictions remains the benefit theory since a TNC derives certain benefits from the jurisdictions where it operates, for example, payroll, property, and sales, as well as the protection afforded to it by the jurisdiction’s legal regime.³⁶ However, in reality, it is questionable whether the sole criterion for the taxation of TNCs is the fact that these enterprises use the infrastructure of their host countries. Governments not only actively seek to attract TNCs; they also compete to facilitate the location of TNC headquarter activities within their jurisdiction.³⁷ It may well be that the reasons for this range from positive spillover effects

³² *Lawrence v State Tax Comm’n of Mississippi*, 286 U.S. 276, at 281 (1932).

³³ *Wisconsin v J.C. Penney Co.*, 311 U.S. 435, 333 (1940).

³⁴ *Ibid.*

³⁵ S.I. Langbein, ‘A Modified Fractional Apportionment Proposal for Tax Transfer Pricing’, (10 February 1992) *Tax Notes* 719, at 730.

³⁶ R.S. Avi-Yonah, ‘Slicing the Shadow: A Proposal for Updating U.S. International Taxation’, (15 March 1993) *Tax Notes* 1511, at 1513.

³⁷ G.C. Hufbauer & J.M. Van Rooij, *U.S. Taxation of International Income: Blueprint for Reform* (Washington D.C.: Institute for International Economics, 1992), at 93.

on the national economy to the creation of positive externalities that ultimately benefit both parties.

Nonetheless, it may be necessary to look beyond the classical explanation of the benefit principle to justify the exercise of taxing power through the use of global formulary apportionment. The integration theory, as expounded by Harding as far back as 1933,³⁸ justifies a jurisdiction's entitlement to tax income arising from the interaction of all the factors of production assembled by an enterprise and integrated within the economic structure of that jurisdiction. Accordingly, the state within which the TNC is located has jurisdiction to tax the whole of the income generated by such factors regardless of where it is sourced.

Once the question of jurisdictional nexus in a global formulary apportionment is solved, there arises the issue of whether the system reasonably identifies the value contributed by each component part of an integrated business. In other words, in order for it to be universally accepted, formulary apportionment must, as a matter of principle, identify the contribution of each constituent part of a TNC to the overall profit, and assign an acceptable value to such contributions. This question of assigning value is inextricably linked to the choice, the definition, and the valuation of factor components. This valuation question is a particularly vexing one since it is very difficult, for example, to define and value the factors of the Massachusetts Formula. Some of these difficulties pertaining to the sales factor have already been discussed while others will be examined later. There is little doubt that in an international context, because of different legal and traditional methods of doing business, these difficulties are likely to be exacerbated. However, since time immemorial such differences have constantly been dealt with successfully in international trade. Consequently, it is probable that compromises will be found in order to make such a system workable.

As for the issue of property valuation, it is submitted that if a clear definition of property is reached, especially tangible property, then an acceptable value is also achieved. Property should comprise both tangible and intangible property owned by the taxpayer, as well as rented property. The question of tangible and rented property has been solved in the U.S. state taxation context and there seems to be no serious problem in adopting the same compromises on a worldwide basis. Intangible property is ignored by the UDITPA, presumably to avoid the problem of assigning them a location.³⁹ In reality a TNC's portfolio of intangible assets is an attribute of the whole enterprise. As such, it does not need to be assigned to a particular situs. Furthermore, since the benefits arising from its ownership accrue to the whole enterprise, there is strictly no reason to justify its valuation and the allocation of

³⁸ A.L. Harding, *Double Taxation of Property and Income*, (Cambridge, Mass: Harvard University Press, 1933).

³⁹ Hellerstein, *supra* note 16, at 310.

part of that value to the components of the TNC. The problem of intangible property, with all its nuances, will be explored below. As for the many valuation methods currently advocated for tangible property, the debate centres on whether use should be made of either historical costs or present net worth or some other valuation method.

Referring back to the question in the American context there was, prior to the relative uniformity brought about by the UDITPA, a wide diversity in the methods of valuing property. Hartman documents at least five methods of valuation of real and tangible personal property owned by businesses:⁴⁰ annual average value, market value, average monthly net book value, average quarterly value, and original costs adjusted for depreciation. The problem is seemingly solved in the U.S. by the UDITPA adopting valuation of property at its original cost.

The original cost method has some undeniable advantages. It avoids the difficulties associated with either current market value or any method requiring the use of depreciation allowances. However, whilst the use of original cost may favour older TNCs, or those whose acquisitions were made in times of low inflation, it remains nevertheless easier to administer as it is easily ascertainable from the books of the taxpayer. The discussion as to what is the most appropriate method of valuation of tangible property is strictly not relevant in this context. What is crucial to achieve is uniformity in valuation methods so that TNCs are treated on an equitable basis. Such uniformity can only be achieved by the implementation of international standards for the valuation of property and for depreciation allowances. Until such international standards are implemented, Intertax may well have to use original cost for the valuation of tangible-owned property. Unfortunately, even the use of original cost is not likely to be universally acceptable. There is a wide disparity as to the cost of plant and property between various jurisdictions. Petersen notes that 'it would have cost \$244 million in California in 1969, to build an oil refinery to produce 125,000 barrels per day; the cost of the same refinery in Germany, however, would have been only about \$190 million.'⁴¹

Yet another problem arises from the use of original cost in valuing property. In the Californian practice the numerator of the property factor, that is, that part of property owned by the TNC within California, is calculated on the basis of original cost. However, the denominator of the property factor, that is, the worldwide property of that TNC is computed 'by converting the original cost of the property worldwide at *current* exchange rates'.⁴² As a result, the

⁴⁰ Hartman, *supra* note 28, at 68.

⁴¹ R. Petersen, 'California Franchise Tax: Combined Income Report affects Foreign Companies', (1976) 44 *J Tax'n* 184, at 187.

⁴² F. Latchan, 'Unitary Doctrine in Applying Franchise Tax, Statement to the Franchise Tax Bd. on Behalf of Container Corp. Of America, Xerox Corp., Colgate-Palmolive Co. and Crocker National Bank', (12 July 1977)

denominator is often understated thus increasing the weight of the property factor in favour of allocating income to California. This problem may be obviated by utilising historical exchange rates to compute the denominator of the property factor. However, this leads to complications and increased costs for both the taxpayer and the tax administration.

Rented property poses a similar problem. The UDITPA provides for the valuation of rented property at eight times the annual gross rent, that is, including all consideration paid by the taxpayer for the use of the rented property. This valuation method seems to be acceptable. However, if possible, it is perhaps more equitable if the opportunity cost theory be applied in this context. In other words, the value of rented property should equate to that which the tenant would have paid had it chosen to purchase the desired property at the time it entered into the lease. There might be a certain percentage discount allowed in order to reflect the uncertainty that a tenant faces.

Even if these methods were to be proposed by Intertax, their appropriateness is still questionable. This is because on a worldwide basis there is a serious differential in the rate of factor return and that of factor productivity. Thus in *Container*⁴³ it was argued that the profit margins of the various components of a TNC vary considerably. The allocation formula, however, assumes a uniform rate of return and thus overstated the value contributed by some of these various components. For instance, it was demonstrated that the cost of production fluctuates as between jurisdictions and that:

[E]xcept for the possibility that lower gross sale prices may offset lower production costs, the apportionment formula contains no adjustment for the fact that higher rates of return may be available in some jurisdictions because of lower plant and labour costs.⁴⁴

Therefore, if a TNC produces income at a lower cost in terms of property and payroll, then the result of a normal apportionment formula is that jurisdictions with higher costs are able to unfairly tax value generated outside their borders. This claim is pertinent and must be recognised as one whose resolution is fundamental to the acceptance of formulary apportionment on a worldwide basis.

The payroll factor has the same inherent problem since wage rates differ substantially between countries. For example, if the salary of a U.S. executive is taken to be double that of his counterpart in a particular jurisdiction while the productivity of both remains constant, then the

14 (on file at *Santa Clara Law Review*), in G.T. Yamate, 'Comment' (1980) 20 *Santa Clara Law Review* 123, at 139.

⁴³ 103 S Ct, at 2933.

⁴⁴ D.L. Simmons, 'Worldwide Unitary Taxation: Retain and Rationalize, or Block at the Water's Edge?', (1985) 21 *Stanford J Int'l L* 157, at 167.

U.S. executive salary is double-weighted in the apportionment formula. As a result if payroll is computed on a monetary basis a disproportionate amount of income is allocated to the U.S.⁴⁵ The fact that wage levels vary considerably on a worldwide basis has also been convincingly demonstrated. Although the figures used by Petersen may have changed, a substantial disparity between countries as to the remuneration of labour remains. Such disparity would presumably be greater as between industrialised and less-developed countries. Petersen found that:

[W]age levels are considerably lower in Japan, Italy or almost any other country than in the United states for the same work. In 1969, the cost of engineering work in Japan was only 70 per cent of that in the U.S. (England was 75 per cent, Holland 80 per cent, France 90 per cent). In 1972 the cost of skilled labour in Japan was approximately \$14 per day including social charges. In Argentina, the cost was \$7 per day. In England, it was \$10 per day. In the United states, the cost is about \$25 per day.⁴⁶

Petersen also documents the same type of disparity that exists as to the cost of plant or property.⁴⁷ Petersen's work was carried out in 1976 and it is doubtful whether the same conclusion could be drawn today. Indeed, because of the strength of the yen, costs in Japan are relatively higher than in other industrialised countries.⁴⁸ However, the point is that such disparities could be mitigated through the use of a formula based on 'units' rather than monetary values. Thus, the size of real property used in various jurisdictions rather than its monetary value would be an appropriate solution. Likewise, the size of the workforce rather than the size of the payroll, or the volume of sales rather than the value of sales could well prove to be adequate.⁴⁹

2 The Sales Factor Revisited

History, in the U.S. state taxation context, shows that the sales factor is more open to manipulation. Therefore, its presence in an apportionment formula represents a major cause of conflict which is still not settled.

⁴⁵ J. Condrau, 'Statement by the Union Bank of Switzerland to the California Franchise Tax Board Regarding the Effect of Application of Worldwide Unitary Accounting', in Yamate, *supra* note 42, at 139.

⁴⁶ Petersen, *supra* note 41, at 187.

⁴⁷ *Supra* note 41, at 187.

⁴⁸ However, increases in productivity and the yen's decline against Asia's dollar-linked currencies in 1996 have raised Japan's competitiveness in manufacturing. See J. Barnathan & B. Einhorn, 'The New Asian Reality', *Business Week* (Asian Edition), (15 September 1997) 18, at 19. However, this observation needs to be tempered given that recently the yen has been strengthening.

⁴⁹ D. Sandler, 'Slicing the Shadow-The Continuing Debate Over Unitary Taxation and Worldwide Combined Reporting', [1994] *BTR*, 572, at 594.

The sales factor attributes the proceeds of a sale to either:⁵⁰

- the state of destination, or the market state,
- the state of origin, or the manufacturing state, or
- the state where the sale was solicited, negotiated, or executed.

Therefore, income from sales may be included in the tax base of at least three different jurisdictions if each uses a different concept for locating the sale in a formula. Consequently, as one author puts it, ‘it [the sale factor] is perhaps the most difficult part of the entire problem to resolve in an equitable and acceptable fashion.’⁵¹ The controversies about which of the manufacturing or sale components of a business is responsible for generating an enterprise’s income are not new.⁵² Yet, the debate is far from over as evidenced by recent developments in the U.S. states’ taxation environment.

A Analysis of the Sales Factor

Basically, the issue that needs investigation is whether sales add value to an enterprise. Two lines of arguments are put forward in the debate: The first relies on the benefit theory, and the second on a purely economic analysis.

The question as to whether a state where an enterprise sells its products has a legitimate claim to tax the proceeds may be analysed on the basis of the benefit theory. Viewed differently the question is: does a sale constitute a sufficient nexus or connection as is required for exercising taxing jurisdiction?

An enterprise that makes a sale in a particular jurisdiction receives from that jurisdiction protection and other benefits. For example, that enterprise may sue the market state for the payment of any moneys owed to it as a result of the transaction. Moreover, by permitting an enterprise to exploit its market, a marketing state is entitled to a return for providing that enterprise with the opportunity to make profits. In short, the justification of the sales factor rests on the view that both the market and the manufacturing states are entitled to a share of the tax base. This result is perceived as being equitable since income is generated by both manufacturing and selling activities.

⁵⁰ P.J. Hartman, ‘State Taxation of Interstate Commerce: A Survey and an Appraisal’, (1960b) 46 *Virginia Law Review* 1051, at 1104.

⁵¹ A.D. Lynn, ‘The Uniform Division for Income Tax Purposes Act’, (1958) 19 *Ohio St LJ* 41, at 49.

⁵² Huston, *supra* note 13, at 758.

However, serious reservations as to the inclusion of the sales factor in an apportionment formula have been voiced, more especially by economists.⁵³ For example, it has been argued that:

the situs of sales is a particularly volatile element, often determined by trivial variations in the circumstances of the sale. In a fully competitive world, indeed, the net income of a firm would be attributable to capital and entrepreneurial effort, not to payroll or sales.⁵⁴

Again it is claimed that:

one serious defect of most of today's formulas is use of the receipts (sales) factor. This has little or no economic justifications, and analysis leads to a conclusion sharply at variance with established practice.⁵⁵

At the outset, it is arguable that economists have a very limited role in determining the composition of an apportionment factor.⁵⁶ After all, the choice of factors in this formula is a political matter often justified ahead of purely economic considerations. Yet, even after the UDITPA and the MTC had more or less harmonised the system applicable in the U.S. states' context by proposing the Massachusetts Formula, an economist maintained that:

[T]his simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they were ever taught about statistics and economics.⁵⁷

The truth is that 'none of the existing formulas that the states use is grounded on economic principles or on economic models, nor were they intended to be.'⁵⁸ However, the absence of economic theory in the design of a formula does not mean that attention should not be paid to broad taxation policy objectives, themselves designed with economic efficiency in mind. Professor Michael McIntyre has in fact developed a set of principles which he considers as essential in this context.⁵⁹ These are, inter alia, administrative simplicity, neutrality, economic nexus, inclination to tax, and sovereign control of tax. These criteria will be studied further down.

⁵³ For a vigorous attack on the appropriateness of the sales factor, see P. Studenski, 'The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist Viewpoint', (1960) 46 *Virginia Law Review* 1121.

⁵⁴ W. Vickery, 'An Updated Agenda for Progressive Taxation', (1992) 82 *Am. Econ. Rev.* 257, at 260.

⁵⁵ Harriss, *supra* note 22, at 362.

⁵⁶ Musgrave, in McLure, *supra* note 3, at 241.

⁵⁷ Vickery, *supra* note 54, at 260.

⁵⁸ R.D. Pomp, 'Issues in the Design of Formulary Apportionment in the Context of NAFTA', (1994) 49 *Tax Law Review* 795, at 812.

⁵⁹ M.J. McIntyre, 'Design of a National Formulary Apportionment Tax System', (1991) 84th Conf. on Tax'n, Nat'l Tax Ass'n 118, at 119.

i The Supply-Based and Supply/Demand-Based Source Rules

It is not clear, even at a purely conceptual level, what factors should be included in a formula and how they should be weighted. Whilst formula apportionment is not an attempt to determine the true source of income,⁶⁰ an economic analysis aimed at deciding what factors should be used to apportion a TNC's income may start with an attempt to determine, on an objective basis, the geographic source of that income. Professor Peggy Musgrave has made such an attempt.

Professor Musgrave does not favour the triple-factor formula consisting of payroll, assets and sales. Starting from the assumption that corporate taxation is motivated by an effort to attribute the tax base to the taxing jurisdictions that are 'entitled' to tax it, Professor Musgrave inquires as to whether entitlement is to be based solely on 'supply' (production) considerations or whether it needs to also reflect 'demand' (consumption) considerations. She thus distinguishes between supply-based source rules and supply-demand-based source rules.⁶¹ In the supply-based source rule paradigm consideration is put on payroll and property, but not on sales since these two factors adequately capture the contributions of a sales force and sales-related capital. If a supply-based source rules paradigm is considered, Professor Musgrave concludes that:

[I]nclusion of sales makes no sense for a formula designed to implement a supply-based entitlement rule, but it does make sense if the entitlement is broadened to allow for demand as a source of value.⁶²

Professor Musgrave's reasons take into consideration a state's entitlement to tax as explored earlier. She also claims that in:

the more complex situations where the interjurisdictional business units exhibit interdependence in their operations and when separate accounting is simply not applicable, the choice of formula cannot readily be derived.⁶³

If the supply-demand view of the source principle is favoured, then the inclusion of sales in the formula becomes necessary. Therefore, a formula based only on property and payroll is

⁶⁰ C.E. McLure, Jr., & J.M. Weiner, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Taxation', paper prepared for presentation to the International Seminar in Public Economics/Research Center for Economic Policy Conference on Reform and Harmonization of Company Taxes in the European Union, at The Hague, 35 April 1997, at 16. It seems, with this statement, that Professor McLure has cleared the ambiguity arising from an interpretation of his 1981 article, (C.E. McLure Jr., 'Towards Uniformity in Interstate Taxation: A Further Analysis', (13 July 1981) 13 *Tax Notes* 51). The ramifications of that article have been analysed in Chapter 5 of this thesis.

⁶¹ Musgrave, in McLure, *supra* note 3, at 237 ff.

⁶² *Supra* note 3, at 240.

⁶³ *Supra* note 3, at 241.

inadequate in more complex situations where economic rents can be traced to market power instead of other factors. Sales clearly play a different role in these cases compared to other highly competitive situations. The inclusion of the sales factor is therefore justified only if it is intended to broaden the entitlement rule to allow for demand as a source of value. Having broadened the base, the relative weights assigned to sales and supply factors become merely a matter of entitlement judgement. However, Professor Musgrave concedes that it would be impractical to attempt to consider market power in designing apportionment formulas. In short, beyond recommending that the factors reflect what generates income, according to Professor Musgrave, economists have relatively little to say about the design of apportionment formulas.

The views expressed by Professor Musgrave are heavily reliant on pure economic analysis. It ignores the fact that formulary apportionment is not an exact science.⁶⁴ Pure theory cannot take precedence over pragmatism. Rather, a blend of both is necessary. A system will be successful only if it is administratively capable of being implemented and intrinsically satisfies the needs of those to whom it is to apply. Furthermore, Professor Musgrave argues that the problem relates to a source rule aspect of entitlement rather than ‘the assignment of the profits tax base to meet a benefit-based criterion of entitlement [and as such] this may well be best implemented by a single-factor formula involving only capital entering into that formula.’⁶⁵ In addition, such a formula does not require any weighting system. It would seem, though, that primarily, the question revolves around the question of entitlement to tax rather than on pure source rules as argued by Professor McIntyre.⁶⁶ Moreover, it is generally agreed that entitlement to tax on the basis of a formula does not rest primarily on source rules, but rather on the benefit principle, as demonstrated throughout this thesis.

ii The Contribution Analysis Approach

In 1992 Professor Stanley Langbein grappled with ‘the more complex situations where the interjurisdictional business units exhibits interdependence in their operations’ as identified by Professor Musgrave.⁶⁷ This approach, which according to Professor Langbein is in accord with the contemporary theory of the multinational firm, consists of a two-step process. The first step would require that each component of a TNC be granted a return on its costs plus an

⁶⁴ Miller, *supra* note 3, at 133.

⁶⁵ Musgrave, *supra* note 3, at 240.

⁶⁶ See Professor McIntyre’s ‘inclination to tax’ theory. ‘To the extent feasible, income with an economic nexus in more than one country should be sourced in a country that is inclined to subject the income to taxation. By designing source rules to conform to the inclination-to-tax guideline, policy makers would reduce the risk of under taxation, thereby promoting fairness and economic efficiency.’ See M.J. McIntyre, *The International Income Tax Rules of The United States*, (Massachusetts: Butterworths, 1989), at 3-65-6-70.

⁶⁷ Musgrave, in McLure, *supra* note 3, at 241

appropriate return on its assets (about 20 per cent). The second step would allocate any residual profit by way of a two-factor formula consisting of assets and sales. Professor Langbein argues that this method would approximate the component's relative contribution to the enterprise's total profit.

To justify his method Professor Langbein relies on the modern theory of the multinational firm as examined earlier in this thesis.⁶⁸ Briefly, the very essence of the TNC is to integrate its operations thereby generating 'joint' profits greater than the profits achievable by the separate parts.⁶⁹ In a forward integration model Professor Langbein demonstrates that a pure sales allocation figure splits the profit between the home and satellite jurisdictions in such a way that the relative contribution of each of the two components, that is, manufacturing and sales, are taken into account.⁷⁰ The method used to control this result involves the disaffiliation of the constitutive components of the TNC and an approximate determination of the profits that each part would have derived in these circumstances, that is, an arm's length result.

Professor Langbein concedes that the examples he uses to illustrate his model have obvious shortcomings, including the administrative difficulties of determining what kind of integration a particular TNC is constituted. He therefore concludes that it would be administratively more expedient to settle on 'a residual allocation scheme that would give 50 percent weight to the sales factor and 50 percent to the asset factor in all settings' in spite of the fact that this solution departs from a 'relative contribution' standard as defined.⁷¹ However, he maintains that:

sales, if anything, are the more or most important factor in indicating the 'relative contribution' of a component of an enterprise's group profit.⁷²

iii Sales as a Positive Externality

Professor Rueven Avi-Yonah has put this concept forward. When a corporation sells its products in a particular market, it provides a service in that market for which it receives a

⁶⁸ See Chapter 2, Section III, 1, B, at 79ff.

⁶⁹ Langbein, *supra* note 35, at 724.

⁷⁰ *Supra* note 35, at 727. Professor Langbein also examines the situations involving backward integration as well as multistage vertical integration. In the forward integration context a single sale factor is found to be the most appropriate allocation formula, whereas in a backward integration context, that is, a situation where one component is able to 'hold up' the main enterprise, as examined in Chapter 2 of this thesis, a single factor asset is most appropriate. In cases of multi-stage vertical integration, a mixed sales and assets factor seems to be suitable.

⁷¹ *Supra* note 35, at 729.

⁷² *Supra* note 35, at 729.

concurrent and full compensation in the form of income.⁷³ The same does not hold when a corporation pays its employees compensation on a consensual basis for whatever services the latter provides it with. For instance, a corporation employing labour provides over and above the normal wages and salaries valuable training that is highly portable. Since a corporation cannot bind its labour force to it, it receives an inadequate compensation for the training it has dispensed. Thus society receives a benefit in excess of what the corporation receives in return.

Given the fact that a corporation's outlay and its receipts are matched only when it sells its product, then, according to the author, an apportionment formula needs to be based solely on sales. First, Professor Avi-Yonah argues that a market state has a right to tax income derived from exploiting its market.⁷⁴ Second, he maintains that the modern theory of the TNC demonstrate that these firms exist because of advantages inherent in controlling sales directly in order to control the various hazards faced by TNCs as examined in Chapter 2.

Professor Avi-Yonah, however, does not examine the concept of the jurisdictional threshold that would be required in his proposal to trigger the market state's right to tax. In a formulary apportionment system, it is critical for the threshold rules to be coordinated with the rules defining the apportionment factors.⁷⁵ This coordination is what Professor McIntyre calls 'the inclination to tax' criterion. An illustration of the interaction of these principles may be found in the provisions of Article 5(4) of the OECD Model.⁷⁶ Pursuant to this provision, the maintenance of a stock of goods solely for display does not constitute a permanent establishment (PE). In Professor Avi-Yonah's model it would suffice for a TNC to maintain such a showroom from which orders are referred to head office, for example, to allow an enterprise to avoid the PE categorisation, unless the system is cluttered with throwback or throwout rules.⁷⁷ In the words of Professor Pomp:

⁷³ Avi-Yonah, *supra* note 36, at 1511.

⁷⁴ *Supra* note 36, at 1513.

⁷⁵ M.J. McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance', (1994) 49 *Tax Law Review* 769, at 769.

⁷⁶ OECD, *Model Tax Convention on Income and Capital*, (Paris: OECD, 1992), loose leaf (1997 update), at para. 2(11). (Note: A 2000 update is now available.)

⁷⁷ For a discussion of throwback and throwout rules, see R.D. Pomp, 'Reforming a State Income Tax', (1987) 51 *Albany Law Rev.* 375, at 704-707. Section 16 of the UDITPA provides for a throwback rule. It states: 'Sales of personal tangible property are in this state [and thus included in the numerator of the receipt factor] if...the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser. See also Pomp, *supra* note 58, at 815 n 69. Moreover, even the throwback definition of the UDITPA has given rise to controversy, for example concerning the so-called 'dock sales' or 'dock pickup sales'. A dock sale refers to sales of goods picked up at the seller's location by an out-of-state purchaser using its own vehicles for transportation to an out-of-state location. If both the dock state and the destination state claim that these sales should be included in their sales factor numerator, an attribution problem arises. Section 16(a) of the UDITPA provides that sales of tangible personal property are

[I]f receipts are one of the factors in the apportionment formula, the consequent of a permanent establishment threshold rule is that income may be assigned to countries unable to tax it.⁷⁸

To sum up, it is perhaps necessary to reconsider the questions at issue in designing an apportionment formula. It would seem that the question that needs to be resolved does not relate to the issue of determining the source of income. Rather, the fundamental question is: what produces income? It seems that income is produced by the combination of human effort and property, such as land buildings and equipment, in a two-tier operation. First, the manufacturing side, using capital under the direction of the entrepreneur, produces the goods, and second, the sales force transforms these goods into income. Even this analysis is fraught with uncertainties. The confusion in determining what constitutes the true source of income is enduring. Some argue that it is essential to distinguish between where income is earned and where it is paid.⁷⁹ In this scenario, sales contribute to the production of income but are certainly not an independent factor in the income-producing process. Clearly, therefore, the contribution of the sale personnel is already reflected in the payroll factor. If this analysis were correct, then an appropriate formula would consist of property and payroll only as only these two factors produce income.

As examined earlier, in designing a formulary apportionment system, regard must be had to the crucial relationship that exists between the formula and the jurisdictional threshold rules. What has been proposed earlier in this thesis is that the jurisdictional threshold rule be based on the functions performed by an enterprise in a particular jurisdiction. Given that functions performed must involve a certain number of factors such as the assets used and risk assumed, to use the OECD's terminology, then a country's ability to tax depends on the presence of such factors within its jurisdiction. Therefore, the presence of such factors should be regarded as a sufficient connecting factor equivalent to the enterprise having a PE in that jurisdiction.

A further question revolves around the weighting of the two elements in the formula. In other words, the issue is that of determining the proportion by which labour and property

includable in the numerator of the sales factor if the property is delivered or shipped to a purchaser, other than the United States Government, within the state regardless of the FOB point or other conditions of sale. The construction of this section has been subject to litigation. The judiciary has consistently held that 'within the state' modifies the word 'purchaser' thereby attributing back sales to the state of ultimate destination; see, for example, *McDonnell Douglas Corp. v Franchise Tax Board* No. B 064073 (Calif. Ct. App., Second App. Dist. July 7, 1994; modified 8 August 1994 in J.A. Liss, 'Factually Speaking: An Overview of the Sales Factor', (Sep/Oct 1995) *47 Tax Executive* (Issue 5) 372.

⁷⁸ Pomp, *supra* note 58, at 813, and more specially at n 3 where Professor Pomp writes that this defect 'greatly undermines Professor Avi-Yonah's proposal for a one factor formula based on sales'.

⁷⁹ D.K. Barnes, 'Prerequisites of a Federal Statute Regulating State Taxation of Interstate Commerce', (1960) *46 Virginia Law Review* 1121.

respectively contribute to the creation of income. Questions relative to the productivity of labour or the optimum return on equity capital are notoriously difficult to ascertain.⁸⁰ Thus:

[F]or the economy as a whole, labor produces about four times as much as property. Yet there is no reason to believe that labor produces even as much of business net income - the tax base we seek to apportion - as property produces.⁸¹

In view of these difficulties, Professor Harriss suggests that equal weighting of the payroll and property factors 'will probably give results which are reasonably close to the underlying economic reality'.⁸² If no data is available as to the exact measure of the productivity of these factors in the U.S., then it is reasonable to conclude that the same applies on a worldwide basis. Consequently, one might venture to conclude that the solution proposed for the U.S. should be applicable on a worldwide basis. Thus, a two-factor formula consisting of property and payroll could be opted for until such time that reliable data is collected to finetune this option. However, it is doubtful whether consensus could be obtained on such a formula. Indeed, it is most likely that political considerations would demand that a sales factor be included in any global apportionment formula.

B The Sales Factor: The Meeting Point of Economic and Political Considerations

A formulary apportionment system will not work in the international context if Intertax is incapable of devising formula/formulas that would be sanctioned by national governments eager to safeguard their revenue base. The question that arises, therefore, is whether it is advisable for Intertax to include sales in such formulas. In reality, such an agreement hinges on both technical and political considerations.

If the premises of the economic debate are not construed narrowly, as is the case when the analysis is locked in neo-classical economics, then it seems that even then there are good reasons to include the sales factor in an apportionment formula. In the modern world value has more to do with cost of production theories. Value is created not only by the combination of property and labour, but arises also through the intervention of sociological and political considerations.⁸³ Indeed, the classical economic conception of value 'has little or no bearing on tax policy'.⁸⁴ Tax policy in most countries has long recognised that the nexus between the

⁸⁰ See, for example, F.M. Fisher & J.J. McGowan, 'On the Misuse of Accounting Rates of Return to Infer Monopoly Profits', (1983) 73 *Am. Econ. Rev.* 82.

⁸¹ Harriss, *supra* note 22, at 363.

⁸² *Supra* note 22, at 362.

⁸³ J. Hellerstein, 'Allocation and Nexus in State Taxation Interstate Businesses' (1964) 20 *Tax Law Review* 259, at 275.

⁸⁴ *Ibid.*

taxing jurisdiction and the tax subject ‘includes a whole gamut of legal and economic relationships, benefits and protections, and encompasses virtually every step in the economic process, from the creation of the goods to their conversion into dollars in the market place.’⁸⁵ Consequently, a sensible tax policy requires that all those steps in the economic process to be recognised, to a certain degree, as constituting a suitable basis for tax.

This being said, there remains the practical question of determining the most appropriate basis for assigning sales to the sales factor. There are several general bases for assigning sales to the sales factor of the numerator. These are: sales office location, customer location or point of delivery, location of goods sold at time shipped or appropriated to order, and the place where the goods are manufactured or mined.⁸⁶ In the U.S. context, the controversy is based on purely political considerations and it still rages on as to the choice of the appropriate base.⁸⁷ Various states have adjusted the factor composition of their apportionment formula to improve their business climate and their competitive position relative to neighbouring states.⁸⁸ However, these instances of predatory behaviour should not prevail in the proposed model since the exclusivity of designing the apportionment formulas rests with Intertax, which is required to accommodate the interests of both manufacturing and market countries.

The present tendency of TNCs is to locate production in less-developed countries (LDCs) where property value and labour costs are low. If sales on a destination basis were to be excluded from any apportionment formula developed by Intertax for the manufacturing sector, then it is clear that many countries would reject such a formula on the ground that such a measure would attribute virtually all income to the LDCs where the manufacturing plants and

⁸⁵ *Id.*, at 275-76.

⁸⁶ Lynn, *supra* note 51, at 50.

⁸⁷ See section 16(a) of the UDITPA as reproduced in Hellerstein, *supra* note 16, at 345. In his comments to this section, Professor Hellerstein mentions that sales to the United States Government are treated separately because they are not necessarily attributed to a market existing in the state to which the goods are originally shipped. It was not until 1978, as a result of *Moorman Mfg. Co. v Bair* 437 U.S. 267 (1978), that the constitutionality of using a single factor sales allocation by the states was established. Moreover, there is a recent trend in the U.S. to double-weight the sales factor or to even adopt a single sales factor in the U.S. states’ context; see D.L. Eastman, D.A. Joseph & D.L. Manos-McHenry, ‘The Single Sales Factor - A New Trend?’, (September 1996) 27 *The Tax Adviser* (No. 9) 574. See also J.A. Liss, *supra* note 77, at 372. It is doubtful whether the single sale factor would stand judicial scrutiny within the U.S. Indeed, in *General Motors Corp. v District of Columbia*, 380 U.S. 553 (1965), the Supreme Court, while refusing to adjudicate on ‘the constitutionality of a state income tax based on the sales factor alone’ made it clear that ‘the use of an apportionment formula based wholly on the sales factor, in the context of general use of the three-factor approach, will ordinarily result in multiple taxation of corporate net income.’ Moreover, the Court went on to say that ‘the sheer inconsistency of the District formula with that generally prevailing may tend to result in the unhealthy fragmentation of enterprise and an uneconomic pattern of plant location.’

⁸⁸ Liss, *supra* note 77, at 374.

payroll are concentrated.⁸⁹ Conversely, if the sales factor is ignored for purely practical reasons, for example, to promote simplicity, this omission may have serious effects on the revenue side.

In 1964, the Willis Committee recommended strongly that the sales-receipt factor be abandoned altogether.⁹⁰ The Committee based its recommendations not on theory but from a practical standpoint. It argued that the sales factor caused the most serious difficulties in formulary apportionment. It required precise record-keeping, involved additional costs, favoured non-compliance, and rendered enforcement particularly difficult. The Committee went on to demonstrate that no significant revenue loss would be suffered by any state by shifting to a two-factor non-receipts formula.⁹¹ Sheffrin and Fulcher reached the same conclusion. They showed that the inclusion of the sales factor makes relatively little difference to the inter-state distribution of the tax base.⁹²

Whether the findings of the Willis Committee are applicable in a worldwide context is not known. If national governments were to support a two-factor formula on the ground of simplicity, as far as manufacturing and mercantile corporations are concerned, it is essential to demonstrate that such simplicity is not achieved at the expense of revenue. Unfortunately, there is little systematic empirical evidence on that particular issue in state taxation of corporate income, let alone in the taxation of cross-border income.

An attempt to determine whether the amount of the tax base or revenue involved is truly substantial in the U.S. states context was made by Sheffrin and Fulcher.⁹³ One of the questions that these authors set themselves to answer is whether the variations in factors used in apportionment formulas could be used by the states in order to ‘pirate’ some of the tax base of another state. The data that Sheffrin and Fulcher used originated from two sources: the Advisory Commission on Intergovernmental Relations (ACIR), and the Californian Franchise Tax Board (FTB), that is, data collected from the actual returns filed in California. The result

⁸⁹ Miller, in McLure, *supra* note 3, at 135.

⁹⁰ United States, House Committee on the Judiciary, *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce*, 88th Cong, 2nd Sess., 1964, H Rept 1480 in M Sheffrin & J Fulcher, ‘Alternative Divisions of the Tax Base: How much is at Stake?’, in McLure, *supra* note 3, at 196.

⁹¹ Sheffrin & Fulcher refer to the *Report of the Special Subcommittee on State Taxation of Interstate Commerce* Vol. 4, 1st Sess., H Rept 565, at 1143ff; see S. Sheffrin & J. Fulcher, ‘Alternative Divisions of the Tax Base: How much is at Stake?’ in McLure *supra* note 3, at 196. See, however, J. Hellerstein, (1964) *supra* note 83, at 269ff where Professor Hellerstein questions the methodology used by the Willis Committee to conclude that the abandonment of sales in an apportionment formula would have a low impact on the revenues of most jurisdictions.

⁹² Sheffrin & Fulcher, in McLure, *supra* note 3, at 195.

⁹³ *Supra* note 3, at 195.

of this study shows that in some industries it is the sales factor which attributes the greater percentage of income, whereas for some other industries another factor, such as, payroll, will do this.⁹⁴ The authors thus support the findings of the Willis Report which stated '[C]ontrary to common belief, it will be seen that the choice among...formulas is not an issue involving great amounts of money.'⁹⁵

Moreover, the authors point out that as far as the U.S. is concerned, there is a balanced distribution of industries across the various states. On a worldwide basis, industries tend to be concentrated in a few developed countries. Nevertheless, there seems to be a tendency to decentralise both production and management in the evolution of TNCs. Thus, in the automobile industry, for example, the various components are designed, manufactured, and assembled in different countries. There is an obvious dispersion of operations within various jurisdictions that tends therefore to reproduce the U.S. conditions. If this trend continues, then it may well be that the above conclusions would become more and more relevant in a worldwide context.

However, even if the pace at which such reorganisation is occurring accelerates, for the foreseeable future there will still be major manufacturing centres located in particular jurisdictions, whilst sales are concentrated in others. Therefore, many countries would oppose the exclusion of the sales factor computed on a destination basis in any formula developed by Intertax for the apportionment of income derived by manufacturing industries. Moreover, the inclusion of sales is of vital importance to resource rich countries 'since it greatly reduces the scope of their entitlement and spreads the base among the consumer states.'⁹⁶

When all these often conflicting interests are considered relative to their effects on a global apportionment formula, the most reasonable conclusion that may be drawn is that it would be unwise to disregard the claims of the market jurisdictions. As Professor Hellerstein puts it:

the use of a receipts factor with the sales destination test commends itself on a pragmatic basis ... Moreover, that test sets up a standard not easily avoided under a properly drafted formula, a fact of no little significance in this area.⁹⁷

It follows that a destination sales factor needs to be present in any formula developed by Intertax for manufacturing industries and the like as adopted by the UDITPA in the U.S. states' context appears to be reasonable. However, in order to ensure that sales not taxable in

⁹⁴ *Supra* note 3, at 195.

⁹⁵ United states, House Committee on the Judiciary, *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce*, *supra* note 90, at 530 in Sheffrin & Fulcher, in McLure, *supra* note 3, at 196.

⁹⁶ Musgrave, in McLure, *supra* note 3, at 241.

⁹⁷ Hellerstein, *supra* note 83, at 276.

the state of destination are nevertheless taxable somewhere, that is, in order to avoid the so-called ‘nowhere income’, the ‘throwback’ rule provided for by the UDITPA would have to be included in the definition of the sales factor by Intertax.⁹⁸ It will be recalled that the ‘throwback’ rule provides that if a taxpayer is not taxable in the state of destination, then the sale is attributable to the state from which the property is shipped.

Section III Other Possible Solutions

An acceptable formulary apportionment methodology must imperatively reconcile theory and ease of administration. It must clearly and unambiguously reflect ‘the elements that contribute to or measure the processes involved in the earning of net income.’⁹⁹ With these objectives in mind it is now appropriate to examine the ways and means of addressing the major objections to the use of formulary apportionment for the taxation of TNCs.

These objections fall into three main categories:

- First, formulary apportionment is perceived as being arbitrary. In this regard, reservations have been made as to the inherently unrealistic expectation that one formula alone would adequately apply to all types of business activities.
- Second, it is claimed that differences in business practices, both in terms of traditions and specific practices such as valuation methods, are likely to inhibit the emergence of uniformed procedures, which are the prerequisites for the application of formulary apportionment on a worldwide basis.
- Finally, there is some concern as to the impartiality of the method because of the major differences in either the returns on capital invested or the costs and productivity of labour.

In addition, the failure of the current formulas to account for intangible property, and the absence of any plausible method for attributing income generated by such property, are portrayed as serious shortcomings of present day formulas.

⁹⁸ See section 16 of the UDITPA in Hellerstein, *supra* note 16, at 310. Moreover, if sales were to be included in an apportionment formula developed by Intertax, the sales factor ought to be the net of sales taxes. If this was not to be the case, governments could increase the sales figures by imposing a sales tax, thus increasing the receipt from sales within its jurisdiction, and as a consequence shift more profit to it.

⁹⁹ Miller, in McLure, *supra* note 3, at 133.

1 The Arbitrariness and the Valuation Question Revisited

All apportionment methods, whether based on the separate accounting/arm's length method, or the global formulary method, are intrinsically arbitrary. Therefore, there can be no valuation methods that would be universally accepted. As far back as 1922 a Committee of the National Tax Association observed:

[A]ll methods of apportionment of trading profits are arbitrary - the cutting of the Gordian knot...there is no one right rule of apportionment, notwithstanding that there are probably a number of different rules, all of which may work substantial justice...the only right rule of procedure is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule are synonymous.¹⁰⁰

In the apportionment field, therefore, what needs to be aimed at is relative fairness, ease of administration, and relative low compliance cost, rather than scientific precision. It is in this spirit that these questions are examined and solutions proposed.

A Segmentation by Industry

Prior to the adoption of the UDITPA, the various states in the U.S. used a plethora of formulas to apportion income of multistates or even multinational enterprises.¹⁰¹ In addition, tax administrators were often granted the power to modify the existing formulas in order to suit the needs of taxpayers in special circumstances and industries.¹⁰² In the U.S. many states sought the objective of uniformity by first adopting the UDITPA, and second, by entering into the Multistate Tax Compact (MTC). However, even under these regimes the ability of tax administrators to modify the apportionment formulas remained unchecked.

If it is agreed that Intertax is to be solely responsible for devising, implementing and policing these measures, then the fear that different countries would utilise different definitions of the taxable unit, different tax bases, or indeed different formulas in order to maximise their income share is eliminated. However, uniformity is a relative concept and must be apprehended in a holistic way rather than as a concept applicable to all with no nuances. On a worldwide basis, TNCs operate in such diverse fields as agriculture, mining, pharmaceutical, and services. Intertax must be made to provide for the conflicting requirements of these different environments. Consequently, in the American states taxation system, even under the UDITPA, the need to modify the standard Massachusetts Formula was clearly understood. For example,

¹⁰⁰ United states, Report of the Committee on the Apportionment Between states of Taxes on Mercantile and Manufacturing Business (1922) *Proc Nat'l Tax Ass'n* 201, at 202, in A.D. Lynn, 'Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum', (1957) 18 *Ohio State LJ* 84, at 87-88.

¹⁰¹ Hudson & Turner, *supra* note 9, at 593.

¹⁰² Miller, in McLure, *supra* note 3, at 133.

‘a two-factor formula of payroll and sales was used for most service businesses and the average value of outstanding loans replaced the property factor for financial corporations.’¹⁰³ In addition, as Miller observed, ‘efforts to provide a precise formula would certainly require the design of formulas for each industry and, in a perfect world, require that any industry formula be individualized for a specific taxpayer.’¹⁰⁴

It may not seem feasible to reach this perfect state of having one formula for each TNC, although it can be argued that if most TNCs choose to pursue the advance pricing arrangement (APA) route, then their individual particularities would be reflected in the particular transfer pricing methodologies that they would put forward in negotiations with various tax authorities. In short, the possibility for Intertax to propose different formulas to suit different industries is achievable if adequate time and resources are allocated to the organisation. In addition, the need for precision may be satisfied if the formulas adopted are flexible enough ‘to reflect the dynamics of both a business organization and the variety of economies in which the business operates.’¹⁰⁵

In order to achieve this objective, agreement needs to be reached on the various categories of industry types and the necessary criteria which, if depicted by a TNC, would determine its inclusion in each specific category. Some TNCs would engage in activities that straddle two different categories, although the present business strategy of TNCs is to concentrate on core activities where they have a ‘comparative’ advantage. There must obviously be a threshold level of activity that triggers the classification into a particular type of industry. Indeed, in many instances certain activities are necessarily predominant. Such TNCs would be classified in that category where their activities are predominant. If a TNC operates to an equal level in two different categories it could be assessed as two different entities, or it may well be that the formulas that would have been applicable to the two different categories are combined to provide a new one applicable to such cases. In any event, Intertax, in conjunction with the concerned TNCs and relevant tax administrations, might duplicate the existing APA procedure and determine how this classification could be achieved in a manner equitable to all parties concerned.

A broad definition of industry types to suit the present needs may follow the classification used in statistics and economics. There could be at least four broad categories: Manufacturing, Financial Services, Natural Resources/Extracting Operations, and Agriculture and Agro-Industries. Each type could then be subdivided into further categories to suit the particular

¹⁰³ *Supra* note 3, at 133 (footnotes omitted).

¹⁰⁴ *Supra* note 3, at 133 (footnotes omitted).

¹⁰⁵ *Supra* note 3, at 133 (footnotes omitted).

circumstances of each. Such subdivisions must obviously be limited to a number which is administratively convenient relative to the resources of Intertax.

Once agreement is reached on the optimum number of classification types, efforts should be made to determine the elements and processes that contribute to the creation of income within each division or sector. Functional analyses would be important tools in the search for these elements. When found, only those elements would be included in a formula developed for each particular type. In this way, the desire for precision and the need to secure a system that is coherent and which can be administered with relative ease could be achieved.

Moreover, a TNC may operate more than one line of business in more than one industry. The questions that arise in these situations relate to the determination of which subsidiaries and branches are engaged in which industry and the delineation of the commercial profits derived in each instance. As suggested, 'this is a far simpler matter than engaging in a functional analysis for transfer pricing purposes, which may require not only the determination, but also precise measurement, of which of two parties to a particular transaction contributed with assets, incurred with expenses, and bore which risks.'¹⁰⁶ Such problems have already been dealt with in the U.S. states' practice. The solution has been to employ separate accounting in transactions between commonly controlled unitary businesses.¹⁰⁷ In an international context, Professor McIntyre has suggested that the arm's length principle should govern such transactions,¹⁰⁸ and the objections to the use of this have been voiced¹⁰⁹ examined earlier in Chapter 4.¹¹⁰

Since the system proposed in this thesis disregards the concept of the unitary business, the problem is limited to the choice of factors in case of a multi-industry TNC. It is submitted that there should be no major problem in determining the commercial profits of each line of business even if these are concerned with different industries. Indeed, the accounting systems of TNCs are sophisticated enough to enable the determination of the profits or loss of each of the TNC's line of business, if only for management purposes. Therefore, the question of what base to be used for apportionment purposes is a relatively easy one to determine. In any

¹⁰⁶ D.R. Bucks & M. Mazerov, 'The State Solution to the Federal Government's International Transfer Pricing Problem', (3 September 1993) 46 *National Tax Journal* 385, at 389.

¹⁰⁷ P.R. McDaniel, 'Formulary Taxation in the North American Free Trade Zone', (1994) 49 *Tax Law Review* 691, at 713.

¹⁰⁸ M.J. McIntyre, 'Design of a National Formulary Apportionment Tax System', (1991) 84th Conf. on Tax'n, Nat'l Tax Ass'n, 118, at 121.

¹⁰⁹ See McDaniel, *supra* note 107, at 106.

¹¹⁰ See Chapter 4, Section III, 2, B, at 176.

event, in case of non-agreement between the TNC and Intertax, the dispute settlement mechanism provided would be called into action.

B Unit Rather than Value

Once the elements that contribute to the earning of income are isolated the need to adequately value them arises. If the valuation problem is restricted to two common factors in present formulas, that is, property and payroll, then one finds that the strongest critique refers to certain particular traits in the valuation of these two factors. First, as far as the property factor is concerned, there is reference to the inherent unfairness of historical cost, the impracticality of ascertaining net worth, and the differences in return on investment. Second, with regard to the payroll factor, the major objections are the difference in costs and productivity of labour in different jurisdictions.

It is essential that uniformity in the methods for the valuation of assets for accounting purposes be achieved in order to determine the accounting profits of TNCs. In this way the value of property in the numerator of a formula would not be easily contested. However, difficulties arise when the value to be included in the denominator of the formula is compiled. This is because of the perceived differentials that exist, for example, in real-estate values as between jurisdictions. The denominator represents the whole of the property owned by the concerned TNC worldwide. A simple addition of all the individual country valuation results, when translated into one currency with all the problems pertaining to that translation, and simply does not reflect these differentials.

The major cause of these difficulties is that the point of focus is the monetary value of these factors. The monetary value of a factor of production is irrelevant to the process of production. To take an extreme example, if a factory is required to house a manufacturing concern in a given location, it matters little whether that factory is built in brick or in marble. Any building material that suits the local climatic conditions would be sufficient. What is important though is that the factory is, for example, large enough to achieve the production capacity for which it was planned. It follows that it is strictly not necessary to view the monetary value of that factory as an essential element of an apportionment formula. In this particular example, factory space would probably suit the purpose in a more neutral way. Comparisons between jurisdictions therefore may be made by using factory floor space.¹¹¹ Thus the arbitrariness of monetary valuation with rented premises is also resolved. Likewise

¹¹¹ After all, under the 'Ancien Régime' taxes such as 'La Taille Personelle' have been levied relative to the number of windows of bourgeois houses; see E. Personne & P. Menard, *Histoire: Les Temps Modernes* (Paris: Fernand Nathan).

for machinery where numbers of any type in one jurisdiction may be compared to those of the rest of the world where the relevant manufacturing concern is operating.

With the payroll factor too, monetary valuations have been responsible for the major problem in computing an acceptable ratio, the existence of different salary levels as between jurisdictions and the differences of productivity being the main causes of controversy. However, using labour dollars across a spectrum of economies may not be acceptable because pay rates are bound to be different between countries. Instead of remuneration the number of people that participate in the production process may be considered as satisfactory. In this instance equal weight would be given to the contribution of the CEO and that of a janitor. This proposition has certain advantages, as it is neutral and easy to determine.¹¹² Labour may, however, be divided into different categories and the number of workers in each category in one jurisdiction being compared to other jurisdictions.

These solutions are likely to favour certain countries. For example, if the taxpayer is a manufacturing enterprise, factories and the number of workers that work therein are located in one jurisdiction alone. In these instances, it is important to prevent the apportionment to the manufacturing jurisdiction of a larger than the normal share of the income generated by such activities. The inadequate solution to this problem developed by the U.S. states is to include in the apportionment formula a sales factor.

A possible solution, in the absence of a worldwide tax equalisation scheme as available in Canada, is the adoption of the former Swiss practice of using a *préciput* to compensate for cases where too little weight is given to the activities of the TNC headquarters relative to its branches.¹¹³

2 The Question of Intangible Property

Intangible property represents a different problem. Such property, whether it be stocks, bonds, or patents, has a capitalised value based upon actual out-of-pocket investment of corporate assets.¹¹⁴ The complications that are likely to be encountered in a formulary system

¹¹² Miller, in McLure, *supra* note 3, at 168.

¹¹³ M.B. Carroll, *Taxation of Foreign and National Enterprises (Volume IV) - Methods of Allocating Taxable Income (Carroll Report)*, League of Nations Document No C. 425. M. 217(b). IIA. 30 September 1933 at 70. A *préciput* is an initial share of profits of 10 to 20 per cent which may be attributed to the canton of situs, and in the present context to the jurisdiction responsible for the development of the intangible, to compensate for that situation.

¹¹⁴ Miller, in McLure, *supra* note 3, at 134.

of taxation inclusive of intangible property are of two kinds.¹¹⁵ First, there arises the question of the inclusion or exclusion of intangibles from the property factor. Second, if a sales factor were present in the apportionment formula, then how would the receipts from such intangibles be included in that factor? Moreover, one of the main difficulties of establishing transfer prices for intangibles is the lack of clear definition of what exactly constitutes an intangible.¹¹⁶

A What is an Intangible?

Chandler and Plotkin¹¹⁷ observe that the unclear picture of what is an intangible stems from the fact that all companies have some form of intangible property which, viewed solely from their perspective, is extremely valuable. From a commercial and a taxation point of view the only intangible assets that have any significance are those that have a positive market price. An eventual purchaser of that intangible property expects that, *ceteris paribus*, it can earn higher profits through its use as compared to using only tangible assets. An intangible asset may therefore be defined as ‘any non-physical asset that allows a firm to earn higher profits than would be expected given its stock of tangible (physical) assets.’¹¹⁸

Moreover, the value that the market is likely to ascribe to an intangible asset is dependent upon its ability to generate ‘above-average profits or economic rents’.¹¹⁹ Such above-average profits or economic rents are generated principally because of the uniqueness of the intangible asset. It entails ownership and control of something to which competitors have no access.

Section 936(h)(3)(B) of the U.S. Internal Revenue Code gives a comprehensive list of intangible property as follows:

- patents, inventions, formulas, processes, designs, patterns, or know-how;
- copyrights and literary, musical or artistic compositions;
- trade marks, trade names or brand names;
- franchises, licences or contracts;

¹¹⁵ In a recent article Professor McLure examines the various solutions that have to date been proposed to deal with the question of intangibles in an apportionment formula. He reluctantly proposes the inclusion of the cost of creating the intangibles in the property factor. Alternatively, he suggests the creation of a fourth factor consisting of a measure of the activities that give rise to the intangibles. See C.E. McLure, Jr., ‘U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles’, (7 April 1997) 75 *Tax Notes Int’l* 859.

¹¹⁶ C. Chandler & I. Plotkin, ‘Economic Issues in Intercompany Transfer Pricing’, (21 October 1993) 2 *Tax Management Transfer Pricing*, No. 12 Special Report 24.

¹¹⁷ *Ibid.*

¹¹⁸ *Ibid.*

¹¹⁹ *Ibid.*

- methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; or
- other similar items.

The theoretical justification for the inclusion of intangible assets in the property factor is easily stated, but its practical articulation is fraught with apparently insurmountable difficulties. The separate accounting/arm's length methodology has been incapable of developing any satisfactory practical solutions to the problem of valuing intangibles. The 1996 update of the OECD 1995 Guidelines¹²⁰ covers the application of the arm's length principle relative to inter-company transfer of intangible property. It would appear that 'much of the discussion suggests refinements rather than changes to the OECD's views on these issues.'¹²¹ However, Boatman also recognises that the OECD's views in this area are evolving in the sense that the Guidelines promote an expanded definition of intangibles. It distinguishes between marketing and trade intangibles whereas the 1979 OECD Report¹²² focused on patents, know-how, and trademarks. Furthermore, the OECD acknowledges the difficulties arising with the valuation of intangible property and thus concedes that changed facts and circumstances may justify a hindsight adjustment to their transfer price. However, the OECD falls short of endorsing the 'commensurate with income' of IRC section 482. In fact, the crisis of the arm's length standard can largely be attributed to the increasing use of intangible property by TNCs. Intangible assets are especially important to TNCs since often their worldwide pre-eminence is due 'to technological advances, product differentiation, market positioning and distinctive managerial methods.'¹²³ Intangible property, therefore, contributes to the total net income of TNCs. As such the question arises as to whether they should be a component part of any formula designed to reflect, or to measure, the processes involved in earning income.¹²⁴

¹²⁰ OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, (Paris: OECD 1995), (1995 OECD Guidelines), Chapter VI, 'Special Considerations for Intangible Property', at VI-1ff.

¹²¹ K. Boatman, 'OECD Transfer Pricing Guidelines Update: Challenges for Taxpayers and Tax Authorities', (1997) 23 *International Tax Journal* 1, at 2.

¹²² OECD, Report of the Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (1979) Chapter III, at 45ff.

¹²³ S. Picciotto, *International Business Taxation* (London: Weidenfeld and Nicolson, 1992), at 213.

¹²⁴ See S.H. Goldberg & P.A. Glicklich, 'Lessons in Avoiding Transfer-Pricing Penalties: DHL Corp.' (1999) 47 *Canadian Tax Journal* (No. 2) 382, for an assessment of the difficulties of valuing intangibles at arm's length. See also *DHL Corp.* 76 TCM 1122 (1998).

B Solving the Impasse: A Tentative Route

In the transfer pricing environment intangibles are classified as either manufacturing or marketing intangibles.¹²⁵ As with any other form of categorisation there are some intangibles that are hybrids while others 'are not clearly distinguishable as either manufacturing or marketing'.¹²⁶ The hybrids derive their value through the activities of the 'R&D/manufacturing and through the activities of marketing/sales'.¹²⁷ Finally, there are other intangibles that are not classifiable. They include software and methods of doing business. However, for the present purpose, the two broad classes consisting of manufacturing and marketing intangibles are considered as sufficient.

i Manufacturing Intangibles

Patents, trade secrets, or unpatented technical know-how are generally considered to be manufacturing intangibles since they are usually developed either by the company's research and development (R&D) department or by its manufacturing activity.¹²⁸ The primary difficulty with respect to intangible property used for production purposes lies in ascertaining their location. Unlike tangible property, even those which are highly mobile, a discernible location cannot be easily ascribed to intangible property. A second not less formidable task is to determine the value of an intangible asset. These complications, as already shown, have been dealt with by the UDITPA by excluding intangible property from the property factor.¹²⁹

At the core of the problem, as far as manufacturing intangibles as valuable items of property are concerned, is whether such items should be included in the property factor. In order to be able to do so both questions of situs and valuation must be solved. It is submitted that concerning intangible property a methodology different to the traditional means of approaching property questions could be adopted. The property factor would consist of two parts; a tangible property part and a notional intangible property part.

If the question of proprietary interest in the intangible is ignored, then both questions of situs and valuation become relatively unimportant. Manufacturing intangibles are developed as a result of considerable investments in R&D activities. So important are these expenses that each component part of TNCs, which is likely to benefit from the results of these activities, are

¹²⁵ Chapter VI of the OECD 1995 Guidelines is entitled 'Special Considerations for Intangible Property' and uses the expression 'commercial intangibles', with marketing intangibles being considered as 'a special type of commercial intangible'. See OECD 1995 Guidelines, *supra* note 120, at VI-1-VI-2 para. 6.3.

¹²⁶ D.R. Wright, 'Intangibles and Transfer Pricing', (April 1994) 1 *International Journal of Transfer Pricing* 5, at 7.

¹²⁷ *Id.*, at 14.

¹²⁸ *Id.*, at 7.

¹²⁹ Hellerstein, *supra* note 16, at 310.

made to contribute to their financing. These contributions are normally made through formal R&D cost contribution arrangements. It is relatively simple to determine the contributions of each entity located in a particular jurisdiction as these are normally claimed as deductions for tax purposes. This figure would form the numerator of the notional intangible property factor. Likewise the total R&D costs on a worldwide basis could be easily computed. Moreover, activities that constitute R&D must be clearly defined according to an international standard. This will no doubt mitigate any dispute as to what constitutes R&D activities. The total of the R&D costs would then form part of the denominator of the notional intangible property factor.

This method focuses on the process of creating intangible property rather than on the ultimate question of ownership. Indeed, in the real world the question of ownership of the intangible does not pose any real problem. Ownership is vested in one entity of the group in order to facilitate the initiation and follow-up of protective measures designed to safeguard the monopolistic exploitation of the developed intangible. However, the free use of the intangible by those entities of the group that have contributed to the financing of its development is assured.

This arrangement reflects the continental concept of proprietary rights.¹³⁰ In one entity is vested the bare ownership of the intangible and in all the others the right to use (the usufruct) of the intangible. In the model described, the right to use, which clearly is a proprietary right, should be valued as being equal to the sum of all the entity's contributions that have permitted the creation of that intangible property. Indeed, what matters in a productive context is the right to use. Ownership rights are only important insofar as the sale of the intangible is concerned.

The situation of the jurisdictions where the contributing members of the group are located needs to be examined. In the present model for apportioning intangible property the focus is on the process of creating items of intangible property. If a contributing entity were given the full use of an item of intangible property developed in consideration for its monetary contributions to the development effort, then the proceeds from such property, that is, any income generated, would automatically be sourced within that jurisdiction either through increased manufacturing output or through increased sales. In any event the standard formula would reflect these increased activities and attribute income to that jurisdiction probably in the same proportion as the increased level of activity.

¹³⁰ Articles 578-624 French Code Civil (Paris: Dalloz, 1968-69). See also for commentaries, H.&L. Mazeau & J. Mazeau, *Leçons de Droit Civil, Tome II Obligations-Théorie Générale, Biens-Droit de Propriété et ses Démembrements* (Paris: Edition Montchrestien, 1966) at 1329ff.

The inclusion of the costs of developing intangible property is in reality an extension of the cost-based approach to the valuation of that type of property. The cost-based approach has serious defects, as with anything else involving the pricing of intangible property. However, for the purposes of the present model, the costs concerned are those that have already been incurred. In addition, such costs do not relate to a particular item of intangible property but relate to the whole of the R&D effort. The need to include in these costs other development costs requires further consideration. At this stage, however, the development of a notional intangible property component alongside the traditional intangible property concept could be the way out of the present impasse.

Whether this simple solution is feasible, and indeed technically sound, needs to be further explored. It can be argued that all the contributions of each component part of a TNC towards R&D would not automatically result in valuable intangible property being developed. This is because R&D efforts are characterised by high investment and high risk. It is because all the contributions made do not necessarily result in an identifiable intangible asset that the fraction in the present model is regarded as a notional intangible property factor rather than an intangible property factor per se.

It may be objected that since not all contributions result in valuable intangible property the system fails the test of equity. However, since all TNCs would be treated identically it is difficult to see how the concept is breached. Furthermore, a particular member of a TNC engaged in a cost contribution arrangement would normally claim as a deduction all of the contributions it has made to the development of an intangible asset. The latter, being developed and owned elsewhere, amounts to the subsidising of R&D carried on abroad. It may well be that the consideration for this subsidy is the inclusion of such payments in the notional intangible property factor. In addition, that inclusion may also be justified on the grounds of the benefit principle.

ii Marketing Intangibles

There is some difficulty in defining marketing intangibles. In general a marketing intangible is taken to mean one that has been developed by the marketing and/or sales personnel of a company.¹³¹ Marketing intangibles 'include trademarks and tradenames that aid in the commercial exploitation of a product or service.'¹³²

One of the most complicated problems that Intertax would have to face is the attribution of income derived from marketing intangible property through formulary apportionment to the

¹³¹ Wright, *supra* note 126, at 10.

¹³² OECD 1995 Guidelines, *supra* note 120, at VI-2 para. 6.4.

various jurisdictions that may, on existing rules, claim jurisdiction to tax. In the American states taxation context the trend is to treat income from both manufacturing and marketing intangibles as apportionable ‘business income’, that is, income arising from transactions and activity in the regular course of the taxpayer’s trade or business. Such income is then assigned to the state in which the income-producing activity is performed, or if the income-producing activity is performed in multiple states, the state where the greatest proportion is performed ‘based on costs of performance’.¹³³

The definition of intangible property in the U.S. for the purposes of federal taxation, as already shown, is very broad. Section 482 of the Internal Revenue Code provides that income attributed to the transfer of intangibles must be commensurate with the income earned by that intangible. This is the so-called super royalty or ‘commensurate with income’ standard.¹³⁴ This provision requires the determination of whether an intangible has been transferred and what value was transferred. It can scarcely be said that the various regulations or recommendations designed to tax income from intangibles have been successful. Therefore, it is reasonable to say that even in the traditional transfer pricing environment the tax treatment of income from intangibles is unsettled.

The 1995 OECD Guidelines maintains that the ‘general guidance set out in Chapters I, II, and III for applying the arm’s length principle pertains equally to the determination of transfer pricing between associated enterprises for intangible property.’¹³⁵ The Guidelines, however, concede that to apply the arm’s length principle to controlled transactions involving intangible property could be difficult ‘because such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction.’¹³⁶

The nature of intangibles, that is their uniqueness, makes it extremely difficult to establish an arm’s length price for their transfer albeit forecasting the returns that could be expected from their use. This is particularly true with marketing intangibles where the imperfect alternative of using a pricing method based on costs, as with manufacturing intangibles, is likely to be

¹³³ E. Coffill & P. Willson, ‘Federal Formulary Apportionment as an Alternative to Arm’s Length Pricing: From the Frying Pan to the Fire?’, (24 May 1993) *Tax Notes* 1103, at 1109.

¹³⁴ ‘In the case of any transfer (or license) of intangible property (within the meaning of Section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.’ See D.R. Wright, *Understanding U.S. Transfer Pricing Rules* (Commerce Clearing House, 1993) ¶205, at 18.

¹³⁵ OECD 1995 Guidelines, *supra* note 120, at VI-6 para. 6.13.

¹³⁶ *Supra* note 120, at VI-6 para. 6.13.

unacceptable. Determining which legal entity in an integrated TNC has developed a particular marketing intangible can be extremely difficult.

In essence, a marketing intangible aids in the commercial exploitation of a product or service for the group as a whole. As such it is responsible for the derivation of synergy profits that are not attributable to any specific entity within the TNC. In reality synergy profits result from the strategic management of internal transactions so that they are attributable to the organisation as a whole rather than to any of its particular components. Since marketing intangibles are responsible to a large extent for the derivation of synergy profits, it is submitted that they should be ignored.

As already argued, synergy profits are attributed to each particular jurisdiction by the effect of the apportionment formula. It is precisely the existence of such synergy profits that have led to the adoption of profit-splits, first proposed in an articulate way in the U.S. with the 1993 Proposed Regulations. Clearly therefore, ‘apportionment methodology is now an accepted and commonly used transfer pricing method under U.S. rules, particularly when intangible property is involved.’¹³⁷

Profit-split methodologies concentrate on sharing profits derived by associated enterprises rather than focusing on the transactions that have given rise to such profits. They are seen as useful in sharing ‘profit arising from high-value, sometimes unique intangibles.’¹³⁸ Although care has been taken to maintain the perception that profit-split methods do not contravene the arm’s length principle, it has been contended that such methods may not be popular outside the U.S. However, it is also conceded that ‘APAs may convince foreign taxpayers that acceptance of an apportionment approach within the context of an APA may be a pragmatic solution to what will surely become a very difficult technical issue.’¹³⁹

The profit-split methodology still clings to the arm’s length standard by providing that any profit-split must correspond to the division of profit or loss that would result in transactions involving unrelated parties each performing the same functions as the related taxpayers engaged in the same business activity under consideration. Formulas are thus still regarded as arbitrary whereas the separate accounting/arm’s length method is deemed free from this defect. Yet, one needs to bear in mind that there is no one right rule in the apportionment debate as a Committee of the National Tax Association observed as far back as 1922.¹⁴⁰

¹³⁷ R.M. Hammer, ‘Will the Arm’s Length Standard Stand the Test of Time’, (January 1996) 24 *Intertax* 2, at 8.

¹³⁸ OECD 1995 Guidelines, *supra* note 120, at III-2 para. 3.5.

¹³⁹ Hammer, *supra* note 137, at 8.

¹⁴⁰ United States, Report of the Committee on the Apportionment Between states of Taxes on Mercantile and Manufacturing Business (1922) *Proc Nat’l Tax Ass’n* 201 at 202, in A.D. Lynn, *supra* note 100, at 87-88.

What is essential is that the preferred methodology should give a correct reflex of the income of TNCs taking into consideration the conditions in which business operates. The acceptance of profit-splits in international taxation is but a first step in the search for the correct apportionment method. Eventually, the adoption of a full formulary apportionment methodology is likely to be the only feasible alternative in an increasingly integrated international framework.

As shown throughout this thesis, two approaches are advocated for the taxation of TNCs. Each aims at determining a country's fair share of taxes in the corporate tax bases created by the activities of TNCs. The separate entity method has been successfully applied to traditional manufacturing TNCs which operated until the end of the Second World War where the foreign subsidiaries of such TNCs may be regarded as mere clones of the parent company rather than forming part of a fully integrated business operating as a single entity.¹⁴¹

The unitary theory or worldwide combined reporting, for its part, views a TNC as a single business which, for legal or economic reasons, are divided into independent branches or separately incorporated subsidiaries.¹⁴² This system in its concepts mirrors the truly global company where 'there are no subsidiaries...but only locations ...[so that] there are few 'exports' and 'imports'...but [only] intra-country shipments.'¹⁴³

At first sight, it may appear as if the separate accounting/arm's length method and formulary apportionment are meant to apply in a mutually exclusive way. However, the OECD has maintained Article 7(4) in its Model Tax Convention. This provision is the direct successor of the League of Nation's Models. It allows the profits of a PE to be calculated 'on the basis of an apportionment of the total profits of the enterprise to its various parts'¹⁴⁴ if it is customary to do so in a particular country and if it accords with the arm's length principle. It follows that Article 7(4) may be considered as a proxy for what may be termed an 'arm's length formulary apportionment' methodology. Therefore, what OECD emphatically rejects is not formulary apportionment per se, but rather, global formulary apportionment methods such as the Californian WWCR which it regards as an unrealistic alternative to the arm's length principle.¹⁴⁵

¹⁴¹ D. James, 'Peter Drucker, The Man Who Changed the World', *BRW* September 15, 1997 48, at 49.

¹⁴² Note, 'Multinational corporations and Income Allocation Under Section 482 of the Internal Revenue Code', (1976) 89 *Harv L. R.* 1202, at 1205.

¹⁴³ James, *supra* note 141, at 49.

¹⁴⁴ OECD, *Model Tax Convention on Income and Capital*, (Paris: OECD, 1992), loose leaf (1997 update), Article 7(4), at M-15. (Note: A 2000 update is now available.)

¹⁴⁵ OECD 1995 Guidelines, *supra* note 120, at III-21 para. 3.63.

Yet, as already argued, there is, notwithstanding this rejection, a indirect move towards a solution of compromise in cases where obviously the arm's length standard shows its obvious limitations. Thus, for example, the introduction of the transactional profit methodologies in the 1995 Guidelines,¹⁴⁶ or the introduction in the U.S. of the comparable profit method (CPM).¹⁴⁷ Whilst the final version of the U.S. CPM takes into account some of the objections voiced by the OECD,¹⁴⁸ the fact is that the final section 482 regulations aims at finding an arm's length outcome or result based upon formulary profitability indicators, such as:¹⁴⁹

- the ratio of gross profit to operating expenses,
- the ratio of operating profit to sales,
- the ratio of gross income/revenue to operating expenses,
- the rate of return on capital employed.

The U.S. final transfer pricing regulations under section 482, therefore, substitute the arm's length price with the arm's length result. As a consequence, 'although the traditional *transaction-based* methods continue to be favoured, the new regulations allow the adoption of *profit-based* methods, whereby a comparable profit indicator derived from similar uncontrolled companies can be used.'¹⁵⁰

Other revenue authorities have not welcomed such steps. Japan, for example, believes that these methods, especially the CPM do not satisfy the arm's length criterion.¹⁵¹ However, the Japanese National Tax Administration (NTA) and the IRS are seeking a common ground relative to this issue. This has been achieved through the APA process since both authorities have reached agreement for the use of a hybrid profit-split/CPM methodology in a bilateral APA with Komatsu, the Japanese conglomerate.¹⁵² What is of critical importance is the fact that following this breakthrough, the NTA will more likely adopt a more 'flexible [line] and is

¹⁴⁶ *Supra* note 120, Chapter III, at III-1ff.

¹⁴⁷ P. Blackwood, 'Australia's New Draft Transfer Pricing Rulings', (1995) 14 *Tax Management Transfer Pricing Special Report* 1, at 5.

¹⁴⁸ OECD, *Intercompany Transfer Pricing Regulations Under U.S. Section 482 Temporary and Proposed Regulations* (Paris: OECD, 1993).

¹⁴⁹ T. Cooper, 'A Comparison of the Profit-based Pricing Methodologies under the Transfer Pricing Rules of Australia and the United States: Are they a Voluntary Compliance Option for the Taxpayer?', (1995) 12 *Australian Tax Forum* 91, at 99.

¹⁵⁰ S. Plasschaert, 'An EU Tax on the Consolidated Profits of Multinational Enterprises', (January 1997) 37 *European Taxation* 2, at 5.

¹⁵¹ T. Katsushima, 'Hybrid Bilateral Advance Pricing Agreements: The Trend for the Future?', (January 1997) 25 *Intertax* 2.

¹⁵² *Ibid.*

willing to focus on the bottom line, rather than on theoretical principles of transfer pricing methodology themselves.¹⁵³

The disparity between the two alternative methods of allocating TNC income is further being resolved by the recognition that in certain sectors, more specifically in global trading, the most realistic approach for achieving a proper allocation of cross-border income is through some form of global formulary apportionment method. Thus, although the expression global formulary apportionment is not used, the IRS has demonstrated its flexibility by agreeing to the use of a profit-split methodology for ‘functionally fully integrated global trading operations,’¹⁵⁴ albeit in the restricted context of an APA, and along specific product lines. In Notice 94-40, the IRS developed a three-factor formula ‘that may be weighted to reflect the relative contribution of each trading location to the overall profitability of the worldwide business.’¹⁵⁵ This profit-split methodology attempts to recognise the true economic profit or loss of each business unit in a worldwide trading entity. To achieve this outcome, the IRS has markedly departed from traditional approaches of section 482 for apportioning income and has thus indirectly acknowledged ‘that current U.S. tax laws are inadequate to treat these financial activities’.¹⁵⁶

The OECD, in a Revised Discussion Paper on global trading in financial instruments, acknowledges the efforts of the IRS and its reliance on the APA process as steps in the right direction in the global trading area.¹⁵⁷ The Revised Discussion Paper then advocates the use of those profit-split methods described in Chapter III of the 1995 Guidelines as the appropriate method for highly integrated global trading operations, whilst maintaining that ‘global formulary apportionment would not be acceptable’.¹⁵⁸ Notwithstanding this objection, formulary apportionment may be the most pragmatic method of income apportionment in the increasingly integrated world of global finance.

¹⁵³ *Ibid.*

¹⁵⁴ United States, 1994-1 C.B 351 (Notice 94-40).

¹⁵⁵ Note, ‘Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology’, (1994-95) 48 *Tax Lawyer* 1057, at 1067.

¹⁵⁶ *Id.*, at 1073.

¹⁵⁷ OECD, *The Taxation of Global Trading of Financial Instruments: A Revised Report by the Special Sessions on Innovative Financial Transactions* (Paris: OECD, 1997) Document DAF/FE/CFA(97)/6/REV3, at 24 para. 114.

¹⁵⁸ *Id.*, at 27 para. 120.

Formulary Apportionment Applied to the Global Financial Industry

This chapter seeks to apply the proposed formulary apportionment methodology to the emerging global financial industry. The hypothesis is that the global financial industry, as described in Section I, offers a clear and unequivocal instance where many of the players truly operate in an integrated way. If this is the case, then it is submitted in Section III that the application of the formulary apportionment method to transnational corporations (TNCs) engaged in financial trade is the only realistic method for the apportionment of their global profits. However, prior to examining this question, Section II explores the contemporary taxation principles applicable to the emerging world of global finance.

Section I The Contemporary World of Global Finance

In a period of 20 years, the financial industry, one of the most regulated industries anywhere in the world, has opened up increasingly to global competition. Trading in financial instruments is now carried out around the clock with few government constraints.¹

1 The Nature of Global Trading in the Financial Sector

A global market may be defined as:

one which has no national boundaries, to which participants - be they investors, issuers, borrowers, or savers—from all over the world have access, in which price is established by supply and demand from around the world, not from a single domestic market, and in which transactions can be effected on a twenty-four hour basis or close to it.²

The global financial industry is generally regarded as highly integrated. However, integration is a matter of degree and depends on which particular line of business is considered. Thus, integration is highest in the foreign exchange market and lowest in equity markets.³

¹ L.B. Samuels & P. Brown, 'Observations on the Taxation of Global Securities Trading', (1990) 45 *Tax L Rev* 527, at 528. In reality the regulatory mix is changing. Thus, if on the one hand there is a certain degree of deregulation at the national level, on the other hand a certain harmonisation and regulation of the industry has emerged with the increased role of the Bank for International Settlements. See P. Goris, *The Legal Aspects of Swaps* (London: Graham & Trotman, 1996), at 202.

² R.A. Debs, 'Globalization of Financial Markets: What is Happening and Why', (1987) 15 *Int'l Bus Law* 198, at 199.

³ It is important to realise that while this chapter uses the term 'global financial markets', it would perhaps be more accurate to say that there is a steady internationalisation of financial markets which is occurring as a result

A An Insight in Global Trading Model

The trend towards globalisation in the financial industry is economically and technologically driven. It aims at increasing trade between various nations on a quantitative as well as qualitative level. This is not a new phenomenon. According to Professor Otmar Issing, in the period of the 'gold standard', that is from the mid nineteenth century to 1914, financial markets had been well integrated.⁴ In fact, if the ratio of current account balance over gross national product (GDP) averaged across a number of countries is taken as an indicator of cross-border flows, one finds an increase in the international orientation of financial markets since the mid-1960s which is still below the levels reached from the mid-1870s to 1914.⁵

In the late 1950s, the effects of the Bretton Woods system inaugurated after World War II in conjunction with a successful reconstruction program in Europe and Japan, and accelerated industrialisation elsewhere, created an unprecedented trade boom. Once the volume of trade had reached a certain mass, it became necessary to ease national controls in order to promote further developments.

Paradoxically, this process accelerated the demise of the prevailing trade system based on fixed rates of exchange as established at Bretton Woods. The introduction of a floating exchange rate regime in 1973 in conjunction with the Organisation of Petroleum Export Countries (OPEC) oil shocks opened an era of volatility in the foreign exchange markets. Volatility breeds risk which in turn requires recourse to risk management techniques. Such techniques are often based on sophisticated models which are not only dependent on technology for their implementation, but also require deep and liquid markets.⁶ To reach the depth and liquidity required by industry, most advanced economies started to dismantle in the 1980s the quantitative restrictions on domestic markets with the view to promoting international capital flows. In other words, these countries started the process now generically known as deregulation⁷, the ultimate result of which is the globalisation phenomenon.

Global markets rely on technology for their efficient operation. For example, automation in the securities trading industry has not only boosted trading, but has also strengthened the

of the globalisation process. For an analysis of the distinction between 'globalisation' and 'internationalisation', see O. Issing, 'The Globalisation of Financial Markets', (12 September 2000) European Central Bank Occasional Papers Series, at 2. This paper is available at <<http://www.ecb.int/>>.

⁴ *Ibid.*

⁵ *Id.*, at 3.

⁶ See J. Bessis, *Risk Management in Banking*, (London: John Wiley & Sons, 1998).

⁷ For a critical analysis as to economic rationale for liberalisation, see H. Stretton, '*Inefficiencies of Global Capital Markets*', (December 1998) United Nations, Department of Economic and Social Affairs, Discussion Paper No 2 ST/ESA/1998/DP.2, at <<http://www.un.org/desa>>.

globalisation process in the securities markets.⁸ Advances in computer technology and telecommunications have further facilitated the high volume and rapid turnover, which characterise global trading. Technologies, such as automatic quotation and communication systems, have displaced traditional trading methods. Today, the so-called screen trading systems are in current use in major exchanges and are rapidly expanding around the world.⁹ Technology, however, ignores national boundaries. As such it requires the convergence of national regulations in the global securities market.

Another factor that initiated and consolidated the trend towards globalisation is the emergence of a wide variety of 'new' financial instruments. In truth, it is difficult to say whether the emergence of these instruments has been the cause, or an effect, of globalisation. It is unquestionably a concurrent development. For example, currency and interest rate swaps have enabled the linkage of all major capital markets and have thus been a major contributor to the globalisation process. The expansion of the global market in financial products has had serious consequences as to how these products are viewed from both a legal and from a taxation viewpoint. One of the major consequences of the evolution of the market is that:

the traditional market distinction between long and short term instruments, between bank loans and securities, between debt and equity and even between different currencies, have all been significantly eroded as market participants have sought to develop innovative instruments tailored to the specific needs of issuers or investors, combining products and bridging markets, all with the objective of improved returns and reduced expenses.¹⁰

The ultimate challenge to tax administrations all over the world is whether they will manage to adopt a concerted approach to the taxation of these financial instruments.

B The Players in the Global Financial Market

There are two types of players in the world of finance: those who create wealth and those who regulate that process. The first category consists of those who use capital to create wealth and those who provide such capital. Traditionally banks have enjoyed a quasi-monopoly in the world of international finance. However, although both commercial and investment banks are still important providers of capital on a worldwide basis, they have now been joined by major corporations, securities firms, and institutional investors like mutual funds and pension funds.

The proliferation of players in the globalised financial markets means that it is difficult to define the characteristics of those who operate there. In the past, the overlapping of functions

⁸ P.A. Abken, 'Globalisation of Stock, Futures, and Options Markets' in *Financial Derivatives: New Instruments And Their Uses* (Federal Reserve of Atlanta, 1993), at 3.

⁹ Debs, *supra* note 2, at 199.

¹⁰ *Supra* note 2, at 200.

between various operators in the financial markets was minimal. For example, commercial banks took deposits and made loans, merchant banks floated shares and traded them, while brokers did brokerage business and corporations borrowed money to further their objects. In the present globalised markets these boundaries have disappeared and traditional legal distinctions between different types of institutions engaged in the business of international finance are gradually becoming irrelevant. A corporation engaged in mining activities, for example, may turn out to be a major player in the derivative market. Therefore, the financial services industry may now be described as a single worldwide industry in which most of the participants trade in a whole range of available financial services. Consequently, the industry is now more homogeneous in nature. To sum up '[F]inancial transactions are being increasingly conducted on a multi-currency, global level; and the intensity of competition between firms continues to increase'.¹¹

The second category of players in the global financial services industry is the regulators, for example, the central banks, the stock exchange authorities, and the national trade regulators. They ensure that the market runs smoothly. Today, these authorities can no longer act in isolation, or rely purely on national legislation to regulate their national markets. For instance, they do not have the necessary financial resources to match those available to traders operating in the global, rather than in purely national, markets. Consequently, the question of control and protection of the market itself needs to be addressed.

The fundamental flaw in the present system is that the supervisory structure designed to police the global financial services market is not only national in its structure, but it is also hopelessly fragmented even at a purely domestic level. In the U.S. or Japan, for example, several regulatory institutions exist for the purpose of control. However, the jurisdiction of each of these institutions is limited to a specific category of market players and, more importantly, they very rarely coordinate their action. Their mandates are also very different. In the U.S., the mandate of the Securities and Exchange Commission (SEC) is to protect the public investor. This is achieved through the publication of information concerning the firms that are quoted on the U.S. exchanges.

When financial regulation is considered in its classical form, one finds that it no longer corresponds to conditions that prevailed when such regulation was inaugurated. In the classical model, central banks regulate commercial banks, investment banks, and other financial institutions. They are also required to protect the national banking system and manage all

¹¹ See W.R. White, *International Agreements in the Area of Banking and Finance: Accomplishments and Outstanding Issues* (Basle: Bank for International Settlements, October 1996), at <<http://www.bis.org/publ/work38.pdf>>.

monetary questions whilst they act also as the lender of last resort. These regulatory measures were, therefore, predominantly national in their application. The advent of deregulation, the emergence of innovative financial instruments, and the use of technology have eroded the effectiveness of these measures. Already, certain regulatory functions in this area are carried out through ‘internationalised’ mechanisms such as the Bank for International Settlements.¹² In addition, in recent years, a bilateral dialogue has been initiated between various supervisory bodies, for example, the major securities regulators in order to coordinate their regulatory efforts. Indeed, it is now felt that only a multilateral effort to coordinate supervisory action would create the optimum conditions for the efficient running of the global financial market.¹³

2 The Organisation of Global Trading of Financial Instruments

In the deregulated financial market now established, financial institutions, mainly banks and securities firms, do act as financial intermediaries as they have always done. However, these institutions are now increasingly seeking to earn profits by directly managing the risks arising from their customers’ transactions. To manage risks, financial institutions have pioneered the use of derivative instruments. This is a dynamic process given that new products are constantly being developed in order to meet their clients’ needs. Moreover, in order to meet the demands of an international client base, financial institutions have developed the ability to execute client orders around the clock, thus the term ‘global trading’. Therefore, a financial institution engages in global trading when it has the capacity to execute customers’ orders in financial products in any market around the world and/or around the clock.¹⁴

A The Emergence of Innovative Financial Instruments

The emergence of a global financial market has also seen the appearance of new capital market instruments which are creating complex problems for tax administrations. For instance, tax administrations are experiencing problems in identifying and taxing income generated by such instruments.

¹² *Id.*, for coverage of international agreements in the financial area.

¹³ *Id.*, at 6. ‘Many of the most important agreements pertaining to international banking and finance have been reached only informally after discussion among a limited number of important nation states or market participants. These agreements have been enforced using domestic legislation or other means, and have been extended to a wider international community only by force of example.’

¹⁴ OECD, *The Taxation of Global Trading of Financial Instruments* (Paris: OECD, 1998) para. 9, at 12.

i Primary and Secondary Instruments

Financial instruments may be classified into two groups: basic or primary instruments and derivative instruments. Within the first class of instruments are two sub-classes: debt and equity. The debt instruments comprise, for example, such products as junk bonds, deep discount bonds, note issuance facilities, and commercial paper. The evolution of the basic instruments has been such, however, that convenient classifications such as debt and equity are no longer absolute, given the emergence of the so-called hybrids which combine the characteristics of both debt and equity.

ii Derivative Financial Instruments

Derivative financial instruments (DFI), for their part, are instruments which are based on the value of a primary instrument but are not themselves primary instruments. Thus the expression derivative given that they derive their value from the existence of the basic or primary instrument. In its paper on global trading, the OECD proposes the following definition of derivative instruments '[A] derivative instrument is a contractual right that derives its value from the value of something else, such as a debt security, equity, commodity, or a specified index'.¹⁵

There are basically two types of derivative financial instruments: the option contract and the forward contract. These may be combined to form new instruments as will be examined later.

A DFI enables one party to match its inflows and outflows by shifting the risk to which it is exposed to another party in consideration for a fee. In other words, a DFI is akin to an insurance contract where A pays a fee called a premium to B in consideration of which B undertakes the risk of paying A an agreed sum if a specified event occurs, for example, a fire or a theft. If the specified event occurs, then A has a claim on B thus giving value to the insurance contract. Therefore, value depends or *derives* from the occurrence of an event beyond the control or influence of either party. If the specified event does not occur, the contract expires without any value to A. Clearly, the utility of the transaction arises because during the specified period, A (the insured) is relieved of the risk of suffering loss by shifting that risk, which is the economic burden that could have occurred as a result of the specified event, to B (the insurer).

Contrary to insurance contracts, DFIs are purely concerned with 'financial' risks such as: a given currency, the price of a given commodity, or interest rate which can all either rise or fall. In addition, where with the insurance contract risk is particular, DFIs are concerned with general risks. The economic consequences of such general risks, for example, the incidence of

¹⁵ *Id.*, at 11 para. 4.

a fall in a commodity price for a primary producer, can be accurately calculated. Consequently, parties to a DFI need not refer to a particular event, require its verification, or provide for the measurement of its economic consequence. They ‘can enter into a contract whose terms will give it value only if and when the specified event occurs, and then only to the precise extent desired.’¹⁶

One common DFI, ‘the option’, is similar to the standard insurance contract in the sense that it calls for a contingent payment. The holder of an option to purchase USD 100,000 at AUD 1.28 per USD will exercise his or her right against the option writer only if the price of one USD rises above AUD 1.28. If this happens, or in other words if the risk occurs, the holder of the option has an economic incentive to require the option writer to sell the USD at the option price of AUD 1.28. The holder’s gain on the exercise of the option therefore reflects the risk that USD 100,000 would rise above the designated level.

A certain type of DFI calls for unconditional rather than contingent payment, for example, the forward contract. Therefore, this type of DFI is different to the standard insurance contract: It resembles another insurance product, the annuity. Basically, the contract of annuity is one whereby in return for a payment of say AUD 100,000, A agrees to pay B AUD 1000 per month for each month of B’s life from say his or her sixty-fifth birthday till his or her death. In this case both parties are required to make payments. This is to be contrasted with the situation that arises under a standard contract of insurance. In this case no payment is made, apart from the payment of the premium, the insurer being required to pay only if the specified event occurs and the insured makes a claim. The same consequences arise with the option where the writer is not required to make any payment unless the option holder makes a claim which would be forthcoming only if the value of the USD, relative to the AUD had risen at the specified date.

With the forward contract, if the parties agree to buy and sell a certain amount of USDs at a specified future date at a price of AUD 1.28 per USD, the obligation to carry out the transaction is fixed and unrelated to the value of the USD on the specified date. However, the financial value of this contract can be computed at any time by reference to the market value of the USD and the parties may choose to settle at the specified date with a net payment flowing one way or another.¹⁷ It is to be noted that whilst DFIs shift risk from one party to another, the party that wants to shift that risk may not be the one that bears that risk primarily. When A

¹⁶ H.D. Rosenbloom, ‘Source-Basis Taxation of Derivative Financial Instruments: Some Unanswered Questions’, (April 1996) 50 *Univ Miami L Rev* 3 597, at 598.

¹⁷ Contrast with the annuity where such contracts are not settled on a net basis because they are meant to provide a continuing flow of funds.

seeks to shift a risk by the use of a DFI, although it does not bear that risk primarily, A is engaged in speculation.

The major difference between the option contract and the forward contract is that the option holder has a right, for which it has paid a premium, but no obligation to exercise this right, whereas the forward contract creates mutual obligations and rights. Since either of the parties may gain from the forward contract there is normally no payment of premiums at its inception. The exchange value takes place at the specified date although that exchange may occur earlier. When either an option or a forward contract requires more than one payment it is said to be a multi-payment contract. A common form of a multi-payment forward contract is a 'swap', which is merely a series of forward contracts each with a payment at a specified date. Another multi-payment contract is a 'cap', which is basically a series of options to claim reimbursement for interest in excess of a specified rate.

Yet another type of DFI is the 'notional principal contract'. It is an instrument, either a forward or an option, where the obligations of the parties are referenced to a stated sum that need not be exchanged, thus the term 'notional principal'. If A contracts to make payments to B for five years to the extent that prevailing interest rates exceed 10 per cent (a cap), the parties need to know the multiplicand in order to compute the required payment. This multiplicand, for example, USD 10 million, is the notional principal. Moreover, an arrangement designed to compensate for the difference in interest rates between two currencies is when A agrees to pay to B for a period of three years interest in say USDs while B agrees to pay to A interest in AUD. In order to do so A and B will need notional principal bases in USD and AUD in order to make the necessary computations. In other words, A and B will pretend to exchange USD for AUD at the outset of the transactions in order to compute their respective obligations. At the end of the specified period they will notionally re-exchange principal amounts in order to compute and pay over the value changes resulting from currency fluctuations.¹⁸

Innovative financial instruments pose some intricate tax issues in the sense that they appear to change the characteristics of well-known economic transactions. As a result the appropriate tax treatment for such products is unclear.¹⁹ On a policy level the question arises as to whether these instruments require a complete set of new tax rules. DFIs have put considerable pressure on established tax definitions and categories, both in the domestic and international tax fields.

¹⁸ In cross-currency swaps there is an exchange of principal at the beginning of the contract and a re-exchange at the end.

¹⁹ For an insight into the inconsistencies in the U.S. tax treatment of various derivative financial instruments, see R.S. Avi-Yonah & L.Z. Swartz, 'U.S. International Tax Treatment of Financial Derivatives', (31 March 1997) *Tax Notes* 1703, where the authors demonstrate that two derivative instruments producing the same economic results are nevertheless taxed differently.

In general, tax law in various jurisdictions, have responded on an ad hoc and piecemeal basis to the problem posed by these products. This has led to rules that are often haphazard, incomplete and inconsistent and often create the possibility for tax arbitrage or double taxation.²⁰ Clearly, at the taxation level, an appropriate solution needs to be found.

B The Characteristics of Global Trading Operations

Whilst not immutable, most global trading structures can be represented along a continuum, at one end of which one finds, to use the OECD's terminology, the 'Integrated Trading' model and the 'Separate Enterprise Trading' model at the other. In the middle is the 'Centralised Product Management' model. These models are defined by reference to the organisation of the trading and risk management activities.²¹ The classification of a particular global trading business under one of the above models does not therefore mean that other activities, such as marketing and support, are organised in the same manner as the trading and risk management activities.

A 24-hour global trading operation centres on the aggregation of four elements: trading, management, sales, and support.²² The trading element is the crucial component of the structure. Traders have two important functions. First, they quote prices that result in either a buy or a sell transaction.²³ Second, they decide whether and how to hedge the position taken.²⁴ Normally, traders in a 24-hour global trading operation model have a wide discretion as to the decisions they make provided they remain within limits defined by management. A trader's decision is based on his or her knowledge of the firm's needs, the client's needs, and his or her expectations as to price movements in the market. In the ideal, a quote minimises the firm's position and maximises turnover.

The second element that binds the rest of the operation is managerial. Managerial functions are carried out by a strategist, or a trading manager, responsible for the implementation of the broad policy and strategic decisions of a particular global trading enterprise as well as the control of all those engaged in these activities

The third component of any global trading operation is the sales and marketing personnel. The first are responsible for finding customers and the second are in charge of running the deal.²⁵

²⁰ *Id.*, at 1712.

²¹ OECD (1998), *supra* note 14 para. 48, at 19.

²² C.T. Plambeck, 'The Taxation Implications of Global Trading', (2 August 1990) *Tax Notes* 1143, at 1147.

²³ C.T. Plambeck, 'Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives', (December 1996) *Taxes* 1129, at 1132.

²⁴ OECD (1998), *supra* note 14, at 23 para. 74.

²⁵ *Supra*, note 14, at 21 paras. 64ff.

Salespersons are liable to the firm's customers on whose behalf sales and purchases have been effected. They advise customers regarding asset, liability and risk management. Salespersons are able to simulate the effects of their advice on their clients' position. They use scenario modelling to analyse and portray the impact of a particular security or financial product on a client's portfolio. They are remunerated by way of commissions for transactions procured.

Finally, support staff or clerical personnel form part of the so-called back office whereas the middle office consists of professionals such as economists, lawyers, financial engineers and accountants.²⁶ The functions of both back-office and middle-office labour is to provide the first three elements of a global trading operation with all the service they require to fulfil their primary role. They do so by administering operational systems that are capable of communicating the position of the trading book worldwide, and giving traders up-to-the-minute information on price quotes, past trades, volume, price movements and exchange rates. Support staff is responsible for the provision to senior management of fully integrated systems that monitor exposure, enable adequate control, and improve reporting. In addition, they are also required to execute certain routine functions, for example, the settlement of transactions, their accounting and invoicing, or other purely administrative functions.

One of the most important functions that are executed in the back office is the funding of operations. This is carried out by the Treasury whose 'book traders are responsible for ensuring that the financial institution has sufficient cash to meet its payment obligations but does not have excess cash that is not being used profitably.'²⁷ Often, the Treasury is regarded as a separate profit centre and as such contributes to the problem of characterising internal payments such as internal hedging transactions for taxation purposes.²⁸

Yet another characteristic of a global trading operation relates to the location of the operators. In the taxation context location traditionally determines source questions.²⁹ In general, traders and strategists are located at major trading centres while risk managers and senior management may be located more centrally, for example, at the head office or the primary market for a particular product. Salespersons are located in the geographical area of their customers. The support staff is located in those centres where demand is heaviest, or at the head office when they are in charge of functions that are required by all the trading centres.

²⁶ *Supra* note 14, at 24 para. 85.

²⁷ *Supra* note 14, at 25 para. 87.

²⁸ *Supra* note 14, at 25 para. 89.

²⁹ R.L. Hamilton & R. Deutsch, *Guidebook to Australian International Taxation*, 4th ed., (Sydney: Legal Books, 1996), at 1-18, elaborating on D.R. Tillinghast, *Tax Aspects of International Transactions*, (Matthew Bender, 1978).

The different locations of personnel crucial to a 24-hour global operation do not facilitate the application of the traditional source rules. In the particular context of global trading, therefore, the operation of those rules is particularly problematic.

An additional distinctive feature of global trading is ‘the book’. The book is essentially the firm’s trading position. Its implications will be analysed further below when the problems with the identification of the tax base are considered.

Finally, global trading relies heavily on telecommunications and computer technology. Special software used by the participants undergoes constant refinement to maximise its effectiveness.³⁰ These tools record deals, tracks risk positions, marks products to market, and interrelates such information. Computer technology not only enables the global market in financial instruments to operate, it also substantially adds to its efficiency. As such, special attention needs to be paid to these sophisticated tools in determining the functions carried out in the global trading context.

Section II Taxation Principles Applicable to New Financial Instruments

In its report on the taxation of new financial instruments, the OECD admits that the prevailing tax rules ‘have proved ill-equipped to cope with the difficult problems which they have presented.’³¹ Tax authorities worldwide are finding it difficult to keep pace with the developments in this field given that the domestic and international tax treatment of financial instruments is often uncertain. Accounting standards bodies are also have ‘to cope with the same problems as tax administrators.’³²

1 General Taxation Issues

The taxation of financial services gives rise to complex problems both at the national and the international levels. The major issue is whether a national tax policy relative to financial instruments is viable in the face of the globalisation of the industry.

³⁰ OECD (1998), *supra* note 14, at 26 para. 95.

³¹ OECD, *Taxation of New Financial Instruments* (Paris: OECD, 1994), at 7 para. 5.

³² *Id.*, at 8.

A Domestic Issues

According to the OECD, three main challenges have to be met in the domestic treatment of new financial instruments.³³

i Characterisation as ordinary income or capital gain

A certain number of taxation systems distinguish between capital and ordinary income. This gives rise to the problem of determining whether payments and receipts under financial instruments are capital gains or ordinary income.

If, in a given system, all receipts are treated as ordinary income and taxed as such, then it is fair to say that system has achieved the goal of simplicity. However, this situation may well be at odds with commercial reality. For example, if a financial instrument is purchased as a hedge for a non-trading debt thereby satisfying commercial requirements, that hedge may well lose its attractiveness in after-tax terms if the income or payments on the hedge are treated in a different way from the instrument that is being hedged. If, however, income or payments on a hedge are treated in the same way as the asset or liability that is being hedged, then a number of difficulties arise. First, the closeness of the correlation between the two instruments subject to the hedge is open to question. It is unlikely that this correlation will be exact, 'and the points where the correlation could break down are innumerable.'³⁴ Second, assets and liabilities may be hedged on a portfolio basis rather than individually. In addition, they may be hedged only periodically in times of uncertainty when markets are most volatile. Finally, a hedge may be retained long after the asset or liability it was meant to hedge has been liquidated. Such problems cannot be readily solved.

ii Timing

Timing rules determine when profits and losses are recognised for taxation purposes. There are three main timing bases:

- a payment or cash basis under which an amount is taxed or relieved when it is paid;
- an accruals basis under which receipts and payments are taxed or relieved over the life of the financial instrument;

³³ *Id.*, at 29 para. 121.

³⁴ *Id.*, at 30 para. 127.

- a ‘mark-to-market’ basis ‘under which all instruments held at an accounting date are brought to account at their market value and realised and unrealised profits and losses are accounted for by reference to the change from the last accounting date.’³⁵

Each timing basis has advantages and disadvantages. For example, the use of a cash basis is relatively inadequate when reciprocal payments are involved. Thus, in an interest rate swap, one party may receive a single commuted payment up-front in consideration of which it is required to make recurring payments throughout the life of the financial instrument. In such a case it is probably inequitable to tax the payment wholly on receipt and to allow for corresponding deductions on the counterflow payment when they are made over the life of the instrument. Indeed, if relief is allowed for up-front payments at the time when these are made while receipts are taxed when received throughout the life of the instrument, then timing of payments between associated enterprises may be exploited to defer tax.

Conversely, the use of an accruals or mark-to-market basis may result in enterprises being taxed on profits which have not been realised. In addition, ‘as with the payment basis, arguably a mark-to-market or accruals basis requires greater flexibility in the utilisation of losses in order to ensure that only the ultimate economic profit is eventually taxed.’³⁶

In addition, if an instrument is of the option type and the option is never exercised, the difficulty of applying the accruals method arises as it is difficult to find a suitable tax treatment for single-sum termination payments.

iii Source

The determination of the source of income arising from financial instruments is of crucial importance for their proper taxation. However, coherent source rules for income generated by these new financial instruments are non-existent in most countries. This is because there are still uncertainties as to the proper characterisation of such income. Income from these instruments may be characterised as interest, dividends, or gains from the sale of property. As such, the relevant traditional source rules would be applicable. But, it may well be that, in the case of new financial instruments, the basis for such characterisation is flawed. Indeed, those rules are frequently based on notions pertaining to the location of the functions that gave rise to the income, and therefore, tend to accurately identify such locations. To precisely pinpoint the location of the various functions that are carried out in global trading is particularly difficult given that these are carried out in more than one jurisdiction.³⁷

³⁵ *Id.*, at 29 para. 122.

³⁶ *Id.*, at 29 para. 124.

³⁷ OECD (1998), *supra* note 14, at 13 para. 16.

Source rules are important for several reasons. In brief, they determine which of the competing jurisdictions has the primary right to tax a particular income stream. Traditionally, at least two jurisdictions may find themselves in competition to tax a particular income stream resulting from certain cross-border transactions. However, the nature of global trading, especially in financial instruments, is such that today more than two countries may claim source taxation rights on income arising from these instruments. Furthermore, source rules play an important part when determining the quantum of foreign income for the purposes of granting tax credit relief in respect of tax already paid on foreign sourced income, and they are also significant for withholding tax purposes.³⁸

The need to provide for clearer source rules has been canvassed by the Ralph Committee examining the reform of business taxation in Australia.³⁹ The Committee held the view that the place where a contract is concluded should not determine the source of income arising from the contract. Instead, it recommended that a general source rule be implemented based on the principle that income is to be considered as sourced in Australia if such income is derived from functions performed in Australia, assets located in Australia, or risks assumed in Australia.⁴⁰ In addition, to this general source rule, the Committee is of the opinion that a specific source rule needs to be inserted in Australian law. It suggested that if a non-resident conducts business in Australia through a permanent establishment (PE), then the foreign source income attributable to that PE be subject to assessment in Australia.⁴¹ The jurisdictional threshold rule proposed by the Ralph Committee is articulated on the concept of the functional analysis. As such, it is arguable this jurisdictional threshold rule is very close to that proposed in this thesis.⁴²

B Cross-Border Issues

A review of country practices carried out by the OECD in 1994 revealed the absence of consistency in the ways countries classify payments relating to new financial instruments for treaty purposes.⁴³ This situation occurs because the domestic legislation of most countries

³⁸ For a discussion concerning the appropriateness of gross basis taxation at source as opposed to net basis taxation at source relative to new financial instruments, see C.T. Plambeck et al., General Report, 49th Congress of the International Fiscal Association, (Cannes, 1995) 'Tax Treatment of Derivative Financial Instruments', Vol. 80b *Cahiers de Droit Fiscal International*, 651, at 685ff.

³⁹ See Australia, 'Responding to Globalisation' in *Review of Business Taxation: A Tax System Redesigned*, (Ralph Report) (Canberra: AGPS, 1999) 623ff.

⁴⁰ *Id.*, at 684.

⁴¹ *Ibid.* There is nothing new in this suggestion as the current PE concept captures this income in so far as the latter is 'attributable' to it.

⁴² See Chapter 5, Section I, 2, A, at 192.

⁴³ OECD (1994), *supra* note 31.

does not even contain rules that are comparable to each other. The classification of payments made under financial instruments is of fundamental importance because the taxation of gains resulting from these instruments follows a standard sequence. Thus, prior to determining taxing rights or withholding taxes, the source of a payment must first be determined. In other words, a payment must first be classified for tax treaty purposes. Classification then depends on a number of factors, such as the character of the taxpayer, the nature of the instrument, the nature of any underlying transaction, and the intention of the parties. Clearly, the presence in any particular legislation of a ‘substance-over-form’ approach goes a long way to facilitate the re-characterisation of transactions in order to determine their true economic utility, and consequently, the true economic profit which is the ultimate taxable amount. With global trading these problems are exacerbated while others emerge. Briefly, the most salient of these issues as identified by the OECD are the following:⁴⁴

- When do trading activities conducted in other countries constitute a permanent establishment?
- How is income to be attributed to such PEs?
- How are traditional transfer pricing methodologies to be applied between the associated enterprises of a TNC?
- What are the basic timing issues involved?

Unfortunately, at this time, there is no agreement as to how these questions should be addressed.

As usual with international tax questions, the immediate issues that come to mind is that of double or under-taxation of gains (or losses) that follow from the global trading of new financial instruments if countries fail to reach agreement on a cohesive method for such taxation.⁴⁵ A cohesive approach in this field is required because first, countries have often found that it is particularly ‘difficult to measure the mobile tax base because income or transactions are not easily identified to a particular location’⁴⁶ and second, the existence of different tax systems for such instruments enables ‘regulatory arbitrage’ which impacts on the efficiency of worldwide production given that business strive to allocate resources to jurisdiction with favourable tax regimes.

⁴⁴ OECD (1998), *supra* note 14, at 13 para. 16.

⁴⁵ OECD (1998), *supra* note 14, at 28 para. 104.

⁴⁶ See J.M. Mintz, ‘Is National Tax Policy Viable In the face of Global Competition?’, (5 July 1999) 19 *Tax Notes Int’l* (No. 1) 99, at 100.

Do the issues of derivative financial instruments really matter in an international context? This is the ‘fairly extraordinary question’⁴⁷ that Malcolm Gammie asks after three years of research with the International Fiscal Association on this issue. Gammie acknowledges a number of articles and books purporting to explain the mechanics of DFIs and the taxation issues that these instruments raise on a purely domestic level. He notes, however, that there is ‘a notable absence in the tax literature of any sustained debate on what the appropriate *international* tax response to derivative financial instruments should be.’⁴⁸ DFIs shift risks from one party to another. In a closed economy aggregate risk arising from the use of DFIs is not reduced given that what is gained by one party is offset by the loss sustained by the counterparty. Moreover, if both counterparties were to gain, then arguably, such gain is achieved as a result of a reduction in tax liabilities. In an international environment, risk and taxable value are shifted between jurisdictions by DFIs. When both risk and taxable value are shifted from one jurisdiction to another, the first jurisdiction should not be concerned as to whether the second properly assesses the value associated with the risk assumed within its borders, as long as ‘the price paid properly reflects a current assessment of the price attaching to the risk assumed’.⁴⁹ Thus, while it would seem that DFIs raise issues pertaining to domestic tax bases only, these instruments create a transfer pricing issue if involved in cross-border arrangements.

The OECD, in its Revised Discussion Paper on global trading, is well aware of this transfer pricing issue when it calls for ‘some international consensus so that double, or less than single taxation can be avoided.’⁵⁰ However, the Revised Discussion Paper continues to hold that the arm’s length principle remains predominantly applicable to transfer pricing issues arising from global trading cases.⁵¹ The contention of this thesis is that the integrated nature of those involved in the global trading of DFIs is such that the arm’s length principle is inadequate for assessing the price attached to such complex transactions.⁵² Instead, it proposes a formulary profit-split system similar to a large extent to that advocated by the OECD as a method of last resort.

⁴⁷ M. Gammie, ‘The Source Taxation of Derivative Financial Instruments, “Synthetic Securities”, Financial Hedging Transactions and Similar Innovative Financial Transactions’ (September/October 1999) *1 Derivatives & Financial Investments* (No. 5) 231, at 232.

⁴⁸ *Ibid.*

⁴⁹ *Id.*, at 233.

⁵⁰ OECD (1998), *supra* note 14, at 28 para. 104.

⁵¹ *Supra* note 14, at 31 para. 118.

⁵² See Chapter 2, Section II, 1, A & B, at 57ff.

C The Relationship between Accounting and Tax Principles

The broad relationship between taxation and accounting principles has already been examined in Chapter 6. The conclusion reached is that the incidence of tax considerations on financial reporting is responsible for the difficulties of achieving worldwide harmonised accounting practices. The emergence of innovative financial instruments has further complicated this issue leaving all interested parties, for example, regulatory authorities, tax authorities, shareholders, traders, and others with serious difficulties in fully apprehending the activities of the industry, and more especially their tax consequences.

One of the main problems in this area is that innovative financial instruments have transformed conventional balance sheet analysis since transactions which they represent are 'off balance sheet'. In these circumstances, there arises a problem of disclosure quite distinct from that of the proper accounting treatment of these new instruments. In order to adequately determine the right tax liability, authorities are in need of adequate information. The disclosure problem which arises because of the off balance sheet nature of these new instruments does not facilitate this determination.

In view of the paucity of rules in the area, tax authorities rely on general principles of taxation in order to ascertain relevant tax liabilities. However, general principles of taxation are themselves sustained by accounting principles and the lack of widely accepted principles in the area 'exacerbates the difficulties of taxing authorities in dealing with such instruments' and renders the development of new tax rules capable of coping with the continuing developments in this field extremely difficult.⁵³

Basically, accounting principles enable the determination of an enterprise's financial position. This is achieved, as far as financial instruments are concerned, if there are coherent rules for the recognition and measurement of the effects of engaging in transactions involving financial instruments. In this connection, several questions need to be addressed, and, according to the OECD, work is continuing 'on the complex recognition and measurement issues which need to be resolved'.⁵⁴ Some of these questions identified by the OECD include:

- When should financial assets and liabilities be recognised for balance sheet purposes?
- When should they be 'derecognised'?
- How should they be valued?
- Should they be amortised?

⁵³ OECD (1994), *supra* note 31, at 27 para. 113.

⁵⁴ *Supra* note 31, at 27 para. 114.

In an international context, an additional question arises as to where profits and losses are to be recognised.⁵⁵

To answer these questions is far from easy given that countries have different traditions with regard to tax and commercial accounting. To harmonise such diverging practices is indeed a daunting task. A further problem arises in that while accountancy relies on the presence of flexible rules in order to provide a fair and true view of the economic performance of an enterprise, taxation authorities for their part strive for certainty in determining the correct tax base. In order to achieve any meaningful result, particularly in the context of financial instruments, taxation authorities and accounting standard-setting bodies need to cooperate in establishing suitable principles and rules.

The OECD has attempted to reach such a synthesis with the publication in 1994 of its booklet entitled 'New Financial Instruments No. 6'. This document represents the findings of the Working Group on Accounting Standards. Unfortunately the Working Group did not approve it and it did not reach any conclusion on the issues discussed therein.

The advent of global trading has exacerbated these problems while creating new ones. The perennial question of international taxation, that is, the apportionment of the tax base between countries having a legitimate claim to the latter, must now be examined in the context of global trading.

2 The Apportionment Question in Global Trading Operations

Global operations pose a series of problems for tax authorities worldwide. Both the OECD and the U.S. Treasury/IRS have suggested tentative solutions to some of these problems. In 1998, the IRS and the OECD almost concomitantly released respectively the Proposed Regulations (PR) on the allocation and sourcing of income from a global dealing operation and an updated Revised Discussion Paper on the same topic.⁵⁶ These two documents canvass the more important questions relative to the taxation of income from global trading.⁵⁷

⁵⁵ *Supra* note 31, at 27 para. 114.

⁵⁶ The U.S. Proposed Regulations (Prop. Regs.) were released on 2 March 1998. See Lexis Doc 98-8571 98 TNI 58-32. On 17 March 1998 the OECD Committee on Fiscal Affairs published its updated discussion draft OECD, *The Taxation of Global Trading of Financial Instruments* (Paris: OECD, 1998), (OECD Revised Discussion Draft). The OECD Revised Discussion Draft supersedes an earlier draft released on 14 February 1997.

⁵⁷ According to Michael Danilack, IRS's Associate Chief Counsel (International), the finalisation of the global dealing regulations (63 Fed. Regs. 11177 [REG -208299-90] (6 March 1998)) has been included in the IRS's 1999 business plan; see A.M. Fernandez, 'U.S. Global Dealing Regs. to Be Finalized in 1999', (8 March 1999) 18 *Tax Notes Int'l* (No. 10) 945.

A The U.S. Treasury/IRS' Practice

i Transfer Pricing Methodologies (TPMs)

In the U.S., guidance for the apportionment of income from global trading operations are to be found in Notice 94-40⁵⁸ and the PR. Notice 94-40 embodies instructions for negotiating APAs with functionally fully integrated global trading enterprises.⁵⁹ The PR deals comprehensively with the question of global trading.⁶⁰ It retains some of the fundamental policy conclusions reflected in Notice 94-40 and rejects others. For example, the PR maintains a preference for the profit-split method. However, contrary to Notice 94-40, capital is no longer regarded as a profit factor but is considered to be only entitled to a routine return where it is employed.⁶¹

Fundamentally, the PR operates as a method for determining, allocating, and sourcing income (whilst applying the U.S. concept of effectively connected income) arising from global dealing operations on an arm's length basis.⁶² It aims at enabling 'participant' taxpayers⁶³ to establish and recognise, on an arm's length basis, the contributions of each participant to the global

⁵⁸ Notice 94-40, 1994-1 C.B. 351, issued on 25 April 1994.

⁵⁹ For the advantages of Notice 94-40 as a prime example of the IRS providing guidance in areas with special technical difficulties, see S.C. Wrappe, 'APA Guidance: What Ever Happened to Notice 94-40?', (21 April 1999) 7 *Transfer Pricing Report* (No. 25) 978.

⁶⁰ There is a difference in terminology between the OECD Revised Discussion Draft and the Proposed Regulations. The first uses the expression global trading while the second opts for the term global dealing. Richard Hoge, from the IRS Office of Financial Institutions & Products, described the commonly used term 'global trading' as something of a misnomer. The proposed regulations apply to dealers in the financial service industry, not traders. Unfortunately, the name has stuck. See Tax Analysts 'IRS Officials Discuss Global-Dealing Regs', (18 February 1999), WTD 33-4, Lexis Doc 1999-6857.

⁶¹ Notice 94-40 was based upon the IRS' experience in issuing APAs involving the allocation of profit from functionally fully integrated global dealing operations. The implicit conclusions of the IRS as reflected in Notice 94-40 were that traditional transfer pricing methodologies are inapplicable in global trading carried out through the fully integrated model. Thus, the use of a profit-split method to allocate the income of functionally fully integrated global dealing businesses is viewed as the most appropriate method applicable in these cases as it mirrors what occurs in joint ventures. Factors that could be considered for splitting profit include trader and support staff remuneration as well as capital provision/risk assumption. Moreover, sourcing follows the allocation of profit and the sourcing of capital is determined by the place where it is employed. As already mentioned, it would appear that 'Barclays Bank was the recipient of the global trading ruling addressed in Notice 94-40.' See M.J. McIntyre's letter to the Editor TNI, 'McIntyre on APA Report and More', (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1775.

⁶² E. Breindel, D. Considine, B. Mace, K. Sorrells & T. Wolosoff, 'U.S. Treasury Issues Proposed Global Dealing Regulations', (16 March 1998) *Tax Notes Int'l* 1837.

⁶³ The term 'participant' is defined as a controlled taxpayer, that is, either a regular dealer in securities or a member of a group of controlled taxpayers. It includes a regular dealer in securities, so long as that member conducts one or more activities related to the activities of such a dealer. Related activities are defined as the marketing, sales, pricing, and risk management activities necessary to the definition of a global dealing operation. Additionally, brokering is a related activity that may give rise to participant status.

dealing operation. Where global dealing operations are conducted by a branch or a deemed branch, the PR applies the arm's length principle as provided for by section 482 in order to determine the source of income, and the extent to which it is 'effectively connected' with the conduct of a U.S. trade or business and attributable to a U.S. PE under U.S. income tax treaties.

New transfer pricing methodologies (TPMs) are provided for in the PR. A TPM is to be selected pursuant to the 'best method' rule.⁶⁴ The best method rule consists of two principal elements: the comparability of the transaction, and the quality of the data and assumptions, in terms of completeness, accuracy, and reliability.⁶⁵ Accordingly, taxpayers are required to perform a functional analysis to determine the appropriate TPM.⁶⁶

The TPMs applicable to global dealing operations that would replace the specified methods under section 482 regulations⁶⁷ are discussed below.

1. The Comparable Uncontrolled Financial Transaction Method

The comparable uncontrolled financial transaction method (CUFT) evaluates whether controlled transactions satisfy the arm's length standard by comparing the price of a controlled financial transaction with the price of a comparable uncontrolled financial transaction.⁶⁸ Under this method, the contractual terms, risks assumed, and the economic factors prevailing when the parties entered into the controlled financial transaction are considered as the most important comparability factors.

2. The Gross Margin Method

The gross margin method (GMM) determines if the gross profit realised on the sales of financial products acquired from controlled parties is at arm's length by comparing that profit to the gross profit earned on uncontrolled transactions.⁶⁹ The GMM measures the arm's length price by subtracting the appropriate gross profit from the applicable resale price for the financial transaction under examination.

3. The Gross Mark-Up Method

⁶⁴ Regs. §1.482-1(c).

⁶⁵ Regs. §1.482-1(c)(2).

⁶⁶ Prop. Regs. §1.482-8(a)(3)(i).

⁶⁷ §§1.482-3 through 1.482-6.

⁶⁸ Prop. Regs. §1.482-8(b)(1).

⁶⁹ Prop. Regs. §1.482-8(c)(1).

The gross mark-up method (GMUM) determines if the gross profit earned on the purchase of financial products from uncontrolled parties and sold to controlled taxpayers is at arm's length by comparing that profit to the gross profit earned on uncontrolled transactions.⁷⁰ Like the GMM, comparability under this method depends on the similarity of the functions performed and risks assumed in the controlled and uncontrolled transactions. Accordingly, adjustments should be made for differences between the functions performed in the sale or transfer of financial products to controlled parties and the functions performed with respect to the sale or transfer of financial products to uncontrolled parties.⁷¹

4. Profit-Split Methods

The profit-split method is the only specified method applicable if neither the CUFF nor the GMM or GMUM apply. An implicit preference for the profit-split method may be found in the preamble to the PR where it is stated that the integrated structure of some global dealing operations may make it difficult to apply a traditional transactional method.

The profit-split method evaluates whether the allocation of the combined operating profits of a global financial institution is at arm's length by focusing on the relative value of each participant's contributions. The profit or loss generated by the activities of the participants is combined and then divided between them based upon the relative value of each participant's economic contribution to the combine venture.⁷² In other words, profit-splits aim at sharing the outcome by reflecting in each share the functions performed, risks assumed and the assets used by each participant. Two new profit-split methods are proposed for global dealing participants, as detailed next.

a. The total profit-split method⁷³

The total profit-split method entails a one-step process whereby the operating profit is allocated among the participants based on their relative contributions to the profitability of the global dealing operation. The total profit-split method may be useful to allocate income earned by a highly integrated global dealing operation where each participant in each location performs all routine and non-routine dealer functions. Accordingly, total profit or loss of the global dealing operation may be allocated among various jurisdictions based on the relative performance of equivalent functions in each jurisdiction.

⁷⁰ Prop. Regs. §1.482-8(d)(1).

⁷¹ For the difficulties in making such adjustments in the context of integrated economies, see H.N. Higinbotham, 'When Arm's Length Isn't Really Arm's Length: Issues in Application of the Arm's-Length Standard', (1998) *Intertax* (Issue 8-9) 235.

⁷² Prop. Regs. §1.482-8(e)(1).

⁷³ Prop. Regs. §1.482-8(e)(5).

b. The residual profit-split method⁷⁴

The residual profit-split method entails a two-step process. In the first step, the routine functions are compensated with a market return based upon the best transfer pricing method applicable to that transaction. Routine functions may include, but are not limited to, functions that would not give rise to participant status.

After compensating the routine functions, the remaining operating profit (the residual profit) is allocated among the participants based upon their respective non-routine contributions. Again, heavy reliance is put on a careful functional analysis that would identify the functions performed by each participant, the risks assumed, and the resources employed.

Profit split methods may be used to evaluate if the allocation of operating profit from a global dealing operation compensates the participants at arm's length for their contribution by evaluating if the allocation is one that uncontrolled parties would agree to. Accordingly, the reliability of this method is dependent upon clear identification of the respective contributions of each participant to the global dealing operation.

As for the profit-split factors, a taxpayer can use any factor or factors that accurately measure contribution to value.⁷⁵ The PR suggests that profits should be split according to the value assigned to the 'integral' functions of the global trading operation, such as trading.⁷⁶ Finally, the profit-split method generally allocates net operating profit, with the exception of interest expense and taxes.⁷⁷

ii The Question of Capital

The PR specifies, however, that certain activities, such as the provision of capital through a guarantee or other credit support, are either not within the scope of global dealing operations, or merit a routine return. By contrast, the OECD Revised Discussion Draft makes no such clear distinction. Therefore, the unsettled nature of the treatment of capital as evidenced by the difference between the OECD and the IRS could lead to vastly different allocations by various taxing authorities.⁷⁸

⁷⁴ Prop. Regs. §1.482-8(e)(6).

⁷⁵ Prop. Regs. §1.482-8(e).

⁷⁶ Prop. Regs. §1.482-8(e)(6).

⁷⁷ Prop. Regs. §§ 1.482-8(e)(3); 1.482-8(e)(5)(i); 1.482-8(e)(6)(i).

⁷⁸ D.M. Aaron et al., 'Proposed IRS Regulations on Global Dealing: Ignoring Capital and Taxing it Too?', (26 October 1998) 39 *Tax Management Memorandum Special Edition 1998-10*, from Proquest Database, at <<http://Proquest.umi.com>>.

Under the PR, contrary to the treatment accorded in Notice 94-40, capital put at risk in a global dealing operation is treated as a routine function that does not deserve a profit share. It would appear that this shift might be attributable in part to the U.S. Treasury's conclusion that determining the profit attributable to capital is infeasible.⁷⁹ It is arguable, though, that financial institutions are now in possession of sophisticated methods for measuring the amount of capital placed at risk by each party in a global dealing operation. Thus, it may well be that the Treasury might reconsider its position on this question when issuing final regulations.⁸⁰

The PR gives two reasons as to why capital is to be remunerated through a routine return.

First, an affiliate is not a participant in a global dealing operation if it has only provided a guarantee, or some other access to capital, to the exclusion of any other activity. Therefore, the affiliate's return on the capital it has provided needs to be ascertained under traditional TPMs. For example, an entity or branch that serves as a booking location will not be a participant if its only activity is providing a guarantee or acting as counterparty to third-party transactions.⁸¹ It will not be entitled to a share of profits, but only to an arm's-length return for its 'limited' function.

Second, in the case of the residual profit-split method, capital is treated as a routine function such as back-office activity. An entity is entitled to receive a market return (for example,

⁷⁹ *Id.* The reluctance of the Treasury to consider the effectiveness of models attributing a return on capital at risk is puzzling. Financial institutions have developed sophisticated capital asset pricing models in order to measure the earnings on capital exposed or employed. Financial institutions routinely use such models to determine regulatory capital requirements. Two prominent techniques are the risk adjusted return on capital (RAROC) and the return on risk-adjusted capital (RORAC). Use of these methods permits an accurate allocation of capital to each party in a global dealing operation. The appropriate rate of return can be determined by reference to a capital asset pricing model, the internal hurdle rate or a published market rate. Indeed, the Proposed Regulations contemplate that indirect evidence of the price of a CUFT may be derived from a proprietary pricing model if the data used in the model is widely and routinely used in the ordinary course of the taxpayer's business to price uncontrolled transactions provided adjustments are made to the amount charged to reflect differences in the factors that affect the price to which uncontrolled taxpayers would agree. Prop. Regs. §1.482-8(b)(5), and Example 4. For the U.K. view as to the role of capital, see U.K. Inland Revenue, *Inland Revenue Bulletin Issue 38*, at <<http://www.inlandrevenue.gov.uk/bulletins/tb38>>.

⁸⁰ Nevertheless, it is also arguable that methods for determining capital at risk predate the Proposed Regulations and that in spite of this the Treasury has thought fit to adopt the present position. Moreover, the Proposed Regulations recognise that proprietary valuation models have probative value for allocating income. See Prop. Regs. §§1.482-8(b)(2)(iii); 1.482-8(b)(5), Example 4 (allowing the use of internal pricing models to establish a CUFT). Accordingly, there is no logical reason why internal measurements of the amount of capital placed at risk should not be considered in allocating the profits from a global dealing operation. See Aaron et al., *supra* note 78. As will be argued further below in this thesis, there is no need to remunerate capital separately in the presence of the property factor.

⁸¹ Prop. Regs. §§1.482-8(a)(2)(ii); 1.482-8(a)(5), Example 2.

interest or a guarantee fee) on any capital that it provides to an affiliate rather than having a portion of the global dealing operation's profits allocated to it.⁸²

Moreover, the PR moves away from the application in Notice 94-40 of the fungibility principle. Notice 94-40 provides that capital is a key factor in generating profit. Thus, the risk factor measured the potential risk to which a particular trading function exposed the worldwide capital of the organisation.

In fact, Notice 94-40 states that the risk 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 such as the maturity-weighted volume of swap transactions or open commodity positions. The reasons for the departure from the position in Notice 94-40 are not entirely clear, but may, in part as indicated earlier, reflect the position that measuring the return due to capital put at risk by each party in a global dealing operation is not feasible.

iii The Permanent Establishment Threshold Question

The PR suggests certain rules for determining whether a vehicle used for global dealing operations satisfies the PE threshold. It is thus provided that, for purposes of making an inter-branch allocation of global dealing income, a qualified business unit (QBU)⁸³ shall include a U.S. trade or business that is deemed to exist because of the activities of a dependent agent in the U.S.⁸⁴ However, it is arguable that this special rule regarding a deemed QBU may conflict with the provisions of the OECD Revised Discussion Draft, the OECD Model Treaty, as well as the U.S. Model Treaty.⁸⁵ Indeed, the PR expands the definition of 'dependent agent' to

⁸² Prop. Regs. §§1.482-8(e)(8), Example 5; 1.863-3(h)(v), Example 3.

⁸³ Branches and other divisions of a multinational company may be treated as qualified business units (QBU) for tax purposes; see Regs. §1.989(a)-1(b) which defines a 'qualified business unit' as any separate and clearly identified unit of a trade or business of a taxpayer that maintain separate books and records.

⁸⁴ Pursuant to the preamble to the Proposed Regulations, a special rule provides that activities of a dependent agent may give rise to participant status through a deemed QBU that performs its participant functions in the same location where the dependent agent performs its participant functions. Accordingly, §1.863-3(h)(3)(iv) of the Proposed Regulation provides that, for purposes of making the inter-branch allocation of global dealing income, a QBU shall include a U.S. trade or business that is deemed to exist because of the activities of a dependent agent in the U.S. (without regard to the Regs. §1.989(a)-1(b) books and records requirements for a QBU).

⁸⁵ Pursuant to Article 5(6) of the U.S. Model Treaty, if an agent is determined to be independent and acting in the ordinary course of its business, the activities of that independent agent do not give rise to a PE. The exact definition of the concept of independence is, however, unclear. The Treasury's Technical Explanation to the U.S. Model Treaty provides that whether an agent is independent is a factual determination with respect to two requirements: the legal and economic independence of the agent. In other words, the existence of a deemed PE is not based on the ownership or control relationship between the companies, but rather on these factors only. As for the test for legal agency, it is agreed that a contract of agency exists if the agent is subject to detailed

include subsidiaries properly characterised as ‘independent agents.’ Moreover, since the application of this special rule to the activities of dependent agents is open-ended, there are concerns that it might apply to activities beyond those covered by the dependent agent PE rules.⁸⁶ The deemed QBU/PE provisions of the PR may, therefore, cause great uncertainty for taxpayers and have other far-reaching implications.⁸⁷

iv Inter-Branch Allocations

In the context of branch taxation as perceived by the Proposed Regulations, three points need to be noted as explained below.

1. Split-Sourcing

Extending the implicit conclusions of Notice 94-40, the PR largely eliminate the ‘all or nothing’ rule of current regulations under which the full amount of profit from a global dealing transaction is attributed to a U.S. branch that ‘materially participates’ in such a transaction.⁸⁸

instructions regarding the conduct of its operations or is under comprehensive control. In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk: an independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. See also *Taisei Fire and Marine Ins. Co., Ltd., et al. v. Comr.*, 104 T.C. 535. Moreover, the Treasury’s Technical Explanation provides further that an agent may be economically independent, notwithstanding an exclusive relationship with the principal, if it has the capacity to diversify and acquire other clients without substantial modification to its current business and without substantial harm to its business profits; see Aaron et al., *supra* note 78.

As for the dependent agents, Article 5(5) of the U.S. Model Treaty provides that, if an agent is determined to be a dependent agent, its actions will give rise to a PE if the agent has and habitually exercises the authority to conclude contracts in the name of the principal. The Treasury’s Technical Explanation states that the purpose of Article 5(5) is to encompass those persons who have ‘sufficient authority to bind the enterprise’s participation in the business activity in the State concerned.’ The Technical Explanation also makes clear that the activities referred to in Article 5(5) are those relating to the essential business operations of the enterprise, rather than ancillary activities. With respect to the issue of habitually executing contracts, several questions arise in the specific context of a global trading operation. It is not clear that a U.S. participant with severely restricted authority to execute contracts (e.g., only when the markets are closed abroad and within certain value or risk guidelines) would qualify under Article 5(5). Moreover, it is not always clear when marketing or customising activities blur into concluding contracts. To conclude, therefore, this issue is particularly difficult in the context of global dealing operations. In the absence of more detailed guidance in the final regulations, the IRS could attempt to apply the deemed QBU/PE rule to such activities; see Aaron et al., *supra* note 78.

⁸⁶ Aaron et al., *supra* note 78.

⁸⁷ Thus, for example, the consequences of having a deemed QBU/PE go beyond direct taxation of the global trading income allocated to such QBU/PE. A foreign participant with a deemed QBU/PE could be subject to section 884 branch profits tax. In addition, a failure to file U.S. returns could result in the denial of deductions in computing taxable income and give rise to section 6114 penalties; see Aaron et al., *supra* note 78.

⁸⁸ Regs. §§ 1.863-7(b)(3), 1.864-4(c)(1)(i), 1.864-4(c)(5)(iii).

Under the PR, entities engaged in a global dealing operation within the United States will be taxable in the U.S. on the basis of an arm's-length allocation reflecting the relative economic contribution of each QBU.⁸⁹ This split-sourcing rule does not apply to income from activities that do not give rise to participant status, for example, interest, dividend, or guarantee fee income received by an owner or guarantor of a global dealing operation that is conducted by another controlled taxpayer.⁹⁰ The source of such income continues to be determined under current applicable regulations.⁹¹

2. Treatment of Capital

The PR contains specific provisions regarding the sourcing of capital within an entity. These provisions maintain the principle of fungibility as expressed in Notice 94-40, but eliminate the use of capital provision/risk assumption as a factor for allocating global dealing income. Because capital is viewed as fungible and sourced wherever it is employed, that is, the branch where traders are located, neither a routine return, for example, a guarantee fee, nor a profit allocation for the provision of capital is permitted within a single legal entity under the profit-split method. In other words, capital is ignored as a factor for allocating profit among the different branches of an entity. Thus, Proposed Regulation §1.863-3(h)(3)(ii) states:

[S]ince the entire capital of a corporation supports all of the entity's transactions, regardless of where those transactions may be booked, the payment of a guarantee fee within the entity is inappropriate and will be disregarded.

Therefore, the allocation of global dealing income carried out through inter-branch transactions is made on the basis of the non-routine functions mentioned above (for example, marketing, and trading).

3. Fungibility of Money

The inter-branch sourcing/allocation of capital reflects two long-standing IRS/Treasury policy principles: money is fungible and branches are not respected as separate legal entities. There seems to be little other reason justifying the differing treatment of (wholly owned) subsidiaries and branches, as both are equally subject to the control of either the parent or head office, as the case may be.⁹²

4. Interest Expense Allocation

⁸⁹ Regs. § 1.863-3(h)(3)(i).10.

⁹⁰ Prop. Regs. §1.863-3(h)(1); Preamble.

⁹¹ Prop. Regs. §1.863-3(h)(1); Preamble.

⁹² See Aaron et al., *supra* note 78.

In accord with the principle of fungibility, interest expense cannot be allocated under a profit-split method but must be allocated in accordance with Regulation Section 1.882-5. Under these long controversial rules, interest expense is allocated under a three-step formula, which attributes interest expense to ‘U.S. assets’. In this regard, it is pertinent to note that Regulation Section 1.882-5 conflicts with the OECD Revised Discussion Draft’s criticism on allocating interest expense according to gross income. It also conflicts with most of U.S.’s trading partners’ treatment of the amount of taxable income attributable to a global dealing operation. As such, these provisions may have the potential to expose the income of a foreign bank operating globally to more than single taxation.

The fate of these controversial provisions relating to interest expense allocation rules have now been judicially adjudicated. The U.S. Court of Federal Claims, in a decision dated 7 July 1999, ruled that the IRS incorrectly imposed tax on the National Westminster Bank PLC (Natwest) based on Regulation Section 1.882-5 to compute the interest expense of the bank’s U.S. branch.⁹³ The Court held that these provisions were inconsistent with Article 7 of the U.S.–U.K. Convention for the Avoidance of Double Taxation. In essence, the Court found that the regulation treated Natwest’s U.S. branch as a unit of a foreign enterprise in violation of the treaty’s separate entity provision which requires that the profits of a PE be computed as if it were a distinct and separate enterprise dealing independently with the rest of the enterprise of which it is an integral part.⁹⁴ It can thus be seen that the extension of the separate accounting/arm’s length methodology in the field of global banking is bound to cause severe strain on the system. In spite of these difficulties, the OECD is proceeding with its attempt to treat a PE as a hypothetically separate entity from the enterprise of which it is a part. In other words, in order to determine, on an arm’s length basis, the profits arising from the business of international banking carried out in branch form, the OECD purports to create yet another fiction when, for the purposes of calculating the profit attributable to PEs, it proposes to treat such branches as if they were subsidiaries of the enterprise.

⁹³ *National Westminster Bank PLC v United States of America* 84 AFTR2d Par. 99-5017 reproduced in Tax Analysts Document Number: Doc 1999-234444, at <<http://taxbase.tax.org/taxbase/tmi3>>. See also K. Vogel, ‘Tax Treaty News’, (June 2000) 54 *Bulletin for International Fiscal Documentation* (No. 6) 254.

⁹⁴ See H.L. Adrion, ‘U.S. Court Holds That Separate Entity Approach Under U.K.-U.S. treaty Overrides IRS Regulations’, (19 July 1999) 19 *Tax Notes Int’l* (No. 3) 216.

B The OECD's Position

i TPMs

The OECD Revised Discussion Draft maintains that traditional transactional methods of taxation should remain the primary methods for analysing global trading.⁹⁵ However, because the activities of each location engaged in global trading are often so highly integrated, or conducted in such a different manner from the activities that are conducted between independent parties,⁹⁶ the OECD Revised Discussion Draft concludes that traditional transactional methods may not be fully capable of reaching appropriate results. Furthermore, the OECD Revised Discussion Draft also states that the transactional net margin method⁹⁷ may not be generally applicable to test the profits from a global trading operation. Accordingly, profit-split methods may have to be applied as a 'last resort' whilst the use of unspecified TPMs is also not precluded.

The OECD Revised Discussion Draft discusses a number of possible ways of applying profit-split methods but offers few firm conclusions.⁹⁸ It considers both the 'contribution analysis' and 'residual analysis' methods but does not recommend one over the other.⁹⁹ Moreover, it provides that if a profit-split method is to be used, care must be taken to ensure that its use is in conformity with the arm's length principle. In particular, it warns against the application of global formulary apportionment methods.¹⁰⁰ It notes the three factors as set forth in Notice 94-40, that is, the value factor, the risk factor and the activity factor, but states that Notice 94-40 is merely a starting point for the analysis.¹⁰¹

The OECD Revised Discussion Draft provides generally that trading, marketing, management, and major supporting activities should share in profits and losses. It does note that performance of both traders and specialised marketers is the key to the profitability of global

⁹⁵ R.T. Clair et al., 'Is the OECD's View of Global Trading Consistent With the Arm's Length Standard: A U.S. Perspective', (26 March 1997) 24 *Tax Management Transfer Pricing Report* (No. 5) 752.

⁹⁶ OECD (1998), *supra* note 14, at 39 para. 154.

⁹⁷ The similarity of the transactional net margin method (TNMM) and the U.S. comparable profits method (CPM) has already been examined. An important provision of the PR is that for purposes of the best method rule (which applies in the context of global dealing), the CPM is not available under the 'specified methods' pursuant to Regs. §1.482-8. The reason given is that in the finance industry, profits are too volatile to serve as the basis for income allocation. Because profits are prone to fluctuate radically, even over a short duration, use of the CPM is likely to yield unusual and unreliable results; see Aaron et al., *supra* note 78.

⁹⁸ OECD (1998), *supra* note 14, at 65 para. 258.

⁹⁹ *Supra* note 14, at 43-44 paras 174, 176, 178.

¹⁰⁰ *Supra* note 14, at 34 & 43 paras 133, 173.

¹⁰¹ *Supra* note 14, at 44-45 paras 180-81.

trading, but offers no guidance with respect to measurement. It states further that the proper treatment of capital provision/risk assumption is perhaps the most difficult global trading issue to resolve.¹⁰² Although the OECD Revised Discussion Draft states that there is obviously a relationship between capital provision/risk assumption and expected profits, it notes that member countries disagree regarding whether it is possible to measure the contribution.¹⁰³ Finally, the OECD Revised Discussion Draft notes that no satisfactory basis for assigning weights to the selected factors has yet been articulated.¹⁰⁴

One significant point of divergence between the PR and the OECD Revised Discussion Paper is that the first provides that the choice of the profit-split method is to be determined under the 'best method' rule whereas the second expresses a preference for traditional transactional methods,¹⁰⁵ with the use of profit-split admitted as a method of 'last resort' in instances of highly integrated operations.¹⁰⁶

It is arguable that, in most likelihood, the profit-split method will be the best method for the IRS and would thus be applied as a matter of first, rather than one of last resort.¹⁰⁷ Consequently, it may well be that the differences between the two documents lie in application of the various TPMs rather than the choice of TPMs. Moreover, there are also significant differences in the treatment of capital in the two documents.

ii The Question of Capital

The OECD Revised Discussion Draft, in contrast to the PR, advocates the treatment of capital provision/risk assumption as a factor for allocating profits from a global trading operation. However, the OECD Revised Discussion Draft documents the lack of consensus among members regarding the treatment of capital provision/risk assumption. Therefore, rather than coming to a definite conclusion, it specifically requests guidance from the business community regarding the role of capital.

¹⁰² *Supra* note 14, at 46 para. 190.

¹⁰³ *Supra* note 14, at 46-48 paras 191-96.

¹⁰⁴ *Supra* note 14, at 50 para. 205.

¹⁰⁵ *Supra* note 14, at 32 para. 121.

¹⁰⁶ *Supra* note 14, at 41 para. 165.

¹⁰⁷ In fact, 'profit-based transfer pricing are becoming more popular than traditional methods in many of the countries that have adopted them.' This trend is 'unavoidable' according to Robert E. Culbertson 'a former IRS official who participated in the drafting of the U.S. regs that introduced the comparable profit method in the United States.' See A. Fernandez & T.F. Field, 'Canadian Tax Foundation Holds First World Tax Conference', (6 March 2000) 20 *Tax Notes Int'l* (No. 10) 1056, at 1060.

The OECD Revised Discussion Draft emphasises the fact that access to capital is essential to engage in global trading.¹⁰⁸ It is capital that enables a global trading business to fund its cash needs and assume the variety of risks, for example, credit and market risks, arising from its global dealing operations. It therefore states that it is very important to examine the facts and circumstances surrounding the provision of capital in order to evaluate exactly what function is being undertaken.¹⁰⁹ If the capital provider is simply lending money, then its reward may be a simple arm's length interest rate. If, however, the capital provider acts as an entrepreneur, for example, if it underwrites all the risks of the activity, it is likely to demand a share of the profits commensurate with the risks undertaken. In between these extremes are capital providers whose function may be similar to that of an intermediary. In such cases it may be possible to apply traditional transactional methods reliably. This position is underscored by the OECD's assertion that the influence of capital is likely to be more important for products that are complex and innovative and where the duration of a contract is long rather than short.¹¹⁰

Finally, the OECD Revised Discussion Draft maintains that there is a relationship between capital provision/risk assumption and expected profits. However, given that Member States disagree on whether it is possible to measure the contribution, the OECD Revised Discussion Draft invites comments specifically on the general issue of risk and more specifically on the inclusion of capital provision/risk assumption as a factor in a profit-split method.¹¹¹

iii The Permanent Establishment Threshold Question

The OECD Revised Discussion Draft largely refers to the OECD Model Treaty and the OECD Commentary thereto with respect to the issue of deemed PEs. Moreover, it rejects the position of the business community that sought to treat all global dealing operators as independent agents in order to avoid the problems posed by branch taxation.¹¹²

Article 5(6) of the OECD Model Treaty provides that an enterprise shall not be deemed to have a PE in a Contracting State merely because it carries on business in that state through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.¹¹³ In this area, it has always

¹⁰⁸ *Supra* note 14, at 27 paras 100-102.

¹⁰⁹ *Supra* note 14, at 41 para. 164.

¹¹⁰ *Supra* note 14, at 41 para. 166.

¹¹¹ *Supra* note 14, at 46-48 paras 191-96.

¹¹² *Supra* note 14, at 59 para. 234.

¹¹³ OECD, *Model Tax Convention on Income and Capital* (Paris: OECD, 1992) loose leaf (1997 update). (Note: A 2000 update is now available.) Paragraphs 36-39 of the OECD Commentary discuss the definition of independent agent.

been agreed that an agent's independence is ascertainable relative to whether he or she demonstrates a certain level of legal as well as economic independence relative to his or her principal. Both the U.S. Treasury's Technical Explanations and the OECD Commentary recognise this practice. Legal independence is thus ascertained relative to the existence or not of detailed instructions and comprehensive control emanating from the principal. As for economic independence, it is gauged by the degree of entrepreneurial risk that the agent assumes. In addition, the OECD Commentary provides that ownership is not determinative of dependence.

Moreover, Article 5(5) of the OECD Model Treaty provides that where a person 'other than an agent of independent status to whom paragraph 6 applies' is acting on behalf of an enterprise, that enterprise shall be deemed to have a PE in a particular country in respect of any activities which that person undertakes for the enterprise if that person has, and habitually exercises an authority to conclude contracts in the name of the enterprise. The OECD Commentary mirrors the Technical Explanation in requiring the agent to bind the principal's participation in the business activity in the state concerned.¹¹⁴

The OECD Revised Discussion Draft states that one of the most difficult issues presented by global trading is whether the activities of one enterprise constitute a PE of another enterprise.¹¹⁵ The OECD Revised Discussion Draft does not provide clear guidelines other than that this determination depends on the facts and circumstances of each case. It 'refers to problems' in deciding whether certain kinds of activities carried on in a particular jurisdiction give rise to a PE.¹¹⁶ It notes that, given the nature of global dealing, it is likely that most global dealing activities performed in one jurisdiction by an enterprise resident in another jurisdiction will be essential and significant enough to pass the threshold of 'auxiliary and preparatory'.¹¹⁷ Thus, Article 5(4) of the OECD Model Treaty considers that preparatory or auxiliary activities do not constitute a PE. It notes further that the 'mere purchase' exception contained in Article 5(7) of the OECD Model Treaty does not apply in the context of global dealing.¹¹⁸

iv Inter-Branch Allocations

The OECD Revised Discussion Draft refers largely to the OECD Model Treaty in addressing the issue of inter-branch allocation. Under the OECD Model Treaty, branches are generally

¹¹⁴ *Id.*, paras 31-35 of the OECD Commentary is concerned with the dependent agent provision.

¹¹⁵ OECD (1998), *supra* note 14, at 58 para. 230.

¹¹⁶ *Supra* note 14, at 57ff paras. 224ff.

¹¹⁷ *Supra* note 14, at 58 para. 229.

¹¹⁸ *Supra* note 14, at 58 para. 229.

treated on a separate entity basis.¹¹⁹ Therefore, some of the OECD Members have been critical of the U.S. ‘all-or-nothing’ rule which have, in certain cases, been supplanted by split sourcing in the PR, and current applicable special interest allocation rules.

With respect to the inter-branch treatment of capital, the OECD Revised Discussion Draft does not reach any conclusions. It generally considers problems concerning the attribution of income and expenses to a PE of a global dealing business. It specifically criticises the mismatching of income and expense that may result from requiring taxpayers to allocate interest (or other expenses) according to gross income.¹²⁰

To conclude, the most significant differences between the PR and the OECD Revised Discussion Draft, therefore, are:

- The implicit preference in the PR for the profit-split method;
- The treatment under the PR of capital provision/risk assumption as a routine function;
- The creation of a deemed PE in circumstances not necessarily contemplated by the OECD Model Treaty; and

¹¹⁹ The OECD’s paper issued on 1 October 1998, (OECD Steering Group on the OECD Transfer Pricing Guidelines, *The Working Hypothesis for Attributing Profit to a Permanent Establishment (PE)*, DAF/CFE/TP(98)1/REV1), proposes a basis of interpretation of Article 7 of the OECD Model Convention which considers a PE as a hypothetical enterprise distinct and separate from the enterprise of which it is a permanent establishment. If this interpretation gains worldwide consensus, then it is arguable that inter-branch deals such as hedging transactions would be properly ascribed to a particular location. However, hedging transactions associated with global trading are often carried out from specific locations whereas their ultimate effects are accounted for in the global book of the global trading enterprise. A similar situation occurs, for example, with the hedging transactions carried out by the Treasury acting as a separate profit centre. These situations invariably lead to instances where losses are recognised for tax purposes in a jurisdiction other than that in which the gain from an off-setting position is recognised (generally referred to as ‘split hedges’). The fact is that there are economies in engaging in inter-desk deals rather than having to transact with an external party in every situation and that such synergy gains are not capable of being ascribed on an arm’s length basis to a particular location. It follows, therefore, that the Working Hypothesis would have little positive incidence on the question of inter-branch allocations.

¹²⁰ OECD (1998), *supra* note 14, at 13 para. 17: ‘Although several different jurisdictions may participate in a single transaction, domestic tax rules may not provide for the income generated by that transaction to be split between different jurisdictions. If global trading is conducted through branch form, transactions may be taxed, under domestic rules, on an “all-or-nothing” basis; if sufficient activity takes place in a jurisdiction, then all of the gross income from the transaction is taken into account for purposes of determining taxable income; if not, then none of the income from the transaction is taken into account. Expenses, including losses from transactions entered into to hedge the risk arising from the customer transaction, may be allocated against the gross profit arising from the transaction in order to determine the net taxable income. Unless the rules regarding expense or loss allocation are clear, this approach is unlikely to produce, in practice, a result consistent with the arm’s length principle.’

- The IRS treatment of inter-branch transactions as different from affiliated enterprise transactions, including the fungibility of capital (that is, capital sourcing and interest expense allocation).

The OECD's position on the question of intangibles also reflects its long-standing opposition to interbranch royalty payments, a position which is thus transported in the global trading context. Intangibles owned by the enterprise, for example, trading methods, valuation programs, are considered as belonging to the whole entity and not to a particular location. Accordingly, the OECD Revised Discussion Draft states that it would be inconsistent to consider intangibles as an allocation factor for the profit-split or to allow inter-branch deductions for them.¹²¹

Other than these conclusions, however, the OECD Revised Discussion Draft provides that resolution of inter-branch income allocation issues will have to await further agreement on how Article 7(2) of the OECD Model Treaty operates. Although the OECD Revised Discussion Draft notes that a deduction for payments made as an appropriate contribution toward the actual cost of capital or intangibles is authorised by the commentary to the OECD Model Treaty, it states that it is less clear in what circumstances that deduction may be increased to cover a mark-up over actual costs.¹²²

Finally, true to its stated policy, the OECD Revised Discussion Draft rejects formulary apportionment, whether as contemplated by Article 7(4) of the OECD Model Treaty or otherwise, in the global dealing context.¹²³

C Possible Alternative Approaches

i An Appropriate Definition of Interest

The extensive analysis of the PR and the OECD Revised Discussion Draft carried out above shows that there is substantial indecision as to the proper treatment of gains arising from global trading. This situation has led some to canvass possible innovative solutions to some of the problems arising in this environment.¹²⁴ A good example illustrative of such novel ways of dealing with the taxation of income generated by new financial instruments relates to the treatment of 'interest' under a swap. Many payments relating to new financial instruments are similar in economic functions to interest. However, the definition of interest in the OECD

¹²¹ *Supra* note 14, at 49-50, 61 paras 202, 243.

¹²² *Supra* note 14, at 61 para. 242.

¹²³ *Supra* note 14, at 60-61 paras 238-40.

¹²⁴ Plambeck, *supra* note 22.

Model Tax Convention is not broad enough to encompass all such payments. Thus, while discounts are considered as income from debt claims and so fall within the definition, payments from an interest rate swap are not income from a debt claim and are therefore outside the scope of the definition. Although there is no doubt that such payments are calculated on an interest basis, they are considered as income from debt claims and are characterised as income 'in the nature of interest'. This interpretation is however not universally accepted. In countries where legislation subscribes to a substance-over-form approach, payments that are not legally interest may nevertheless be considered as interest for the purposes of construing the Model Tax Convention. In such cases, taxing rights relating to such payments are to be shared between the source country and the country of residence.

In view of the confusion that may arise from conflicting interpretations of Article 11 of the OECD Model Tax Convention relating to the interest article, the latter may well need to be revised in order to make it clear that the definition of interest does not extend to payments under swaps or other financial instruments. Such a measure would significantly reduce the risk of double taxation. Moreover, the elimination of double taxation could be achieved by not subjecting payments made in respect of financial instruments to tax in the source country, an alternative unlikely to be favoured as a result of the loss of revenue that such a measure would entail.

Furthermore, since payments under a swap, for example, are not characterised as interest, they are exempt from withholding tax provisions. However, an exemption from withholding tax of payments made under financial instruments may encourage tax avoidance.¹²⁵ Indeed, there would be a strong incentive to change the nature of the payments from one easily identifiable as interest to one that would not be so characterised in order to escape withholding tax payments. Such transmutation can be easily achieved through the operation of modern financial instruments.

In view of such difficulties, the Committee on Fiscal Affairs examined the possibility of including a separate article for novel financial instruments in the Model Convention.¹²⁶ The objective of such an article would be to ensure that every payment under all financial instruments would not be subjected to source taxation. The problem with this solution is that it is unlikely that a single article could contain a definition broad enough to cover all financial instruments present and future.

¹²⁵ For the use of derivatives for tax avoidance purposes, see, for example, U.K. Inland Revenue, 'Use of Derivatives and Financial Instruments to Convert Interest into Capital', (June 1997) *U.K. Inland Revenue Bulletin*, at <<http://www.inlandrevenue.gov.uk>>.

¹²⁶ OECD (1994), *supra* note 31.

Finally, the Committee also examined the effects of amending Article 21, the Other Income Article, in order to incorporate therein an anti-abuse provision that would enable the application of the arm's length principle to payments made under the new financial instruments.

The emergence of new financial instruments posits new challenges to the taxation of cross-border income flows of income. The question is whether the existing rules are adequate to meet the challenge or whether a rethink of the whole system is inevitable.

ii Towards a Multilateral APA?

The rules for determining income attributable to the various participants in a global financial operation 'are simply not workable'¹²⁷ and it remain to be seen whether the proposals put forward by the OECD and the U.S. Treasury/IRS are capable of preventing double taxation if applied in their format.

An interim solution is available in the form of advance pricing arrangements/agreements (APAs). The trend towards the use of APAs to encourage voluntary compliance in the transfer pricing area is gathering momentum. The IRS holds the view that the number of APAs will increase significantly especially in the global financial industry.¹²⁸

In view of this, the IRS has embarked on a modernisation program and is building expertise by creating a new Office of Financial Products and Transactions and has commissioned the Los Alamos National Library 'to research and develop models for valuing derivative transactions' presumably in order to enable it to obtain a better knowledge of the industry.¹²⁹

It would appear, therefore, that the U.S., at least, has put into place the necessary structures for an expansion of the APA process in the global trading industries. Even prior to these developments Barclays Bank plc and Sumitomo Bank Capital Markets Inc. have signed APAs with the IRS and the U.K. Inland Revenue which reportedly covered global derivative products.¹³⁰ Interestingly, it appears that 'while the details of the APAs are not public, they are said to contain formulas for allocating income and deductions attributable to global derivative

¹²⁷ Y.Z. Reich, 'U.S. Federal Income Taxation of U.S. Branches of Foreign Banks', (10 June 1994) *Tax Notes Today* (Lexis, Fedtax, TNT File, Elec Cit 94 Tnt) 112-31.

¹²⁸ M.M. Richardson, 'Richardson Outlines Progress in International Tax Issues', (19 December 1994) *State Tax Notes* (Lexis, Fedtax, Stn File, Elec Cit 94 Stn) 243-41.

¹²⁹ *Ibid.* See also note from the U.S. Department of Treasury soliciting comments on the scope, algorithms, and use of a mark-to-market software that is being developed by the IRS through the Los Alamos Project, in *Federal Register* (May 29, 1997), at <http://www.irs.ustreas.gov/prov/tax_regs/comments.html>. The Los Alamos Project has been criticised by the Institute of International Bankers; see L. Uhlick, 'International Bankers Question Valuation Software', (13 October 1997) 15 *Tax Notes Int'l* 1225.

¹³⁰ M.M. Levey, 'Proposed 482 Regs.: Attacked at Hearing; Two Banks Sign APAs', (November/December 1992) *J Int'l Tax'n* 248, at 250.

products transactions between the U.S. and the U.K.’¹³¹ If the APA approach is favoured, then the following questions arise:

- Would the current bilateral APAs evolve into multilateral agreements?
- Would the profit-split method as favoured by the U.S.¹³² likely to be incorporated within all multilateral APAs when these eventuate?

According to Michael Durst, a former Director of the IRS APA Program, the next generation of APAs will be agreed on a multilateral basis.¹³³ Already, the U.S., Canada, Australia, and Japan have reached agreement on common procedures for reaching bilateral APAs.¹³⁴ This presumably covers applicable methodologies. Significantly, the APA process may be coordinated with other tax authorities. This may be achieved through the mutual agreement procedure under tax treaty provisions. It may be argued that the OECD’s Revised Discussion Draft envisages such a multilateral APA when it invites ‘multilateral discussions’ to consider the taxation principles applicable to global trading.¹³⁵ Moreover, with the IRS enabling banks to apply the arm’s length principle to inter-branch transactions as examined earlier, the way has been opened for the IRS to enter into unilateral APAs for global inter-branch financial dealings.¹³⁶ In the opinion of the head of IRS APA Program, Peter Kocis, many of such APAs will use the profit-split methodology which he foresees as ‘the wave of the future’.¹³⁷

The APA route seems to be the most valuable method available to TNCs and revenue authorities to achieve some degree of certainty relative to transfer pricing methodologies.¹³⁸ Nevertheless, one must bear in mind some of the reservations regarding the APA as the universal solution to transfer pricing problems. First, it has been argued that for several reasons ‘APAs are not beneficial for every taxpayer engaged in a global trading operation.’¹³⁹ Thus,

¹³¹ *Ibid.*

¹³² M.M. Levey & G.A. Grauer, ‘IRS Indicates a Preference for Profit-split Method in Global Trading’, (July 1994) *J Int’l Tax’n* 300, at 301.

¹³³ J. McKinnon, ‘IFA’s U.S. Branch Considers Recent Worldwide APA Developments, U.S. Conduit Regs.’, (12 December 1994) *9 Tax Notes Int’l* 1815.

¹³⁴ *Ibid.*

¹³⁵ OECD (1998), *supra* note 14, at 26 para. 96.

¹³⁶ Anonymous, ‘Advance Pricing Agreements: Proposed Interbranch Bank Rules Open Way for Unilateral Interbranch APAs, Official say’, (30 June 1999) *8 Tax Management Transfer Pricing Report*, (No. 5) 163.

¹³⁷ *Id.*, at 164. A new type of APA has appeared in the U.S. These are the so-called head office expense APAs that allow foreign banks to plan for future allocation of expenses to their branches in the U.S.

¹³⁸ See Chapter 3, Section I, 2, B, ii, at 109.

¹³⁹ Note, ‘Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology’, (1994-95) *48 Tax Lawyer* 1057, at 1072.

the Institute of International Bankers has urged the development of a realistic alternative to APAs.¹⁴⁰ Second, on 13 May 1999, Karl Kellar, an IRS official said that the service is seeing a decline in demand for APAs involving cross-border inter-branch financial transactions. The official reason for this decline was that the IRS Proposed Regulations intend to allow taxpayers to apply section 482 transfer pricing methodologies to financial institutions' derivatives and financial instrument trading.¹⁴¹ However, it may well be that the reason for this decline is the uncertainty as to the confidentiality of information submitted for APA negotiation as a result of the litigation initiated by the Bureau of National Affairs, Inc.¹⁴² Therefore, as far as globally integrated operations are concerned, there is still a need to find an acceptable worldwide solution.

Section III A Realistic Alternative: Applying Formulary Apportionment to the Global Financial Industry

Generally available evidence shows that 'financial income is impossible to tax at the international level under the arm's length and separate accounting principle.'¹⁴³ Resorting to APAs may be regarded as 'an interim process...a stop-gap measure that is appropriate and sensible.'¹⁴⁴ Therefore, 'unless the existing APA process in the global trading area is viewed as an interim step towards a revision of the applicable substantive rules, it will become increasingly vulnerable to criticism that it is private law.'¹⁴⁵

The mechanical aspect of formulary apportionment methodology does offer certainty for all stakeholders in the field of international taxation. The IRS has even studied its benefits. Indeed, prior to the release of the Temporary Regulations, the sentiment was that the IRS was 'exploring different basic typologies of TPMs, including in particular a worldwide formulary

¹⁴⁰ D. Bodner & L. Uhlick, 'International Bankers Comment on Advance Pricing Agreement Program', (4 August 1994) *Tax Notes Today* LEXIS, FEDTAX, TNT file, elec. cit 94 TNT 152-40.

¹⁴¹ M.J. Tropin, 'Demand Down for Interbranch APAs but not for Global Trading APAs, IRS Says', (31 May 1999) *72 BNA's Banking Report* (No. 22), at 982-83.

¹⁴² See Wrappe, *supra* note 56, at 978. See also Chapter 3, Section I, 2, B, ii, at 109. Legislation is now in place guaranteeing this confidentiality. However, it is arguable that banks remain reluctant to disclose highly strategic information to Revenue Authorities to obtain in return limited protection from a full-blown audit of their activities.

¹⁴³ See Mintz, *supra* note 46, at 101.

¹⁴⁴ Y.Z. Reich, 'U.S. Federal Income Taxation of U.S. Branches of Foreign Banks', (10 June 1994) *Tax Notes Today* (LEXIS, FEDTAX, TNT file elec. cit. 94 TNT 112-31).

¹⁴⁵ *Ibid.*

apportionment'.¹⁴⁶ It would appear, though, that for the time being, the IRS remains committed to the arm's length standard although it advocates new profit-split methods.¹⁴⁷

As for the OECD, its Revised Discussion Draft does not propose any original solution to the various problems in the area. Whilst this was not meant to be the outcome of the draft, yet one would have thought that the OECD would have at least agreed to reconsider its position in order to be at par with the innovative spirit that permeates global trading. Can the OECD maintain its current intransigence in view of the pace at which new business paradigms are emerging? This is not so certain. One of the most significant findings of the Revised Discussion Draft is that in the integrated trading model 'it is not possible to identify any specific transactions between the different locations to which traditional methods could be applied.'¹⁴⁸ However, for the moment, the farthest that the Organisation is prepared to go is to suggest that it is possible to determine:

the arm's length profit of the permanent establishment by using profit-split methods based on the principles of Articles 7(2) and (3) and for these to be applied in a manner consistent with the profit-split methods described for associated enterprises in the Guidelines. In particular, although it is the profit of a particular trading book which is split, rather than individual transactions, these methods are permitted, provided the individual transactions could be combined in accordance with the principles set out at Chapter I, Part C (iii) of the Guidelines. To ensure conformity with the Guidelines, profit-split methods must only be applied to the profits from trading books which consists only of an aggregation of similar and linked transactions.¹⁴⁹

To ensure that it is not even remotely contemplating global formulary apportionment as a possible solution to the problem, the OECD Revised Discussion Draft stresses the point that 'there is no need to apply the approach envisaged by Article 7(4) to global trading cases'.¹⁵⁰

Nonetheless, this thesis submits that, as far as the financial sector is concerned, formulary apportionment, in spite of its imperfections, either real or perceived, is the most appropriate methodology for the apportionment of income generated by TNCs operating in truly globalised markets. It is certainly simple in its concept and in its application. To be convinced one needs only to take note of the confusion generated by the provisions of the U.S. Proposed Regulations and the indecisiveness of the OECD Revised Discussion Draft trying to make the

¹⁴⁶ *Ibid.*

¹⁴⁷ S.D. Conlon, 'IRS Makes a Start Toward Workable Rules for Global Trading' (September 1998) *Journal of Taxation* 171, at 174.

¹⁴⁸ OECD (1998), *supra* note 14, at 230 para. 116. See also comments by Conor Healy of KPMG London who, on 22 April 1999 said that both the OECD and the IRS agreed that the profit-split method is acceptable for global trading, Anonymous, 'Profit Split Gaining Acceptability With IRS, OECD, Practitioner Says' (19 May 1999) 8 *Transfer Pricing Report* (No. 2) 53.

¹⁴⁹ *Supra* note 14, at 60-61 para. 240.

¹⁵⁰ *Supra* note 14, at 60 para. 240.

separate accounting/arm's length method work in an environment so alien to it. The world is fast reaching the point when the question is not *whether* international taxation should be based on formulary apportionment but rather *when* should serious thought be devoted to finding how to implement the methodology without serious disruption to countries' comparative positions in the tax field.

The successful application of a formulary apportionment methodology on a worldwide basis requires that three broad conditions be met:

- first, the taxpayer must be properly identified;
- second, general agreement as to the identification of the tax base must be reached; and
- finally, there must be agreement as to what factors to include in the apportionment formula.

1 Preliminary Considerations

The players in the global financial industry are diverse and there is a variety of trading models to carry out global trading. Some of these trading models are fully integrated and truly act as a single entity. This model creates significant benefits from the various synergies resulting from their mode of operation. Worldwide formulary apportionment should be applied primarily to those entities operating under this model as it fits their requirements. In fact, rather than waiting for the system to be agreed by the OECD, some fully integrated operators are actively seeking, on an individual basis, through the APA process, to have that particular methodology applied to their operations.

A Identifying the Taxpayer

In 1993 Ernst & Young carried out a survey of approximately 100 member banks of the Institute of International Bankers (IIB). The report, published in the U.K.¹⁵¹ in the same year, confirmed the methods of operation of international banks as described by Plambeck.¹⁵² In general, international banks operate in branch form. There are nevertheless instances where, for regulatory or tax reasons, the subsidiary format is used.¹⁵³ Three main categories of cross-border operations have been observed as follows.

¹⁵¹ Ernst & Young, *Taxation of Cross-border Banking* (London: The Economist Intelligence Unit, 1993).

¹⁵² Plambeck, *supra* note 22.

¹⁵³ Ernst & Young, *supra* note 151, at 5.

i The Integrated Trading Model

There is some confusion in the terms used in the context of global trading. Global trading may be viewed from three different angles:

- First, there is the time dimension where the activity of trading is carried out virtually non-stop during a 24-hour period.
- Second, there is the geographical dimension of the trade, where emphasis is put on the fact that financial intermediaries have the capacity ‘to execute customer orders and to take proprietary positions in financial products in markets around the world and around the clock.’¹⁵⁴
- Third, there is also the possibility of viewing the term global trading as meaning the involvement of different business units located in different parts of the world taking part in a single transaction. In the following pages, the expressions global trading and global 24-hour trading are used interchangeably.

An international bank engaged in global 24-hour trading maintains an inventory of financial products. It then systematically passes the authority to trade these products around the world. Each trading centre may make deals and trades during the time slot where authority is vested with it during the 24-hour period. In this model, the management of the assets and liabilities of the banking enterprise is carried out on a global and integrated basis. Indeed, the whole enterprise functions as a single business whether the operation involves subsidiaries or branches.

Such an integrated operation is achieved along the following lines. An inventory of financial products is maintained in each of the major trading regions, which are North America, Europe and the Far East. According to Plambeck, the main markets for each of these regions are located in New York, London and Tokyo respectively. There is also very significant trading occurring in Hong Kong, Sydney, Chicago, Singapore and Toronto and to a lesser extent in Frankfurt, Paris, Amsterdam, Brussels and Los Angeles.¹⁵⁵ In each of the trading regions, primary trading responsibility for each regional inventory is entrusted to respective regional traders. Trading responsibility rotates from one geographical region to another during a 24-hour period when one region closes and the other opens for business. This permits a ‘single book’ or globally integrated operation to be transacted worldwide.

¹⁵⁴ Plambeck, *supra* note 22, at 1143-44.

¹⁵⁵ *Supra* note 22, at 1144.

The shifting of trading responsibility is illustrated through the operation of Merrill Lynch's government securities arm.¹⁵⁶ For example, it is 12.35 pm London time and the 'book', that is, Merrill's open trading positions, is about to be transferred from London to New York where it is 7.35 am. The two regional managers exchange valuable information over the telephone while data from a centralised computer system used to keep track of all trading for the book is made available to New York traders. At the end of the trading day in New York, the regional manager there goes through the same ritual by passing the book to his Tokyo counterpart.

To apply a functional analysis as proposed by the OECD is not feasible within the integrated trading model. Where the trading book is passed from one country to another and the value of the book is achieved by the cooperative effort of staff in more than one location, it is not possible to identify and evaluate the different functions in isolation.¹⁵⁷ Thus, as the U.K. inland revenue admits, 'if the performers of these functions were acting for independent enterprises they might well have agreed to split the profits arising from their activities rather than attempt to price distinct transactions and services between them.'¹⁵⁸ Thus, a profit-split approach must necessarily be the most appropriate apportionment method in such situations.¹⁵⁹

ii Centralised Product Management Model

This type of enterprise is composed of a certain number of trading centres clustering around a primary trading office called the 'coordinating office'. Under this structure, the different trading centres of the firm maintain separate 'books' in a given financial product. Each of the trading centres has a limited discretion as to the amount of trade that it can initiate in a particular product. However, only the coordinating office has overall authority to monitor the trading activities of all the trading centres. Indeed, the coordinating office is responsible for each of its trading centres remaining within the limits of exposure determined by higher management.¹⁶⁰

The supervisory role of the coordinating office is facilitated by the fact that individual trading centres often enter into inter-branch transactions with the coordinating office that offset their third-party transactions. Thus, risks and liabilities are globally adjusted and assets are also globally managed to maximise efficiency.¹⁶¹ Enterprises operating along these lines require a

¹⁵⁶ L. Glynn, 'A Day –and Night– in the Life of the Global Market', (April 1986) *Institutional Investor* 293.

¹⁵⁷ See U.K. Inland Revenue, 'Inland Revenue Bulletin Issue 38', *supra* note 79.

¹⁵⁸ *Ibid.*

¹⁵⁹ In a consultative document dated 19 December 1996, the Australian Taxation Office sought comments on whether it should permit use of profit-splits when allocating income from global trading in financial products. See Anonymous, 'ATO Issues Consultative Paper On Global Trading, Use of Profit Split' (1 January 1997) 5 *Tax Management Transfer Pricing Report* (No. 17) 526.

¹⁶⁰ Glynn, *supra* note 156, at 293.

¹⁶¹ Ernst & Young, *supra* note 151, at 8.

‘congruent worldwide portfolio strategy to achieve the goals of cross-border trading (that is, to ensure the maximum worldwide portfolio return).’¹⁶² Information may be gathered centrally or throughout the enterprise network. Such information is then centralised, processed and disseminated throughout the network. This trading method establishes a global portfolio strategy, it maximises efficiency in the management of a worldwide portfolio, and it reduces administrative and infrastructure costs.

At a particular location, not necessarily that of central management, a product manager is entrusted with the responsibility of managing trade in that particular product on a global basis. He or she then oversees book runners in the various trade centres around the world while traders report to these book runners. Central management is not necessarily a single function located exclusively in one jurisdiction. It may be transferred to a particular trading centre on the basis of that centre’s level of association with a given transaction. In this configuration trading discretion is also passed from one time zone to another but ‘is limited by parameters to ensure that jurisdictions comply with the established portfolio strategy.’¹⁶³ In other words, whilst trading authority is passed from one time zone to another, such authority is limited to certain specifics or is valid only within set parameters. The key point, therefore, is that although authority to trade is passed from one time zone to another, that authority is not general, but is restricted to a certain number of products rather than to all the products within the book. In addition, limits and restrictions are also imposed as to the level of trading within that particular product.

The centralised product management model is characterised by the moving of risk from sales offices, the originating office, to the centre. The main tax issue in this model is whether the originating office can be recognised for tax purposes and, if so, on what terms.¹⁶⁴ If, by virtue of the mirror transaction risk, is transferred from the originating office, then given that it no longer assumes any such risk, a mere commission or a share of the initial profit on the deal may well be considered as a proper remuneration payable to the originating office. How then should the quantum of this commission be determined to satisfy the arm’s length principle? Clearly, the issue of comparability again arises. In Professor’s Issing words ‘it is difficult, if at all possible, to identify financial products which are fully comparable in the various national financial market.’¹⁶⁵

¹⁶² *Supra* note 151, at 8.

¹⁶³ *Supra* note 151, at 9.

¹⁶⁴ See B. White, *Global Trading—Carving Up the Profit cake*, (April 1997) 24 *Tax Planning International Review* (No. 4) 21.

¹⁶⁵ Issing, *supra* note 3, at 4.

This means that once again taxation authorities are confronted with the difficulties of concluding that an appropriate arm's length 'price' for the mirror transaction has been achieved. Several other vexed questions arise. For example, if the originating office has participated in the structuring of a derivative, is it reasonable to assume that it requires a share of the total profit on the deal over and above a commission? If inter-branch transactions are not recognised on a worldwide basis and 'a hedge is transacted centrally, there is a risk that it may not be offset against the result of the customer transaction booked at the originating office.'¹⁶⁶

iii Separate Enterprise Trading Model

Financial institutions operating along this model maintain inventories of financial products within independent trading centres around the world. These centres operate either through the branch or subsidiary form. Each trading centre is characterised by its decisional independence from the head office or parent company, each normally has its own portfolio and risk management although a central location may provide credit risk guidelines.

The major difficulty in applying the arm's length principle in a model where each entity within the global operation is managed as a separate profit centre is that it may be difficult for a 'taxpayer who enters into a forward currency trade with its parent company at 11.00 a.m. on March 3, 1997, to show in March 2000, why it chose to trade at 11.10 a.m. rather than at 10.50 a.m. to price the transaction.'¹⁶⁷ This is a situation where the availability of actual third party transactions may be problematic. The question, it would appear, may be solved if comparables that would serve as a proxy for an arm's length prices could be identified.

It is evident that a notable degree of integration exists only with the first two categories of operations. Even within these two models the measure of integration differs significantly. If a formulary system is conceived for these two models, then such a system cannot be made to apply uniformly to both. Indeed, as will be discussed further below, it is doubtful whether an inflexible model could be successfully applied across the whole spectrum of enterprises operating even in each one of these models. Formulary apportionment is likely to be the most appropriate method of apportioning income generated by highly integrated enterprises. It follows that if there were to be any chance of successfully applying that method, it would have to be relative to the most integrated model within the global financial industry. Consequently, the model retained for the application of the proposed formulary method must necessarily be the integrated trading model.

¹⁶⁶ *Id.*, at 22.

¹⁶⁷ *Id.*, at 21.

B Delineating the Tax Base

The proposed model requires the allocation of global gross accounting profits (or losses) to the various trading centres responsible for their generation. Gross accounting profits are to be calculated according to uniform international accounting standards. In order to formulate standards that would be acceptable throughout the global financial industry, it is important to determine where gross profits arise.

i The Global Financial Industry Sources of Income

Global trading in financial instruments contributes to the profits (or losses) of three major classes of market participants: capital users, capital suppliers and financial intermediaries.¹⁶⁸ In general, financial intermediaries create wealth by servicing the needs of capital users and capital suppliers and, therefore, earn their profits from four major sources as set below.

First, in their role as intermediaries between capital suppliers and capital users, they earn commissions and bid/ask spreads from brokering and dealing in globally traded instruments that evidence ownership in an underlying item. They also earn fees and spreads from trading risk in the form of derivative financial instruments. Again fees are earned through the provision of global custodian and research services for investors.

The second source of profits is through the use of global trading by financial intermediaries to satisfy their own portfolio needs. Global trading facilitates the management of the assets and liability of a firm because its global balance sheet is under unified management. As a result, profits are maximised and the cost of liabilities are minimised by tapping into a variety of funding sources, diversifying risks and opting for the best possible deal in the given circumstances.

The third source of profits for financial intermediaries arises from them trading for their own account. It would appear that speculation is a major source of revenue. A financial intermediary speculates by taking positions with respect to movements in prices, for example, interest and exchange rates. Therefore, the 'operating revenues of a global trading operation are essentially a function of price movements and the size of positions.'¹⁶⁹

Finally, because financial intermediaries use sophisticated communications and data processing systems, they are able to generate additional profits by capitalising on arbitrage opportunities, including tax and regulatory arbitrage.¹⁷⁰

¹⁶⁸ Plambeck, *supra* note 22, at 1145.

¹⁶⁹ *Supra* note 22, at 1147.

¹⁷⁰ Coopers & Lybrands, *Opportunity and Risk in the 24-Hour Global Marketplace* (Coopers & Lybrands, 1987).

The 'book' is at the base of a global firm's trading and it is its efficient running that generates profits.¹⁷¹ The firm's trading position as evidenced by the book is spelled out on the screens of the in-house computer system to which all trading centres are connected. In this context, a trading position is an aggregate of different information such as the firm's market exposure, its profit and loss, and its inventory. The distinctive feature of global trading is the 'passing' of the book from time zone to time zone around the globe. This does not mean that the location of the inventory changes. Neither does this 'passing' result in the transfer of legal title from one jurisdiction to another. What passes is merely the location of trading authority. The recipient trading centre is not a distinct profit centre operating wholly autonomously. Thus firms really 'operate in one profit centre mode.'¹⁷²

The 'one profit centre mode concept' epitomises the integrated and centralised nature of the book. It reflects the whole firm's trading position, and, obviously, the contributions of each trading centre to that position are known at all times. However, the sum of these contributions is not equal to the total trading position because of obvious synergy profits. Thus arises the particular problem of allocating these synergy profits to the various trading centres.

ii Accounting Problems Relative to Measuring the Base

For taxation purposes, derivative instruments need to be valued properly. The choice of a particular accounting treatment to that effect is not simple. An appropriate method of accounting for derivatives needs to be 'reasonable...and one that clearly reflects profits, is supported by available and reliable data, requires few adjustments, and can be properly administered.'¹⁷³ For the following reasons it is doubtful whether the traditional methods of accounting are able to achieve this stated outcome.¹⁷⁴

a The inadequacy of historic cost

In the historic cost model of accounting, assets and liabilities are recorded at historical rather than at market values. This is fundamentally at odds with the intended effect of many of the new financial instruments which is to 'alter the settlement or market values of financial assets and liabilities'.¹⁷⁵ In a situation where historical cost rather than market values is the norm for financial accounting, information relative to the effect of the instruments on the market values of

¹⁷¹ OECD (1998), *supra* note 14, at 14 para. 50.

¹⁷² Plambeck, *supra* note 22, at 1149.

¹⁷³ Australian Income Tax Ruling IT 2682 *Income Tax: Tax Payments Made Under Interest Rate Swap Contracts: Timing of Income and Deductions*.

¹⁷⁴ P. Hancock, *Financial Reporting for Financial Institutions and Accounting for Financial Instruments*, Discussion Paper No. 14 (Melbourne: Australian Accounting Research Foundation, 1990) 77.

¹⁷⁵ *Ibid.*

the assets and liabilities is difficult to interpret and therefore fails the intended purpose of a financial statement.

To solve the problem the Fédération des Experts Comptables Européens proposes the use of the mark-to-market methodology:

[A] theoretical answer to this problem is to value all on-balance sheet and off-balance sheet transactions at market value. The trading operations are then marked to market, this method having no effect on the *net* financial position or the *net* income arising from hedging transaction but 'revaluation' of on-balance sheet positions at market value when such value is higher than historical costs, would be regarded in many countries as being in conflict with general accounting concepts. This leads to a general discussion on the validity of the historic cost concept applied to banks.¹⁷⁶

The Fédération then went on to argue that it is nearly impossible for banks engaging in multi-currency business to identify a single functional currency and, therefore, a single historical cost basis.

b The problem with a transaction-based system

Accounting, Hancock argues, has traditionally been concerned with the recording of transactions, for example, cash sales and purchases.¹⁷⁷ These are clear straightforward transactions. Conversely, the nature of the transactions associated with the new financial instruments is ambiguous. A swap, for example, is neither a deposit, nor a loan or a security. The payment and receipt of a fee under a swap are clearly transactions for the payor as well as for the payee. How are these transactions to be recorded in the accounting system of each of the parties? If income has been earned and an expenditure incurred under a swap, what should be the timing of their recognition? These problems led to the following conclusion

[C]learly, any decision to recognise income in the profit and loss statement with no recognition of the transaction in the balance sheet will distort ratios such as return on assets.¹⁷⁸

c The problem of presenting uncertainty

Accounting has often been criticised for its inability to record transactions whose outcomes are subject to uncertainties. For example, the provision of a single amount for guarantees and letters of credit has been considered inappropriate given that, on the one hand, they are subject to considerable uncertainties, and that, on the other hand, information relative to these uncertainties is usually not provided in the accounts.

¹⁷⁶ Fédération des Experts Comptables Européens, *Accounting and Financial Reporting for New Financial Instruments in Europe* (OECD Symposium on New Financial Instruments, Paris, 31 May-1 June 1988) 17.

¹⁷⁷ Hancock, *supra* note 174, at 78.

¹⁷⁸ *Supra* note 174, at 78.

New financial instruments are also subject to the same uncertainty principle and are therefore subject to the same criticisms. A solution advocated has been the provision in accounting reports of ‘probability assessments of the range of possible outcomes for the instruments.’¹⁷⁹

d A conceptual framework

The difficulties in developing rules for new financial instruments arise because of the absence of ‘a clearly enunciated and readily understood complete statement of the conceptual basis for accounting (often referred to as a conceptual framework).’¹⁸⁰ When this conceptual framework is developed, it would need to contain accepted definitions and recognition criteria for assets, liabilities, equity, revenue and expenses against which a transaction would be considered in order to determine its appropriate classification.¹⁸¹

Financial reporting is basically concerned with reflecting economic reality. It follows that the question to be determined when it comes to developing appropriate accounting rules applicable to the various financial instruments is to clearly apprehend the economic conditions that these instruments are seeking to exploit.

iii *International Accounting Standards for Financial Instruments*

In accounting for financial instruments the critical issues that need to be addressed are those of:

- recognition, that is, the extent to which they meet the definition of assets and liabilities;
- measurement, or, in other words, the assessment of their worth; and
- disclosure of risks and other pertinent information that would be useful for the users of these financial statements.

The need for harmonised accounting standards has already been examined in Chapter 6 of this thesis.¹⁸² At a more specific level, given the competitive pressures arising in the international capital markets, the demand for harmonised accounting standards concerning financial instruments as well as a single global regulator is becoming more imperative.¹⁸³ In September 1991, the International Accounting Standards Committee, in its Exposure Draft 40 (E40),

¹⁷⁹ *Supra* note 174, at 78.

¹⁸⁰ *Supra* note 174, at 78.

¹⁸¹ In this regard, it is interesting to note that the *Ralph Report* on the reform of business taxation in Australia considers that soundly based definitions of the terms ‘asset’ and ‘liability’ is required for the integrity of the system it proposes. See *Ralph Report*, *supra* note 39, at 159ff.

¹⁸² See Chapter 6, Section II, at 265ff.

¹⁸³ D.C. Morris & G.M. Ward, ‘One Global Corporate Reporting Standard: Nightmare? Dream? Or Reality?’, PricewaterhouseCoopers, reproduced in *Notable Quotations Concerning the IASC*, at <<http://www.iasc.org.uk>>.

proposed a set of measurements concerning financial instruments.¹⁸⁴ E40 classifies financial instruments in three categories:

1. Investing and financing financial instruments

Investing and financing instruments are those held for a long period of time or until they mature. E40 suggests that they be measured at historical cost given that, contrary to derivatives, they are not held for risk management, but are held primarily as investment vehicles.

2. Hedging financial instruments

The fundamental purpose of 'hedge accounting' is to match the recognition of changes in the value of the hedging instrument in the profit and loss account with the recognition of equal but opposite changes in the value of the particular exposed position.¹⁸⁵ Therefore, the primary objective of a hedging instrument is to offset the risk of loss arising from a specifically identified position that is exposed to a risk of loss as a result of adverse price changes in financial markets.¹⁸⁶

To be characterised as an effective hedge, a financial instrument must eliminate or substantially reduce the risk of loss from the position being hedged. An effective hedge is one in which there is a high degree of correlation between changes in the net market value of the hedging instrument and opposite changes in the net market value of the position being hedged.¹⁸⁷

In the case of a perfect hedge the profit or loss on the hedging instrument exactly offsets the loss or profit on the exposed position. Conversely, if the hedge has been imperfect, then the extent of the imperfection is recognised in the profit and loss account in the same reporting period that the profit or loss on the exposed position is recognised.¹⁸⁸ If the hedging financial instrument is no longer an effective hedge, that is, if it ceases to reduce substantially the risk of loss from the position being hedged, then hedge accounting should be abandoned according to E40. The instrument is then reclassified in the two categories earlier defined. Clearly, therefore, the characterisation of a hedge instrument is dependent on the management's intention in entering into such a transaction. Consequently, E40 requires that this information be disclosed.

3. Operating financial instruments

¹⁸⁴ International Accounting Standards Committee, *Exposure Draft 40, Financial Instruments* (London: International Accounting Standards Committee, 1991) para. 59.

¹⁸⁵ *Id.*, at para. 105.

¹⁸⁶ *Id.*, at para. 94.

¹⁸⁷ *Id.*, at para. 101.

¹⁸⁸ S. Henderson, & G. Peirson., *Issues in Financial Accounting* 5th ed. (Melbourne: Longman Cheshire, 1992) 481.

An instrument which is neither a hedge nor an investing or financing instrument is regarded by the proposed standard as an operating instrument.¹⁸⁹ These include speculative instruments which are bought or sold for short-term profit. E40 proposes that financial assets and liabilities resulting from operating instruments be marked to market at each reporting date, that is, their net market value be reassessed at these specific dates. Any changes in the net market value of a financial asset or liability should be recognised as revenues or expenses in the reporting periods in which the changes occur.

The criteria proposed by the International Accounting Standards Committee (IASC) for the classification of financial instruments have been criticised. Hancock argues that to focus on the intention of management in order to determine whether a transaction is a hedge or not is unrealistic 'because of the sheer volume of transactions and the need for coordination across all divisions and all countries.'¹⁹⁰ Furthermore, the distinction between hedging and trading/operating has also been perceived as being arbitrary. Thus Roberts argues that:

the economic substance of currency contracts undertaken as hedge transactions and those undertaken as speculative transactions is identical; there is no economic justification for defining gains and losses on the contracts differently.¹⁹¹

The author concludes that since the distinction between hedge contracts and speculative contracts depends on the subjective motive underlying the transactions, it is essentially arbitrary.

As a result of such adverse comments E40 was withdrawn and E48 was introduced in January 1994. In response to E48, in March 1995, the IASC issued IAS 32, *Financial Instruments: Disclosure and Presentation*.¹⁹² IAS 32 represents the first of a two-phase process. It focuses on three issues relative to the disclosure and presentation of financial instruments.

First, it aims at providing guidance as to:

the classification of instruments between liabilities and equity, the classification of related interest, dividends, losses and gains, and circumstances in which financial assets and financial liabilities should be offset.¹⁹³

Second, the Standard deals with:

¹⁸⁹ IASC, *Exposure Draft 40*, *supra* note 184, at para. 91.

¹⁹⁰ Hancock, *supra* note 174, at 117-18.

¹⁹¹ D.A. Roberts, 'Accounting for Foreign Currency Transactions and Currency Contract', unpublished minor thesis for Master of Economics at Monash University, May 1982, in Hancock, *supra* note 174, at 117.

¹⁹² IASC, *IAS 32-Financial Instruments: Disclosure and Presentation* Australian Accounts Preparation Manual, (CCH Australia Limited 1995) 98-630, at 92-221.

¹⁹³ *Id.*, at 92-222.

information about factors that affect the amount, timing and certainty of an enterprise's future cash flows relating to financial instruments and accounting policies applied to the instruments.¹⁹⁴

Third the Standard encourages:

disclosure of information about the nature and extent of an enterprise's use of financial instruments, the business purpose they serve, the risks associated with them and management's policies for controlling those risks.¹⁹⁵

The second phase of the IASC strategy to deal with financial instruments was launched with the release of a Discussion Paper in 1997 describing the IASC's approach to the central problem of recognition and measurements of financial instruments and their reporting. The IASC Board then established an international joint Working Group with a number of national accounting-setters to develop an integrated and harmonised standard on financial instruments to be completed by the end of 2000.¹⁹⁶

In June 1998, E62, *Financial Instruments: Recognition and Measurements* was released. E62 is articulated on the principle that all financial assets and liabilities ought to be disclosed in the balance sheet for the sake of transparency and neutrality. Therefore, the initial measurement of all financial assets and liabilities, including derivatives, are to be made according to the fair value of consideration paid or received. Such questions are far more difficult to standardise on a worldwide basis as evidenced by the controversy that these proposals have stirred in the banking industry.¹⁹⁷ Even the U.S. Financial Accounting Standards Board has 'struggled' with these issues without any success as yet. In fact, as argued by Epstein and Mirza, 'the only new ground broken by the IASC has been to commit to a strict substance over form approach and to require separate presentation of disparate elements of compound financial instruments.'¹⁹⁸

¹⁹⁴ *Ibid.*

¹⁹⁵ *Ibid.*

¹⁹⁶ The 'G4' [now known as the G4+1] group comprising Australia, Canada, the U.K. and the U.S., with the IASC participating as an observer, has been established to seek joint solutions to international reporting issues including the accounting problems relative to the reporting of future events such as provisioning and hedging; see Australian Accounting Standards Board, *AASB Issues Policy on International Harmonisation*, Media Release 2 May 1996.

¹⁹⁷ See Joint Working Group on Standards Setters, 'Financial Instruments: Issues Relating to Banks', (31 August 1999), at <<http://www.iasc.org.uk>> & Joint Working Group of Banking Associations on Financial Instruments, 'Accounting for Financial Instruments for Banks', (4 October 1999), at <<http://www.iasc.org.uk>>.

¹⁹⁸ B.J. Epstein & A.L. Mirza, *IAS 97: Interpretation and Application of International Accounting Standards* (New York: John Wiley & Sons Inc, 1997) 130.

After some changes decided by the IASC Board in November and December 1998, IAS 39: *Financial Instruments: Recognition and Measurement* was released in February 1999 to be effective for financial years beginning on or after 1 January 2001.¹⁹⁹

The major objective of Intertax is to allocate to each of its members a fair share of the profits of global trading institutions. To achieve this, Intertax must necessarily start from financial statements that are clear and unambiguous. The IASC aims at producing such standards which ‘faithfully represent transactions and events’.²⁰⁰ The success of the model proposed in this thesis, therefore, is based to a large extent on the successful application by Intertax of the IASC’s standards relative to financial instruments. In this regard, consensus on the appropriateness of some of these standards has not yet been achieved. As mentioned earlier, the provisions of IAS 39 is premised on fair value measurement of financial instruments. Some representatives of the banking industry deny the relevance of fair value. They hold that, as far as the banking industry is concerned, a cost-based or mixed cost/fair value-based system for general external financial reporting purposes is more appropriate.²⁰¹ The argument is that ‘a full fair value system does not provide a sound basis for predicting banking book net cash flows and [therefore] lack relevance.’²⁰² It is to be noted that those objections do not apply to short-term transactions in a trading environment.²⁰³

It is submitted that there should be no differentiation in the accounting treatment of activities whose finality is the same. Clearly, therefore, all the transactions carried out by all financial institutions need to be measured by a common measurement rule that is most likely to clearly reflect the income of global financial institutions.

Whilst it would appear that a part of the banking industry questions the relevance of fair system for the banking book, that is, non-trading items, it does approve the system for trading activities. Thus, it would appear that there is consensus as to the appropriateness of market values for the global financial industry. In Walley’s opinion, this method:²⁰⁴

- is a simple way of computing profitability;

¹⁹⁹ For an insight into IAS 39, see IAS 39: *Financial Instruments: Recognition and Measurements*, at <<http://www.iasc.org.uk>>.

²⁰⁰ The Australian Research Foundation, *Proposed Statement of Accounting Concepts SAC 3*, at 16.

²⁰¹ Joint Working Group of Banking Associations on Financial Instruments, *supra* note 197, at 6.

²⁰² *Supra* note 197, at 4.

²⁰³ *Supra* note 197, at 1.

²⁰⁴ M. Walley, ‘Interest Rate and Currency Swap: Characteristics and Accounting Implications of New Financial instruments’, (OECD Symposium on New Financial Instruments, Paris 31 May-1 June 1988) 19, at 20.

- records accurately the profits and losses earned by a trader rather than those merely realised;
- is consistent with the view that profits and losses arising in respect of marketable instruments should be recognised whether realised or not, merely by virtue of their *realisability*, either by disposal in the secondary market or by executing the appropriate hedging action;
- avoids the distortions caused by hedge accounting; and
- records more accurately the impact of interest-rate risk on the profits of the bank.

Where a fully hedged portfolio exists, the mark-to-market approach effectively achieves the spreading of ‘locked-in’ profits over the life of the transactions within it.

The arguments in support of this view are convincing. Indeed, it has even been claimed that market values need to be used for the measurement of all assets and liabilities of financial institutions.²⁰⁵ In the field of derivative financial instruments many financial institutions use the mark-to-market methodology to value the global book at the time of receipt and that of passing the book from one time zone to another in order to determine the contribution of the traders in each jurisdiction.²⁰⁶ Having thus determined the allocable trading profit, what is left is to allocate expenses incurred for the derivation of such gross profits. This allocation is performed ‘either under the traditional realization approach or under a formula allocation.’²⁰⁷

It is important to note that this practice achieves the apportionment of net profits between jurisdictions. Indeed, since the gross contribution of each trading centre is known pursuant to the practice of marking the book to market prior to passing it, what remains to be carried out is the allocation of expenses by way of a formula. This approach, although relatively objective, has certain weaknesses. It is particularly suitable for products that are traded in stable markets. In addition, the system allocates profits by market movements rather than on traders’ performance. Finally, it does not cater for cases where there are time zone overlaps or simultaneous trading.²⁰⁸

The model proposed by this thesis requires the division of the global gross operating profits according to an agreed formula. If it is taken that agreement will eventually be reached as to

²⁰⁵ G.J. Benston et al., *Perspectives on Safe and Sound Banking: Past, Present and Future* (MIT Press, 1986).

²⁰⁶ Plambeck, *supra* note 22, at 1155.

²⁰⁷ *Supra* note 22, at 1155.

²⁰⁸ *Supra* note 22, at 1155.

the use of internationally accepted accounting standards to be released by the IASC,²⁰⁹ and if the mark-to-market approach for the measurement of the base is achieved, then what remains to be found is an appropriate formula or formulas for its apportionment. Although this proposal may seem to be radical, one must remember that even Lawrence Summers, the deputy secretary of the Treasury—before he came to Treasury—was of the opinion that a move to formulary apportionment in the international context was inevitable.²¹⁰ Therefore, as Senator Dorgan says, '[T]he change will come inevitably, the question is how do we get there.'

2 The Search for an Appropriate Formula

An apportionment formula is composed of factors which attempt to attribute a portion of the business income derived from a particular jurisdiction or attributable to sources within that jurisdiction. A formula needs to be theoretically sound and relatively easy to administer. Theoretical considerations are satisfied if a formula reflects the factors that contribute to or measure the processes involved in the earning of business income. What then are those factors which, in the global financial industry, perform these functions?

A The Wealth-Creating Factors

The profitability of an international operation rests on many factors. Today is the era of human capital.²¹¹ This means that skilled and educated people are at the centre of the production process, whether in manufacturing or in services. In the global financial industry the traders are, without doubt, of major importance since the profitability of their firm is directly proportional to their performance. They are indeed the 'gold-collar' workers and are remunerated primarily by way of a bonus based on the profitability of the book as a whole together with a base salary.

The sales persons, management and support staff are also of crucial importance to the efficient running of the firm. They contribute to a significant extent to the creation of wealth in the global financial industry by respectively finding customers, managing the firm's business, and providing systems that enable decisions to be made.

²⁰⁹ On the 2 May 1996, the Chairman of the Australian Accounting Standards Board (AASB), Mr Ken Spencer, announced that while the Board intends pursuing its objective of achieving a set of harmonised global accounting standards applicable in the world major capital market, the interim objective of the AASB is 'to work towards ensuring that financial reports prepared in accordance with Australian accounting standards comply with the International Accounting Standards Committee's (IASC's) standards.' See Australian Accounting Standards Board, *supra* note 196.

²¹⁰ A. O'Connell Devereaux & A.M. Fernandez, 'International Tax Developments Discussed at TEI Midyear Conference' (24 March 1997) 14 *Tax Notes Int'l* (No. 12) 967, at 969.

²¹¹ R. Crawford, *In the Era of Human Capital* (Harper Business, 1991).

Clearly, the labour factor, or human capital, must be one of the major factors in any apportionment formula designed for the industry. However, given the different levels of staffing and the qualitative differences in various trading centres, the question is what weight needs to be accorded to each group comprising the labour force? A further question is whether the factor should be valued in monetary units or whether the number of personnel in each category should be taken into account. Even the OECD advocates in its Discussion Paper the need to consider the number of employees rather than their monetary compensation.²¹²

A second factor in the creation of wealth in this area is property. Property in this context consists mainly of communications and computer equipment and office space but as is argued further below it also reflects the level of capitalisation of the operation.

Global trading in financial products is dependent on technology since ‘an electronic position-keeping system is a prerequisite for 24-hour operations.’²¹³ Computer technology and telecommunications constitute, therefore, another factor which needs to be prominent in an apportionment fraction. The standard equipment and software used are relatively easy to value. There remains, however, the usual problem of valuing special software that incorporates valuable intangible property.

Standard software is readily available for running a system, and this is traded in the market. However, the design of a system specific to a firm’s needs and in line with its management philosophy requires the modification of standard software and the incorporation of costly inputs which constitute valuable intangibles. Thus, the OECD also advocates the position adopted in this thesis relative to intangibles. It maintains that ‘intangibles owned by the enterprise are recognized as belonging to a whole corporation and not to a particular location’ so that intangibles should not be included as an allocation factor.²¹⁴ In the global financial industry, the proposed solution relative to intangibles is also applicable. Each trading centre of the international firm must be regarded as having contributed to the development of the intangible in question through either a real or a notional cost-sharing arrangement.

As for office space, the usual problem of large differences in value among the various trading centres is ever present. Again it is suggested that floor space be taken into consideration rather

²¹² OECD (1998), *supra* note 14, at 43-44 para. 175.

²¹³ L. Marion, ‘Creating a Global Book’, (March 1987) *Institutional Investor* 231, at 232.

²¹⁴ OECD (1998), *supra* note 14, at 47 para. 193.

than the annual rental value, although the amount of floor space used is directly related to the price of the property itself or its rental value.²¹⁵

Finally, the amount of revenue generated by a firm trading globally depends on the volume of business it conducts, the expenses it incurs, and the risks it assumes in the process. It has been suggested that all derivative products are valued on a mark-to-market basis. This means therefore that their aggregate net present value, and such value broken down for each trading centre, is known.

If the expenses incurred by each trading centre is considered a relevant factor in the derivation of the aggregate gross income of the firm, then a ratio can be worked out between expenses incurred and revenue derived which be included in an apportionment factor.

B A Suggested Formula

It is evident that different formulas for the apportionment of income from global operations may be proposed. For example, the Multistate Tax Commission (MTC) has, on 17 November 1994 adopted the 'Proposed Uniform Method for Allocation and Apportionment of Net Income from Financial Institutions'.²¹⁶ The formula proposed therein consists of three factors, namely a receipts factor, a property factor, and a payroll factor. To date, uniformity in this area has not been achieved given that certain U.S. states still promote variations in nexus rules, covered financial institutions, combined factor reporting, and factor weighting.²¹⁷

The model proposed in this thesis requires that the chosen formula apportion gross accounting profits derived by financial institutions operating globally. In this regard, it is appropriate, when devising the formula, to refer to the principles which guided the U.S. Supreme Court in *Container Corp. of America v Franchise Tax Board*.²¹⁸ The Court made it clear in *Container* that an apportionment formula must not be arbitrary and that its outcome be reasonable. In fact, the Court held that a rough approximation rather than scientific precision is all that is required of an apportionment formula. These standards, together with administrative feasibility, are what is required of any formula applicable to TNCs.

When the problem of designing a worldwide formula is considered, the first observation is that the players in the global financial industry do not operate along the same lines. Consequently, it

²¹⁵ Even when floor space is used a problem is likely to arise in that there is a marked difference between the costs of maintaining certain centres. Thus in order to lessen the impact of high cost centres on the apportionment formula, and on equity grounds, careful consideration needs to be paid to the weighting of the property factor.

²¹⁶ P.M. Plant and R.P. Edwards, 'MTC Financial Institutions Regulations, Summary of 1996 Actions by States', *74 Taxes*, (November 1996) 677.

²¹⁷ *Id.*, at 684.

²¹⁸ 463 U.S. 159 (1983).

is certain that a single relatively uncomplicated formula would never satisfy the requirements of the industry in general. In fact, given the general tendency for the emergence of mega-players in the world of global finance, it may be possible, at some stage, to contemplate an individualised formula for each of these players. Nonetheless, for the purposes of this thesis, a basic formula needs to be proposed even though modifications to suit particular circumstances might be required.

In the world of global finance, labour and property are the two factors directly responsible for generating revenue. They should therefore constitute the only two factors in an apportionment formula.

The labour factor needs to be a four-tier factor with different weights to each tier in order to reflect the different levels of contribution of the traders, management, sales and the support personnel.

As for the property factor, it should integrate both the tangible and intangible elements. Again the problem of valuation arises. For the tangible element there seems to be less difficulty in valuing standard equipment. However, difficulties arise with the valuation of floor space used. It has already been suggested that surface area be used rather than monetary value. As for intangible property, if there is a cost-sharing agreement as between the various trading centres, the share of each of the latter in developing the intangible is to be regarded as forming part of the numerator whilst the denominator would consist of the aggregate cost of developing the intangible.

Such a formula would give a certain allocation percentage which, when multiplied by the global gross profit, would result in the allocation of the latter to each jurisdiction.

Thus for a given fiscal period, the gross global profit is allocated say to Trade Centre A on the basis of the following formula:

Trade Centre A's Share of Total Global Profit = [Total Global Profit] x [Allocation Percentage]

$$\text{Allocation Percentage} = [(L) + (P)] \times [100/1]$$

Where: L = Labour Factor as calculated below

P = Property Factor as calculated below

Labour Factor: {4 tiers, different weights to each tier}

$$L = W_L \times \{ [W_T \times T_{NA} / T_{NT}] + [W_M \times M_{NA} / M_{NT}] + [W_S \times S_{NA} / S_{NT}] +$$

$$[W_{SS} \times SS_{NA} / SS_{NT}] \}^{219}$$

Where:

W_L = the weighting applicable to the labour factor

W_T = the weighting applicable to the traders' contribution to profit

W_M = the weighting applicable to the management staffs' contribution to profit

W_S = the weighting applicable to the salespersons' contribution to profit

W_{SS} = the weighting applicable to the support staffs' contribution to profit

T_{NA} = the number of traders located in Centre A

M_{NA} = the number of management staff located in Centre A

S_{NA} = the number of salespersons located in Centre A

SS_{NA} = the number of support staff located in Centre A

T_{NT} = the total number of traders worldwide

M_{NT} = the total number of management staff worldwide

S_{NT} = the total number of salespersons worldwide

SS_{NT} = the total number of support staff worldwide

Property Factor:

{IP is based on the value of standard equipment in monetary terms and, therefore, needs a common currency: TP is based on surface area}

$$P = W_P \times \{ W_{IP} \times IP_A / IP_T \} + [W_{TPE} \times TP_{AE} / TP_{TE}] + [W_{TPS} \times TP_{AS} / TP_{TS}]$$

Where:

W_P = the weighting applicable to the overall property factor²²⁰

W_{IP} = the weighting applicable to intangible property

W_{TPE} = the weighting applicable to tangible property in the form of equipment

W_{TPS} = the weighting applicable to tangible property in the form of office space²²¹

IP_A = the cost of intangible property located in Centre A²²²

²¹⁹ $W_T + W_M + W_S + W_{SS} = 1$

²²⁰ $W_P + W_L = 1$. If equal weighting is given to the labour and property factors then $W_P = W_L = 0.5$.

²²¹ $W_{IP} + W_{TPE} + W_{TPS} = 1$

IP_T = the total cost of intangible property worldwide²²³

TP_{AE} = the cost of tangible property, ie, equipment located in Centre A²²⁴

TP_{TE} = the total cost of tangible property, ie, equipment worldwide²²⁵

TP_{AS} = the floor area of tangible property, ie office space located in Centre A

TP_{TS} = the floor area of tangible property, ie office space worldwide.

There is an argument that since risk is a major factor in the financial service industry, it needs to be accounted for and thus be a determinative factor in any apportionment formula for the global financial sector.

Risk, in general, is 'defined by the adverse impact on profitability of several distinct sources of uncertainty.'²²⁶ In the general corporate context, risk may be considered as the exposure to the possibility of economic or financial loss (or gain) as a consequence of pursuing or not pursuing a particular course of action. In order to control its profitability, a business needs to properly manage its risk exposure.²²⁷ Thus, risks must be identified and a decision made as to which part of the enterprise is likely to assume the risks.²²⁸ Such risk management is a crucial aspect of the banking business because there is a direct correlation between profitability and risk-taking.

In order to assume the risk of doing business, the OECD holds that a global trading enterprise needs a strong capital base and credit rating, especially in the case of trading in 'over-the-counter' (OTC) derivatives. Likewise, the U.S. regulations on global dealing regard capital as a proxy for risk-taking. The reason underlying the recognition that an adequate level of capital is critical to enable a global trading business to carry out its activities arises because any losses that may be sustained by the business is cushioned or absorbed by its capital.²²⁹ It follows that

²²² These costs need to be denominated in the same currency, that is, currency translations will become necessary.

²²³ *Ibid.*

²²⁴ *Ibid.*

²²⁵ *Ibid.*

²²⁶ J. Bessis, *Risk Management in Banking* (London: John Wiley & Sons, 1998), at 5.

²²⁷ For an overview of these functions, see Bessis, *supra* note 226, at 24ff.

²²⁸ This assumes that the enterprise is a multi-entity one, or if of a single entity, is run as if it consisted of separate entities with specialisation of functions. If such different functional units are located in various jurisdictions, there arises several international tax issues whose resolution are the primary objective of the various relevant stakeholders.

²²⁹ See J.F. Sinkey, Jr., 'Risk Exposure of Banks' in Peter Newman, Murray Milgate & John Eatwell (eds), *The New Palgrave Dictionary of Money & Finance* (London: The Macmillan Press Limited, 1992) Vol. 3 N-Z, at 371.

a critical relationship exists between the adequacy of a financial institution's capital and its policy towards risk. Indeed, it is the policy of monetary authorities to ensure that a financial institution maintains an appropriate capital cover against the risks it assumes in the ordinary course of its business.

What then is capital? The word itself derives its meaning according to its context. It may have several meanings, such as, wealth, a factor or a means of production, the value of those means of production, the net worth of a business enterprise, the present value of a future sequence of receipts, money, or the money value of assets.²³⁰ From an accounting point of view, capital represents the assets held by a business. Risk is controlled by and directly referable to the quantum of capital. It follows, therefore, that in a formula which apportions profits, a discrete risk factor is otiose; it is represented in the quantum of capital, given that capital, represented by assets, is already accounted within the property factor. This, it is submitted, is the main reason for the refusal of the U.S. Treasury to include capital as an apportionment factor for the allocation of profits among the different branches of a global dealing institution. Indeed, as already shown, Proposed Regulation §1.863-3(h)(3)(ii) states:

[S]ince the entire capital of a corporation supports all of the entity's transactions, regardless of where those transactions may be booked, the payment of a guarantee fee within the entity is inappropriate and will be disregarded.

Consequently, to include a risk factor in the apportionment formula would be a clear case of double counting. Moreover, the inclusion of a capital factor in apportionment formula may be counterproductive according to a study of the Institute for Fiscal Studies, London (IFS) which argues that:

[I]f companies can no longer minimize their tax burden by shifting profits, then the taxation of real activity becomes important to them and the location of real investment becomes more sensitive to capital taxation...Such an outcome could occur under formula apportionment. Although formula apportionment generally eliminates the ability to shift profits, if the formula includes a capital based factor, the location of investment will be distorted as governments attempt to tax the average return, rather than the marginal return, on capital located in their state.²³¹

As was noted at the IFS conference, that result does not arise in an apportionment formula system such as the one used in Canada because of the absence of capital in the formula.

The formula proposed in this thesis is tentative. There is no doubt that it requires to be tested in real situations in order to determine its exact value. However, arguably, it satisfies the tests of reasonableness and simplicity. If it were to be applied centrally through an international tax

²³⁰ J.H. Farrar, *Company Law*, (London: Butterworths, 1985) at 125.

²³¹ See J. Weiner, 'News Analysis: Institute for Fiscal Studies Reports on EU Corporate Tax Harmonization', Tax Analysts Document Number: Doc 2000-14053 (15 May 2000).

organisation as proposed in this thesis, it would also satisfy the ease of administration criterion. Moreover, it is not premised on factors that are totally unconnected with the business of earning a reasonable return from dealing with financial products. In fact, it captures the essence of the banking business which, from time immemorial, has been to make an optimum use of financial capital in conjunction with human capital in order to create value. It enables the sharing of that value between those who have contributed to its creation, that is, the owners, the workers, and the jurisdictions having a nexus with that process. In short, it satisfies the test enunciated by Lawrence Summers in that it promotes competitiveness and prevents tax avoidance.²³²

²³² See L.H. Summers (1996), in Chapter 5, Section I, n 1, at 184.

CONCLUSION

At the core of the emerging global system of international commerce is the principle of economic liberalisation and free trade. The key concept of globalisation is that the constant removal of existing impediments to trade leads to greater welfare and a substantial increase in the overall standard of living around the world. Such concepts, articulated through broad economic law principles, are rapidly gaining worldwide ascendancy in spite of some localised resistance.¹ The global application of these principles in an environment of rapid technological innovation has already altered to a large extent the way international business operations are carried out. Concurrently, this emerging model is inexorably impacting on the existing system of international taxation causing tensions which, as demonstrated throughout this thesis, the existing system cannot fully absorb. If the present system of corporate income taxation is to be maintained in this global environment, then it is inevitable that some part of tax jurisdiction will pass from the national to the international level.

The major players in this new environment are transnational corporations (TNCs). TNCs today engage in two major activities. First, they invest in firm specific assets such as know-how and innovative technologies. Second, they are engaged in the production and sale of goods and services. For each of these two activities TNCs use different inputs. Thus, while their investments in research and development (R&D) or other firm specific assets is often highly localised for cost-effective reasons, their investments in the production of goods is often made in response to the availability of factors of production and adequate tax incentives. TNCs, each with its own technologies and know-how, compete with each other in an increasingly globalised market where production activities are dispersed around the world whilst the coordination and management of these entities are centralised.² Increased competition means increase in world trade which in the end means an increase in overall economic welfare. In addition, since TNCs consider their tax burden as a cost which needs to be adequately managed, they also devise strategies to this end. These strategies, including the so-called dowry-chasing, if not contained, may ultimately lead to ruinous tax competition between nations.

One of the ways of achieving the dual objective of promoting TNC activities while preventing the emergence of destructive tax competition between various nations is by removing any tax

¹ Such resistance is based on the belief that globalisation is more destructive than advantageous for the world at large. It should be clearly understood that in order to stem such opposition, the globalisation process must be harnessed in such a way that its effects are made more equitable. One of the most appropriate ways of sharing the gains from globalisation is the institution of a new international tax system based on worldwide formulary apportionment.

² See S. Sassen, *La ville globale* (Paris: Descartes & Cie, 1996).

measures that inhibit international competition so that, in general, TNCs face an approximately equal tax burden regardless of their location. The ultimate goal, therefore, may be ‘the harmonization of international tax rules of countries in which significant numbers of MNCs [multinational corporations] are based.’³

It is submitted that the system proposed in this thesis goes a long way to creating this harmonised model. Prior to arriving at this conclusion, the thesis first reviewed the origins of the present system of international taxation in order to place the debate in a proper historical perspective. Thus, the compromises wrought out in the 1930s when the system was devised were examined. Second, the legal base for the taxation of TNCs with its limitations was considered. Finally, the ongoing efforts to finetune the system were critically studied with the conclusion that, as a result of its inherent limitations and the emergence of the profound changes brought about by economic liberalisation, an overhaul of the system is necessary.

This analysis uncovered a number of critical elements. First, clearly, in today’s global economy the taxation of international business operations can no longer be premised on the fiction that the constituents parts of TNCs carry substantial business operations as separate and independent entities. What is certain is that if conventional theory, which continues to treat separately what is in fact inseparable, is not abandoned, then ‘inevitably the result must be arbitrary and capricious’.⁴

This fundamental issue of the inability of the separate accounting/arm’s length method to deal adequately with integrated business operations has already been confronted and solved by the U.S. states. The solution involves the recognition of the full range of economic synergies that arises within an economically integrated enterprise operating in a global market. It acknowledges the impossibility of identifying where income is earned because an integrated enterprise benefits from economies of scale and the ability to minimise risks. In addition, ‘the fact that technical expertise and information can often be obtained more cost effectively when it is fixed in the minds of employees than when it has to be purchased on the open market’⁵ also increases the firm’s efficiency. Such efficiencies generate value for the whole enterprise that is greater than the sum of the parts.

³ See D.J. Frish, ‘The Economics of International Tax Policy: Some Old and New Approaches’, (30 April 1990) *Tax Notes* 581, at 590.

⁴ See F.M. Keesling, ‘A Current Look at the Combined Report and Uniformity in Allocation Practices’, (1975) 42 *J. Tax’n* 106, at 107.

⁵ See D.R. Bucks & M. Mazerov, ‘The State Solution to the Federal Government’s International Transfer Pricing Problem’, 46 *National Tax Journal* (3 September 1993) 385, at 388.

This thesis examines the mechanics of the emerging global economy. It shows the processes by which enterprises seek, by rationalising their operations, to achieve efficiencies and create value. It then analyses the weaknesses of the present separate entity/arm's length standard and shows how and why it is incapable of measuring and dividing such value among the separate legal entities which constitute a TNC. What is found is that if applied to global trading operations the separate entity/arm's length standard allows significant under-taxation and, therefore, substantial revenue losses, which are likely to increase as a result of further integration.

The second critical element pertaining to this new economic environment is that, save a major catastrophe, further integration is likely to occur in spite of the market corrections which occur at regular intervals in the international capital markets. The incidence of these developments on the present system of international taxation has also been fully explored. The conclusion reached is that while there is an obvious growth of the bilateral treaty network, an increasing need is being felt for a multilateral solution to the problem of international taxation. Indeed, the need is evolving from one of accommodation of various national tax systems to one that would be more institutional in nature. In addition, in the field of tax administration, the subtle surrender of national sovereignty as a result of the emergence of new rules and practices, more especially in the field of dispute resolution and assistance in tax matters, is well evidenced. This transition, it has been argued, is being fostered by the increased interconnectedness and cooperation between such organisations as the IMF, the OECD, the EU and the WTO. Clearly, therefore, the emergence in the medium term of an international institution resulting from the various formal or informal arrangements among existing international organisations dealing with taxation is under way.

This development is still rudimentary. What this thesis advocates is merely an acceleration and amplification of the process. It therefore proposes the creation of an international tax organisation, the so-called Intertax, whose mandate, powers and functions are to be defined by a multilateral treaty. Calls for the creation of such an organisation are not new and yet the objections to it have often been vehement. Such objections stem mainly from the perceived reluctance of nations to forgo some of their fiscal sovereignty. In addition, concerns have been expressed that it might degenerate into some kind of international tax police. When these objections are critically assessed, the advantages accruing to both taxpayers and governments in terms of increased equity, efficiency and simplicity are clearly demonstrated. On a more positive note, the argument for the creation of Intertax is premised on the fact that economic liberalisation, the intricacies of modern commercial methods, and the advent of new technologies require the institution of a new cooperative arrangement that deals with the

problem of international taxation in a fundamental and innovative way. The possibility of achieving such cooperation through existing structures is also explored. However, the general conclusion reached is that the creation of a specialised international organisation is a more convenient way to achieve this outcome.

Central to this thesis is the submission that the interests of both TNCs and national jurisdictions are best served if the apportionment question, that is, the division of the international tax base resulting from cross-border business activities, is carried out through a formulary methodology in lieu of the present separate accounting/arm's length principle. It is first demonstrated that a TNC is in reality a single business which, for purely legal convenience, is divided into separately incorporated subsidiaries. As such, inter-company transactions 'cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration.'⁶ Therefore, real economic profits need be apportioned according to an index of the real economic contribution of each subsidiary to the production of these profits.⁷ Such a system 'is economically more rational and less arbitrary than separate accounting.'⁸

Moreover, rather than attempting to merely compare the merits of the separate accounting/arm's length principle and formulary apportionment methodologies, this thesis focuses on the ways and methods of reconciling these two approaches. It shows that these methods are at the opposite ends of a continuum with transactional profit-based methodologies in the middle. In other words, the argument holds that because of economic liberalisation and other factors already mentioned the pendulum must necessarily swing towards the proposed methodology with the separate accounting/arm's length principle retaining an important residual role where the correctness of its application is beyond doubt.

On a more practical basis, the proposed system requires a minimum surrender of fiscal sovereignty to an international organisation whose sole objective is to shoulder the logistics of implementing the system. In general, Intertax would be required to:

- measure a TNC's global commercial profits through the use of international harmonised accounting standards, and
- determine each relevant country's share of such profits through the application of an appropriate formula.

⁶ Note, 'Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code', (1976) 89 *Harv. L. R.* 1202, at 1206.

⁷ P.B. Musgrave, 'International Tax Base Division and the Multinational Corporation', (1972) 27 *Pub. Fin.* 394, at 398-99.

⁸ P.B. Musgrave, 'Auditing Multinational Firms: The Unitary Versus the Separate Entity Approach', (1979) 29 *American University Law Review* (No. 1) 361, at 363.

Clearly, the proposed solution requires also the adoption of harmonised international accounting standards for measuring the international tax base. If this is achieved, then even compliance costs, which are often labelled as one of the major defects of global formulary apportionment, are likely to be reasonable. Indeed, the level of compliance costs will depend largely on the degree of uniformity achieved.⁹ There is already a more decisive move towards the adoption of such international standards as proposed by the IASC as evidenced, for example, by the renewed interest in these standards in the U.S. and in Australia. This means, therefore, that one of the fundamental preconditions for the successful implementation of the proposed system is on the verge of being independently achieved.

It is also critical to emphasise the minimalist approach which characterises the proposed system. The latter does not require countries to surrender the process of calculating their own tax liability. Intertax's mission is simply to calculate the share of a TNC's commercial profits that is to be apportioned to a particular jurisdiction within the parameters set by the multilateral treaty creating it. These commercial profits are determinable by strictly following a complete set of international accounting standards produced by the IASC. Apportionment of these profits is then made by way of an apportionment formula or formulas so that each jurisdiction is given a share of the profits based on the contributions achieved by the factors located within its borders, with capital assets, payroll, and sales examined for illustrative purposes only. It follows that other more appropriate factors may be considered. Once this apportionment exercise is achieved, each country would be free, starting from its share of the commercial profits, to determine the taxable income, and, ultimately, the tax payable within its jurisdiction. In other words, each country would remain sovereign in determining its tax rate and adopting whatever tax accounting rules it deems fit relative to its policy objectives. This process is thus simple, mechanical and objective.¹⁰

In line with the submission that the proposed system is merely at one end of a continuum rather than a radically new proposition, it is to be noted that it may be characterised as a formulary profit-split system similar to a large extent to that advocated by the OECD as a method of last resort. Such a system is particularly appropriate for truly global trading operations, thus the choice of global trading in financial products to illustrate the practical application of the proposed system. Therefore, far from being a completely novel solution, the proposed system is in reality the practical expression of the current evolution of the present system.

⁹ J.M. Weiner, 'Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level', (23 December 1996) *Tax Notes Int'l* 2113, at 2133.

¹⁰ B.F. Miller, 'None are so Blind as Those Who will not See', (13 February 1995) *Tax Notes* 1023, at 1030.

Nevertheless, the OECD's warning that 'a profit split method is only acceptable if the factors used to allocate world-wide profits will produce a result consistent with what would have been realised if the parties were independent'¹¹ has to be addressed, although it could be argued that if it were possible to ascertain in the first place an arm's length division of the profits of an integrated financial firm, then there would be no reason to resort to a profit split approach. The thesis demonstrates that this objection, which is really the same as maintaining that global formulary apportionment is arbitrary and ignores market conditions, is inapplicable in the proposed system. This is because the proposed system rejects the application of a single all-purpose formula. Rather, it recognises that TNCs operating in different industries require different treatment and, therefore, suggests the adoption of different formulas to satisfy specific industry requirements. Thus, for example, the proposed formula applicable to a financial institution would certainly be different to that applicable to the pharmaceutical industry. Therefore, the system affords comparable treatment to any TNC operating within a given industry.

Moreover, the common denominator for each formula is the fundamental necessity for it to capture the functions, assets and risks assumed within that industry. Any formula that Intertax is called upon to apply may, if the need arises, be finetuned to fit specific situations. In this connection, it is pertinent to note that the OECD already accepts 'the selected application of a formula developed by both tax administrations in cooperation with a specific taxpayer or MNE group...such as it might be used in a mutual agreement procedure, advance transfer pricing agreement, or other bilateral or multilateral determination.'¹² The proposed system, whilst going beyond these overtly prudent limitations, can thus be reconciled with the separate accounting/arm's length as now enunciated by the OECD. Both systems have the same preoccupations, although it is arguable that the proposed model is merely an institutionalised version of the very system advocated by the OECD. In the words of Professor Bird:

in practice, there is much less difference between the way the arm's length approach actually works and how a reasonable formulary system would work than between the two idealized conceptions that so often are opposed in literature.¹³

The proposed approach is not a panacea for every issue arising from the limitations in the present system of international taxation. It has, however, 'the great benefit...of attacking the international tax problems arising under the OECD Model at their root and therefore the

¹¹ OECD, *The Taxation of Global Trading Of Financial Instruments: A Discussion Draft* (Paris: OECD, 1997) Document OECD/GD(97)29, at 36 para. 166.

¹² OECD, Report of the OECD Committee on Fiscal Affairs, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators* (Paris: OECD, 1995), at III-20 para. 3.60.

¹³ R.M. Bird, 'A View From the North', (1994) 49 *Tax Law Review* 745, at 752.

ongoing tinkering and interactions that second-best solutions to tax problems usually entail would be reduced if not eliminated.’¹⁴ Certain difficulties may be envisaged if it were to be implemented. These are, however, not insurmountable.

First, under the proposed method, TNCs may have an incentive to manipulate the rules in order to either fall within or without the definition of an integrated enterprise. It is a notoriously difficult proposition to trace corporate inter-relationships given the secrecy laws of various nations. However, such manipulations may be seriously undermined if de facto rather than de jure relationships are considered.

Second, the question arises as to whether Intertax should act as a tax collector in addition to it determining the claim of each country to the international tax base arising from the cross-border activities of TNCs. The question of tax collection may be dealt with by maintaining ‘international business and withholding tax collection regimes.’¹⁵ Thus, for example, a withholding tax could still be collected by each relevant jurisdiction with Intertax acting as a clearinghouse administering some form of set-off mechanism between various countries.

Third, it is most probable that a certain number of countries, unconvinced as to its advantages, would remain outside the system. It is therefore fundamental to the success of the proposed method that the major trading nations be part of the system. This will create a critical mass essential to enable its coherent application. If this is not achieved, then a dual system would coexist, that is, one group of nations would be linked to a multilateral system while the rest would remain within a bilateral system. The linkages in the emerging global economic system are such, however, that serious disruptions will arise when these two blocs interact.

A corollary problem relates to free-riders, such as tax havens, which would deliberately opt to remain outside the system in order to exploit its weaknesses. However, it is unlikely that tax havens could seriously interfere with the integrity of the proposed system. Indeed, the method allocates income only to those countries which are able to demonstrate that TNCs carried out substantial commercial activities within their jurisdiction. Therefore, any artificial location of transactions within tax havens will be irrelevant for allocation purposes. In the words of Professor Pomp:

A combined report, however, automatically deals with tax haven corporations in a more complete manner. Intercorporate transactions among corporations included in a combined report have no effect. Consequently, much of the income shifting opportunities facilitated by the use of a tax haven corporation would be undone. Moreover, to the extent that few activities of substance would

¹⁴ R.J. Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’, (April 1991) 45 *Bull Int’l Fiscal Documentation* 151, at 159.

¹⁵ *Ibid.*

take place in the haven country, the apportionment formula also would be unaffected. Because neither the preapportionment tax base nor the apportionment formula would be affected, a combined report would undercut the goals of using a tax haven.¹⁶

In addition, any attempt to locate the residence of a TNC's parent in such countries could be defeated by an adequate definition of corporate residence. Nevertheless, it will be necessary to attract non-participant countries and to do so a series of incentives may be contemplated.

Thus Professor Vann suggests that such incentive could be:

tax ceiling applying only among the members, unrelieved double taxation for taxes levied outside the members, allocation of the whole international tax base among members, or other measures [which] would flow quite naturally from the GATT-type structure extending most favoured nation status only to members of the system.¹⁶

The success of implementing such a system, as advocated by this thesis, depends on the level of international cooperation that countries are willing to achieve as pointed out by the deputy secretary of the Treasury, Lawrence H Summers at a conference held by the U.S. Treasury Department on formulary apportionment.¹⁷ Once again, in the European Union, attention is being given towards the seemingly insurmountable problem of harmonisation of direct taxes. Cooperation in tax matters, however, needs to be achieved on a worldwide basis in order to stem the steady erosion of the international corporate tax base and the consequential decrease in revenue available to governments. In an era where demand for government services is increasing, it is simply unacceptable that any government could sustain revenue losses to the magnitude of USD 10-12 billion annually.¹⁸ As Professor Bird rightly observed some years ago, 'it is clearly time for a change'¹⁹ and change will not occur as long as the defects of formulary apportionment are exaggerated relative 'to some perfect version of the transactional arm's length approach that has never existed and cannot exist.'²⁰

Moreover, it is important to keep in mind that it was not economic theory but concerns for the essential unfairness of both double taxation and zero taxation that shaped the League of Nation Models. These principles are still at the core of the OECD Model. However, the economic realities of the present are eroding the utility of the solution founded by the League. Consequently, a paradigm shift is required to steer international taxation into achieving its real

¹⁶ *Ibid.*

¹⁷ A.M. Fernandez, 'Dorgan Blasts Arm's Length Transfer Pricing Method', (23 December 1996) *Tax Notes Int'l* 2081, at 2082.

¹⁸ This figure was estimated by research done by the MTC for the USA. See Bucks & Mazerov, *supra* note 5, at 386.

¹⁹ R.M. Bird, 'Shaping a New International Tax Order', (1988) 42 *Bulletin for International Fiscal Documentation* 292, at 298.

²⁰ Bird, *supra* note 13, at 752.

purpose: the allocation to each jurisdiction of a fair share of taxes levied on the international profits of TNCs.

Finally, the proposed system is essentially a corporate income tax system administered on a multilateral basis through the use of formulary apportionment and a form of worldwide combined reporting. It is, in essence, a territorial tax system. It allocates the consolidated profits of a TNC exclusively to various tax jurisdictions by way of an apportionment formula. This allocation exercise is based on the principle that a country may tax income generated by the factors of production with which it has become identified regardless as to where this income is sourced.²¹ Therefore, whilst each jurisdiction taxes the profits allocated to it, it must however give up 'the right to tax income allocated to places outside its territorial boundaries.'²² This 'form of territorial system has great appeal from the perspectives of fairness, efficiency, and administrative economy. As Professor McIntyre admits, 'the problem with it has been and remains largely political.'

²¹ A.L.Harding, *Double Taxation of Property and Income*(Cambridge, Mass: Harvard University Press, 1933), at 24ff.

²² Anonymous, 'McIntyre on APA Report and More', (17 April 2000) 20 *Tax Notes Int'l* (No. 16) 1775, at 1776.

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