THE US PRESIDENT'S INTERNATIONAL TAX REFORM PROPOSALS IN HISTORICAL AND ECONOMIC PERSPECTIVE

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Although I recognize that I am north of the border, I plan today to focus on events in the United States, because I think that the United States may be at a pivotal point in our history, including the history of our tax system. In particular, I will try to put into historical, political, and economic perspective the international tax reform proposals that President Obama has put on the table, primarily—but not exclusively—as those proposals involve transfer pricing.[1] I apologize in advance for the US-centric nature of my remarks, but not too profusely, because these proposals will, if enacted, have implications throughout the world, and especially here in Canada, the United States' largest trading partner.

In order to understand the Obama Administration's proposals, it is necessary to go back in history almost 50 years, to the early 1960s, a time when the United States and the rest of the world were in the midst of a love affair with a young, vibrant, and inspiring US president. By that time, the years following the Second World War had seen the birth of the modern multinational business group. Multinationals had, of course, already existed for many years but, because of the limitations of communications and transportation technology, these groups could not function as true multinationals with centralized management. Instead, the different companies within multinational groups tended to operate as separately managed members of loosely aligned confederations. Pricing among the members of these pre-war groups almost certainly resembled pricing between independent companies acting at arm's length, if only because the existing technology did not permit any other approach.

For international tax purposes before the war, countries generally subscribed formally to the "arm's-length standard," owing largely to the efforts of a committee of

[1] The historical and economic discussions in this speech are based in large part on the discussions in Michael C. Durst and Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today" (2003) vol. 57 *Tax Law Review* 37.

the League of Nations that had commissioned an academic study of income apportionment. But having the arm's-length standard on the books did not make much practical difference, because multinational groups, such as they were, naturally tended to price at arm's length anyway.

The situation changed dramatically after the Second World War. When the war ended, the United States was left as the only economic superpower with its industrial infrastructure intact. Communications and transportation technology were vastly improved; it was now possible to fly quickly from continent to continent with reasonable confidence of arriving at one's destination in one piece. Also, whereas the pre-war economy had been based largely on agriculture, mining, and manufacturing, technology had taken great leaps. Indeed, the exciting, central focus of US industry in the immediate post-war years was that epitome of high-value, portable intangibles, the pharmaceutical patent. This was the age of penicillin, streptomycin, and the other wonder drugs.

The new technologies in communications and transportation made it possible to manage multinational groups much more centrally. Once it became possible to manage groups centrally, arm's-length pricing was no longer the natural method of intragroup pricing, not only for intangibles-intensive companies, but also for companies in the older industrial sectors. Instead, the natural method of internal pricing—even with no tax considerations present at all—was one with which all of us are familiar, because it is used today in some form within virtually all multinational groups. Today, multinational groups, in one way or another, divide themselves into "cost centres"—typically, the parts of the groups responsible for manufacturing—and "profit centres"—typically, the sellers within the groups—that interact directly with the customers and therefore have some feel for the customers' demand curves. The generally accepted practice, to promote profit maximization, is to cause the cost centres to sell at their estimated costs of production—not at cost-plus—to the profit centres. That way, the profit centres can, through the group's internal pricing, "feel" the company's costs of production. The profit centres can then set their prices to the market so that the group's marginal revenues will approximately equal the group's marginal costs. This is, as all students of economics learn, the point at which the enterprise maximizes its profits.

This cost centre/profit centre approach to internal pricing has many variations in practice, but it is, in my experience, almost universal among multinationals, and it has nothing to do with taxation. The main message is that whereas arm's-length pricing might have occurred naturally within multinational groups 100, or even 75, years ago, it is not the natural method of internal pricing for modern multinational groups. Multinational groups today typically use arm's-length internal pricing only for purposes of tax reporting; for purposes of internal management, they usually use some form of cost-based pricing. Therefore, when one sees a multinational group departing, for management purposes, from the arm's-length standard, the departure does not necessarily indicate a tax-avoidance motive; the arm's-length standard is not a natural pricing standard for multinational groups.

Now, to return to the early 1960s. By that time, US pharmaceutical companies had refined the technique of assigning rights in patents to "base companies" located, typically, in Switzerland or Puerto Rico. Under the arm's-length standard, the companies developed economic analyses, based on what the companies presented as comparable royalty rates for their internal licences, that resulted in much of the companies' global incomes being treated as earned for tax purposes in those low-tax jurisdictions.

Enter now the Kennedy Administration, and what became the Revenue Act of 1962. The 1962 Act served as Congress's initial attempt to address what it perceived as excessive apportionment of the taxable incomes of intangibles-intensive multinationals—and, in the early '60s, that meant, largely, pharmaceutical companies—to base companies in low-tax countries.

Congress's initial focus in 1962 was on transfer pricing, and particularly on the concern that attempting to rely on arm's-length comparables to regulate transfers of interests in high-value intangibles might represent an impossible task. The 1962 Revenue Act, as must all tax laws under the US constitution, originated in the House of Representatives. The House passed language that would have required a formulary approach to the pricing of interests in intangibles. If this had become law, the international tax world would look much different from the way it looks today.

The US Senate, however, dropped the formulary provision from its version of the legislation, and it was not reintroduced. The record of the Senate's deliberations that resulted in dropping the formulary language is fairly sketchy, at least as far as I have been able to research it. It seems likely, though, that the Senate worried that the US pharmaceutical industry, which in many respects was the country's economic crown jewel, and remains one of the crown jewels today, would, as a practical matter, experience a substantial tax increase as a result of replacing the arm's-length standard with a more enforceable formulary approach.

Ultimately, in the Revenue Act of 1962, perhaps in part to compensate for the decision not to require formulary apportionment, Congress enacted the first version of the US controlled foreign corporation (CFC) legislation, in what remains subpart F of the Code.[2] The new CFC rules, however, left essentially untouched the kind of foreign base company manufacturing arrangement that the legislation seems initially to have been intended to address.

An important political observation concerning the congressional decisions in 1962 is now in order. An apparently intended effect of the 1962 legislation was to ratify existing structures that allowed a significant industry to enjoy global effective tax rates lower than those faced by other industries. This might have been a good idea from the standpoint of the nation's overall economic well-being, but I doubt that the

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2 United States, Internal Revenue Code of 1986, as amended (herein referred to as "the Code").

public would have tolerated this legislation if the intent had been stated clearly. Instead, the effect of the legislation was obscured by a cloud of complexity and terminology that only those with time on their hands, and a great deal of motivation, could hope to penetrate. The terminology involved—particularly the "arm's-length standard"—seemed reasonable on its face. One had to have a high degree of familiarity with the international tax system to understand how the complex system operated to give some industries lower global effective tax rates than were faced by other industries.

In response to the 1962 act, the US Treasury, in what became the 1968 US transfer-pricing regulations, released the first of what has become a series of lengthy instruction manuals concerning how tax administrations are supposed to administer the arm's-length standard. Maybe the best known of such instruction manuals today is the 1995 Orgnanisation for Economic Co-operation and Development (OECD) transfer-pricing guidelines,[3] but the 1968 regulations set the pattern for this literary genre, and the pattern really has changed little since then. Basically, the regulations and the guidelines set forth grand theoretical pictures of how the market sets prices—based on functions performed and risks borne—as well as literally scores of different factual items (for example, who contributes to research and development [R&D] and how much, who contributes to brand development, who performs the currency hedging function, who pays for shipping and insurance, and dozens of others) that the tax examiner is supposed to develop and weigh, in order to come up with a market price.

Anyone who has ever participated in a transfer-pricing examination knows how far this picture departs from reality. At least one notable observer during the 1960s raised the warning that the transfer-pricing system was miring itself in a theoretical fantasy world. Professor Jim Eustice wrote of the US regulations, while still in proposed form:

> Their constant references to all facts and circumstances and the numerous valuation complexities created by the various formulas contained therein, bode ill for ease of administration hopes. Moreover, the incredible mass of detail contained in the proposed regulations, coupled with their almost equally consistent retreats to vaguely worded general principles, tends to weaken the cohesive structures of these provisions.[4]

This observation was written decades before the 1995 OECD guidelines were written, but Professor Eustice's description is as pertinent to the guidelines as it was to the US regulations that were being developed when he wrote in 1967. Professor Eustice

[3] Organisation for Economic Co-operation and Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf) (herein referred to as the "1995 OECD guidelines").

[4] James S. Eustice, "Tax Problems Arising from Transactions Between Affiliated or Controlled Corporations" (1968) vol. 23 *Tax Law Review* 451, at 517.

concluded with a warning: "It may well be that the new proposals, despite their general readability, just cannot be applied to concrete situations in practice."[5]

I will now fast-forward from the 1960s to May 2009. As a general matter, such a large jump is justifiable, because in many respects the basic structure of US international taxation has remained fundamentally unchanged for more than 40 years. En route back to the present day, however, I need to stop our time machine briefly for a visit to the late 1980s and early 1990s, the tumultuous period that has come to be called the time of the great transfer-pricing wars.

The remarkable thing about the transfer-pricing wars is that, although the difficulties in administering the arm's-length standard were widely known by the mid-1980s, the war ended when many governments of the world joined multinational companies in insisting on retaining the arm's-length standard and rejecting formulary approaches. Indeed, the war ended with the drafting—by the world's tax administrations—of that literary monument to the arm's-length standard: the OECD transfer-pricing guidelines of 1995. How did this happen?

The answer to this question lies again, I think, in events that centred on the United States. As of the late 1980s, the United States Treasury faced two perceived problems relating to transfer pricing. First, despite 20 years under the 1968 regulations, the Internal Revenue Service (IRS) still regularly lost cases that resulted from IRS challenges to the royalty rates that taxpayers were setting. Also, new industries that depend heavily on high-value intangibles, largely in electronics, had arisen over the prior 10 years or so, and they were quickly joining their pharmaceutical industry counterparts in building their tax plans around foreign base companies, resulting in low global effective tax rates.

Second—and here is what clouded things so much—the US dollar, during the second half of the 1980s, weakened dramatically against many other currencies, notably the Japanese yen (as well as European currencies). This occurred before the establishment of "transplant" manufacturing plants in the United States. It became impossible for non-US companies to, for example, manufacture cars in Japan, pay their personnel and other costs in yen, and then sell the resulting cars profitably in the United States, in US dollars. As a result, the foreign companies faced low profits, or even losses, on their manufacture of products destined for sale in the United States.

The Japanese manufacturers and their government were of the view that these subnormal results, or even losses, should not be borne for tax purposes entirely by the Japanese parent companies, but should instead be shared between the parent companies and the US distribution subsidiaries. The US Treasury, however, felt that the distributors were essentially performing a limited-risk service for the parent companies in the United States, and that the subsidiaries should earn profits even when the parent company was not.

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[5] Ibid., at 517.

Out of the two concerns of US officials—first, the longstanding concern that some US-based companies were transferring too much of their profit to foreign intangibles-holding companies and, second, the somewhat different concern that non-US-based manufacturing groups were not guaranteeing profits within their US subsidiaries—emerged the early versions of what, in modified form, today is known as the comparable profits method (CPM) in the US regulations and the transactional net margin method (TNMM) under the 1995 OECD guidelines. The basic idea, at least as many saw it, was that US subsidiaries of foreign parents would be required to maintain minimum levels of taxable income in the United States, and foreign subsidiaries of US parents would be limited to ceiling levels of taxable income in the countries where they were taxed.

Governments of countries other than the United States generally reacted with horror. Other countries, perhaps because of tighter CFC rules or other features of their tax systems, or perhaps a willingness to accept outbound transfers of interests in intangibles on economic grounds, do not seem to have shared the US government's concern that outbound transfers of interests in intangibles had become excessive. Similarly, the currencies of the United States' trading partners generally had, of course, appreciated as the US dollar declined, so other countries did not face the issue of loss-making subsidiaries faced in the United States.

Instead, the other countries viewed the US proposals as calling for, in essence, an easy-to-apply formulary method that would deny non-US companies high levels of income, and would require US subsidiaries to maintain specified levels of income in the United States. Furthermore, because only the United States seemed to think it necessary to devote large resources to transfer-pricing enforcement, the other countries of the world would be left defenceless against US attacks on their tax bases, unless they too chose to devote large resources to levels of transfer-pricing enforcement that previously had been seen as unnecessary.

The result was a grand lobbying effort by a coalition of multinational companies—many based in the United States—and the governments of countries around the world, to quash the emerging US approach. The outcome was, largely, a capitulation by the United States, both in the US regulations and in the 1995 OECD guidelines, which were written as essentially a peace treaty between the US Treasury and the rest of the world. The US regulations and the 1995 OECD guidelines retained CPM and TNMM, at least in form, but the two methods were subjected so heavily to "all the facts and circumstances" as to render them almost unrecognizable from the early US proposals. More importantly, in the 1995 OECD guidelines, the arm's-length standard as a concept became enshrined in a veritable Mount Everest of towering prose, in which the admonition that results, in every case, must be determined after considering all the facts and circumstances—whatever that means in practice—seems to recur several times in every paragraph. The 1995 OECD guidelines remain the most current international statement of consensus on transfer-pricing matters.

Before addressing the Obama Administration's proposals, I should acknowledge that throughout the last 40 or so years, debate has continued among serious-minded

people over whether the arm's-length system can, feasibly, be replaced, or whether it is instead the best of available evils. I plainly have formed my own views on this topic: I think that a more formulary approach, while subject to many difficulties, is not only feasible but would be much less problematic in administration than the current approach.

Speaking here in Toronto, I should say that I am especially puzzled by the argument sometimes raised that moving away from an arm's-length system, without raising undue double taxation conflicts, requires international agreement on a single formula, perhaps at a grand global Congress of Vienna—or, remembering the role of the League of Nations in our history, maybe a Versailles Conference—on international taxation. One needs only to look at the state of competent authority proceedings today, not only between the United States and Canada but also around the world, to determine how well the arm's-length standard has fared in managing international disagreement, including double taxation. Under a formulary system, even if different countries use different formulas, there would at least be clear starting points for negotiation and compromise.

I need to acknowledge that over the years during which I have worked in transfer pricing I have grown older, and I am less open-minded than I used to be. Even if one were to present persuasive arguments in support of the current system, I might simply be unwilling to hear them. I recognize that there are some, including maybe some in this room, whose views are different from mine, and I acknowledge the importance of those positions. This nevertheless cannot be the forum for resolving this debate, so please permit me simply to acknowledge that I am giving air time to only one side of what is still an unresolved debate.

Also, before moving on to the president's recent proposals, I should observe, as background, that the political positions of non-US governments with respect to the arm's-length standard have, I think, changed at least somewhat since the mid-1990s. Today, not only companies in the high-tech areas, but also traditional brick-and-mortar companies, have learned the technique, through "restructuring," of using the principles of the arm's-length standard to direct portions of their incomes to low-tax jurisdictions. Therefore, tax administrations that felt themselves immune to such techniques 15 years ago do not view themselves as immune today.

If the issue of a formulary approach versus an arm's-length standard were to come up again, it is not clear whether governments around the world would be as adamant in supporting the traditional "facts and circumstances" approach as they were during the early 1990s. The continued, albeit sometimes faltering, consideration within the European Union of the common consolidated corporate tax base proposal attests, I think, at least to some fluidity of views on this question.

We seem now to have arrived back at the present day, so let us look at President Obama's recent proposals. Four of these proposals relate directly to the topics that I have just discussed. First, the proposals disallow deductions by US parent companies of certain expenses that are apportionable to the income of CFCs. The main

practical effect of this proposal would be to disallow certain interest and, probably to a lesser extent, headquarters deductions; therefore it would primarily affect US parent companies that are highly leveraged. Second, the proposals would partially repeal the so-called check-the-box rules that the US Treasury issued in 1997; this proposal would subject some, but not all, current "deferral" structures to the subpart F CFC regime, causing some income that is now deferred to be taxed currently in the United States. Third, the new rules would modify the language of several provisions of the Internal Revenue Code that govern the definition of "intangible property." The intended effect is to strengthen the government's hand in demanding the establishment of higher royalty rates, or other compensation, in outbound migrations. Fourth, one of the proposed changes to foreign tax credit rules, the "pooling" proposal, would reduce, somewhat, the value to US multinational groups of earning income in low-tax foreign jurisdictions.

Together, the proposals are intended to raise additional revenues from companies that currently are deferring income through transfer-pricing plans and the use of CFCs. The magnitude of the revenue increase, however, and which industries and companies would be hit most substantially if the proposals were enacted, are far from clear.

I should say at this point that I enthusiastically support the current Administration in Washington; I voted for the president last year, and I would happily do so again. I like the direction in which the Administration is leading the United States. Nevertheless, I think the Administration's international tax proposals are seriously flawed, and that the Administration should pull the proposals back and rework its international tax effort. My reasons for believing this relate to the events of 1962.

In 1962, the House of Representatives tried to remedy a perceived problem of excessive tax deferral directly and systemically by replacing the arm's-length standard with a formulary rule. Apparently, however, the resulting tax increase on affected businesses posed too great a risk of economic damage. Therefore, Congress instead adopted a partial approach, which left the arm's-length standard intact—and in fact enshrined it in US law—and enacted what remain, today, the complex and porous CFC rules of subpart F.

The opaque complexity of the system that arose from the 1962 Act has made it a perfect vehicle over the years for political deal making, which progressively has made the system even more complex. Through small changes to legislative language that few, even in Congress, really understand, companies and industry subgroups can achieve meaningful reductions in their effective tax rates. This political manoeuvering, which is visible to the public even if the details cannot be understood, is one factor that has led, I think, to public disenchantment with the US tax system. And, while the system has produced more and more complexity and political manoeuvering, the underlying problem that Congress perceived in 1962—lack of control over companies' effective tax rates—remains entirely unaddressed.

The problem with the Administration's current proposals, I think, is twofold. First, the proposals are piecemeal; they fall far short of the kind of systemic reform that is needed today, at least as much as it was needed back in 1962. If the current proposals are enacted, the mind-numbing complexity of the tax system will not meaningfully be reduced. The system will remain vulnerable to piecemeal, political manipulation, because the tax system will continue to have no coherent structure. The international tax system will remain a maze that is designed—if design is even the right word—to *obscure* any coherent principle, rather than to delineate it.

In addition, the Administration's proposals should be reconsidered because the economic effects of their intended increases in tax revenues seem largely unknown. The discussion here will not resolve the overall question whether increases in corporate income taxes represent a sensible way to raise revenue under current business conditions, but I think the question needs to be raised in connection with international tax reform. Furthermore, no one seems to know exactly which businesses and industry subgroups the Administration's proposals would hit hardest in terms of increased global effective tax rates, and how badly the companies' after-tax profitability would be affected.

The alarmed reaction of many companies and, I need to say, my own judgments concerning the likely effects make me think it likely that the effects would be scattered throughout the economy, but would hit particular pockets of industry, particularly those that depend on the development of high-value intangibles, particularly strongly. I will admit that some of the companies likely to be affected are among my clients, and I have a natural tendency to identify with their interests. But I also think that just as it would not have been prudent to increase the tax burden of the pharmaceutical industry in 1962, without careful understanding of what one was doing, now is not the time to scatter potentially large corporate tax increases among the different components of the US or, for that matter, global economy.

If Congress is going to devote substantial resources to international tax reform today, it should insist on systemic reform so that the intractable problems of the last half-century do not continue to recur. Effective reform, which will provide meaningful benefits over the long term, should include a thorough reworking of those components of the current system, notably the transfer-pricing rules, that currently doom the system to unenforceability and unadministrability. The current unenforceability and unadministrability dooms Congress to being unable to predict adequately the level of federal revenue; it also prevents investors from being able to predict the effective tax rates and, hence, the after-tax incomes of the corporations in which they invest.

In addition, a reform effort needs carefully to take into account its effects on the profitability of different industry groups and to remedy the resulting difficulties through transitional or other rules to the extent that Congress deems sensible. This is a difficult point. It can be argued that the current situation, in which some industry groups face lower global effective rates than others, can itself be considered undesirable, and some might think that the optimal result, in terms of public policy, is to change the rules promptly, without transitional arrangements.

A willingness to increase some companies' effective tax rates abruptly may be magnified by loose language to the effect that those companies that today face low effective rates do so because they have participated in "abuses." Even a brief look at the history of the last 60 years, though, shows that companies that face low effective rates today do so because of policies that Congress and the Treasury Department have knowingly tolerated and even encouraged. Where, after all, did the check-the-box rules originate? For anyone in government to cry "abuse" in these situations is a lot like Claude Raines in *Casablanca* expressing shock that gambling is taking place at Rick's Café Américain.

I think that policy making today needs to be based on acceptance that concentrated tax increases, even if they are imposed on companies that arguably should have been paying higher taxes, can have damaging consequences. Jobs can easily be lost, research budgets scrapped, capital can become less available, and stock values can be reduced from already depressed levels. It is not an answer to say that the damage will eventually be righted as people find new jobs and capital gets reallocated to new industries and new companies. The transitional costs of concentrated tax increases will be real costs, and the damage, both to people and to industrial infrastructure, can be long-lasting and even permanent. Congress must have a careful and detailed understanding of which industries and companies are likely to experience tax increases, and by how much, and should put in place remedial measures before taking the step of wide-ranging international tax reform, however necessary such reform may be.

For the historical reasons I have outlined, it has proven very difficult, for many years, for political actors in international tax debates to focus separately on systemic questions and the transitional costs of moving to a new system. The result has been, at least in the United States, that legislators for many years have been paralyzed from fixing obvious defects in the structure of international tax rules because of fear—probably well founded—of the transitional damage that would be caused to particular industries and companies. This gridlock has resulted in what is now an obviously dysfunctional tax system, and the gridlock needs to be broken.

The United States has an administration in Washington that prides itself on clear-headed and penetrating analysis of even forbiddingly complicated questions. The Administration and its congressional colleagues should now consider, with as few prior constraints as possible, which international tax system will work best in avoiding undue economic distortion, excessive uncertainty to investors, and public disenchantment over the long term. Also, in moving to that system—indeed, in making it economically and politically feasible, to move to that system—it is important neither to ignore nor to minimize the dislocations that could be caused to companies that have built their businesses around the current rules. Where Congress deems it sensible to do so, those dislocations should be addressed by transitional rules or other remedial measures.

The necessary analysis might require a delay of a year or even two in accomplishing international tax reform; but largely as a result of intense study over the years,

much of it undertaken by International Fiscal Association members, the analytical tools needed for structural reform already exist. Let's get to work; let's revise the rules thoughtfully and thoroughly; let's address transitional costs pragmatically (in part because if we do not, reform legislation simply will not be passed); and let's come up with a system that will be based on a sound understanding of how multinational groups operate that the public can understand, and that Congress can use to provide both the national treasury and the capital markets with predictable effective tax rates.