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Taxing International Business Income: Hard-Boiled Wonderland and the End of the World

This article seeks to assess why current transfer pricing rules are the source of tax avoidance and explore some possible remedies. It places transfer pricing rules in the overall context of taxing international business income in the situation of a widely held corporate group operating in several countries. The purpose is (1) to show why transfer pricing is the dominant international issue as compared to corporation and shareholder or residence and source taxation and (2) to lay the policy framework for the analysis of the international tax rules for business income in general and transfer pricing in particular. The theory of the firm developed by Coase provides the policy backdrop for the overall analysis. The article identifies three structural issues in transfer pricing rules as the main drivers of tax planning: (1) current rules defining the tax presence of a corporation in a country are too narrow, (2) current transfer pricing rules permit corporations to structure intra-firm contracts as they wish on an inappropriate market analogy, and (3) the current rules place too much emphasis on risk and not enough on other factors in dividing up international tax revenue. Finally the article suggests solutions (1) by limiting contractual freedom in transactions, (2) by putting more emphasis on other factors to locate profits, and (3) by using a form of profit split for the unallocated balance of profits. The final outcome is similar in approach to the current transfer pricing rules, with the important difference that additional constraints or presumptions are introduced in the transactional framework.

1. Introduction

Alarm bells are regularly sounded concerning the loss of corporate tax revenue from international tax avoidance. A common culprit blamed for the loss is transfer pricing.[1] The OECD recently investigated and did not find a fire.[2] This article seeks to assess why current transfer pricing rules are the source of tax avoidance and to explore some possible remedies.

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1. Two examples are Desai, Foley and Hines, "The demand for tax haven operations", 90 *Journal of Public Economics* (2006), p. 513 and Altshuler and Gruber, "Governments and multinational corporations in the race to the bottom", 110 *Tax Notes* (2006), p. 979. Specifically the former focuses on transfer pricing and deferral, while the latter targets the use of hybrids in international taxation, but in the broader sense they are all about transfer pricing-related tax avoidance as appears hereafter. There is a long history of work on the possible revenue impacts of transfer pricing.
2. OECD, "Discussion Draft on transfer pricing aspects of business restructures" (2008), available at <http://www.oecd.org/dataoecd/59/40/41346644.pdf>; for the most recent position, see OECD, "Consultation with Business on Transfer Pricing Aspects of Business Restructurings" (2009), available at <http://www.oecd.org/document/21/0,3343,en_2649_37989760_43033621_1_1_1_1,00.html>.

Work in the area of international business taxation tends to be of two main kinds. The first involves tax administrators and tax practitioners and seeks on the one hand (the administrators) to formulate rules to allocate business profits among countries based on a market analogy and on the other hand (the practitioners) to argue that the international rules may appropriately lead to profits of multinational corporate groups ending up in low-tax jurisdictions – the hard-boiled wonderland in the title. The other body of work by economists tends to suggest that the income tax for international business income is doomed and that other forms of taxation should be applied to international businesses – the end of the world in the title.

Each of these strikes the author as fantastic in the original sense of the word – much like the novel of Haruki Murakami from which the title of the article is derived. Both seem to ignore the real world. The inside of a multinational firm is not like a market, though it is possible to use some market analogies to sensibly allocate profits among countries. Nor has the corporate tax shown any signs of coming to an end, though subject to strong economic pressures; on the contrary, the tax has remained remarkably buoyant.

Legal academics sit between these two camps of theory and practice, often uncomfortably with the result that many defect to one or the other. An important role for legal academics is to investigate how policy prescriptions can be made operational. Coming from this perspective, the author finds the economics literature challenging but ultimately doubts whether the often strong general policy prescriptions for radical change are justified by the theory or the evidence. There are good reasons for thinking that current general policy settings for business taxation represent a sensible direction, contrary to the "end of the world" view. What is more surprising is how and why we have ended up with international transfer pricing rules for allocating tax revenues from firms among countries that are so prone to avoidance activities and apparently removed from the nature of international business. There are solutions that fit better with those realities, contrary to the rules of the current hard-boiled wonderland.

This article first places transfer pricing rules in the overall context of taxing international business income in the common situation where a widely held corporate group operating in several countries derives business income. The purpose is to show why transfer pricing is the dominant international issue as compared to corporation and shareholder or residence and source taxation, as well as to lay the policy framework that informs the analysis of the international rules for taxing business income in general and transfer pricing in particular. The article then identifies that it is structural issues in transfer pricing rules which are the main drivers of tax planning. In turn the analysis suggests possible solutions. The theory of the firm stemming from the work of Coase provides the policy backdrop to the overall analysis.

There are three main problems in current transfer pricing law. First, the current rules for defining whether or not a corporation is present in a country for tax purposes are too narrow. Secondly, the transfer pricing rules permit corporations to structure intra-firm contracts as they wish on an inappropriate market analogy. Thirdly, the rules place too much emphasis on risk and not enough on personnel and assets in dividing up international tax revenues. These problems can be rectified directly, but there also are other mechanisms in tax and corporate law that can possibly assist in dealing with transfer pricing.

The rules with which the article deals are generally a mixture of national tax rules applicable to international situations and bilateral tax treaty provisions. Over the 90 years during which

there has been coordination of income taxation in multilateral institutions, a consensus has developed around the main rules of the international income tax system, including transfer pricing.[3] There is considerable room for national legislation both as regards structural policy choices and elaboration of the agreed international norms, but there has been increasing convergence of the national as well as the treaty rules. No specific country will form the focus; rather the discussion will be relevant to many countries.[4]

2. Context of Taxing International Business Tax

There are three main sets of rules which allocate taxing rights among countries over international business income derived through corporations: rules about corporate-shareholder taxation, rules about residence and source taxation and transfer pricing rules. The first two sets of rules effectively cede primary determination of taxing rights at the corporate level (and the lion's share of tax paid) to the third set of rules and the discussion here indicates how and why. As well as explaining the relative importance of transfer pricing rules in the context of international business taxation, this context will be relevant to the later discussion of solutions to current problems.[5]

2.1. Theory of the firm and the location of profits

This article is based on the view that the firm (specifically in this context, the multinational enterprise or MNE) is seen in international taxation as the origin of value and more than a mere conduit of income. The international tax treatment of income of MNEs is linked to the views of the firm broadly associated with Coase. In these views firms form to make greater profits by directing the allocation of productive resources instead of leaving resource allocation decisions to the market. The explanations in this Coasean tradition of why the firm is able to make profits not available from market transactions vary and include:

- transaction costs (Coase himself);
- incompleteness of contracts;

3. The current OECD rules are contained in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2009), which concern separate associated corporations, and the Report on the Attribution of Profits to Permanent Establishments (2008) on dealings between parts of a corporation located in different countries (referred to respectively as "the Guidelines" and "the Attribution Report").

4. The general statements about various countries' tax systems are sourced from Ault and Arnold, *Comparative Income Taxation: A Structural Analysis* (3rd edn.) (Kluwer, 2010), especially Parts 3 and 4; Vann, "General Report – Trends in company/shareholder taxation: single or double taxation" *Cahiers de Droit Fiscal International* LXXXVIIIa (2003), pp. 21-70; and various OECD materials. The OECD is the prime maker of international income tax norms and in this role tends to reflect overall trends in international taxation, as well as providing country-specific information. References to the overall trend of international rules are provided in this article mainly for material not covered in Ault and Arnold or Vann, generally having recourse to OECD material where it is available. Much of the OECD work finds its way into OECD, *Model Tax Convention on Income and on Capital* (condensed version, 2008) – particularly the Commentaries on the various articles of the Model, which is updated every two or three years. The latest version is 2008, which is generally used in what follows. The 2010 update has been released in draft; see OECD, "Draft Contents of the 2010 Update to the Model Tax Convention", available at <http://www.oecd.org/dataoecd/19/44/45276697.pdf>. References to the Model and Commentaries will be made by article and paragraph numbers, with a date where appropriate for when the relevant change was made.

5. While much is written about each set of rules from both theoretical and practical perspectives, much less is written about their interrelationship and what there is tends to be from a particular perspective (for example, the literature on corporate-shareholder taxation especially in recent decades has been much concerned with the interaction of this set of rules with the residence-source rules of international taxation, but generally residence and source taxation is taken as given and the question is how effectively to fit the two sets of rules together). Hence, in the analysis here, there will only be passing references to these literatures.

- exploitation of assets which because of their special characteristics cannot be fully exploited in the market; and
- the role of the entrepreneur.

Firms differ from the market in directing resources rather than leaving allocation to the market and involve hierarchies of personnel through which this direction occurs.[6] Under the theory in general terms, the firm acquires inputs from the market up to the point that it cannot produce the input internally and make a profit on it compared to the market price, but the firm expects to make profits on its use of inputs acquired from the market (as otherwise it would leave the next step to the market). In terms of outputs, the firm sells to the market only at the point that it cannot make any additional profit on internalizing the sale into the market.

The original purpose of the theory was not to explain where profits are generated in a geographical sense but why firms form in the first place. It is but a series of short steps to apply the theories to the formation of MNEs, to see MNE profits as located where the firm operates, that is, where its resources are located and directed (generally referred to as foreign direct investment or FDI),[7] and to link the theories to transfer pricing.[8]

2.2. Corporate-shareholder taxation

The theory of the firm does not mean that firms should be taxed entirely separately from their shareholders. Although such separate systems of corporate taxation have existed in most countries at some point in time, there is now general agreement in practice that it is the ultimate tax burden on the individual shareholder that matters. Most corporate-shareholder tax systems thus nowadays attempt some degree of integration of the taxes at the corporate

6. Coase's original statement of his position, "The theory of the firm", 4 *Economica* (1937), p. 386 (republished often including in Coase, *The Firm, the Markets and the Law* (University of Chicago Press, 1988)) went according to him at least virtually ignored for 40 years, largely because it did not fit into the dominant approach to microeconomics of the day. See Coase, "The Nature of the Firm: Influence" in Williamson and Winter (eds.), *The Nature of the Firm* (Oxford University Press, 1991) at 61. More recently his position has been elaborated by a variety of scholars, such as Williamson, who in addition to his own major works edited a series of essays on the variants on the theory to mark the 50th anniversary of original publication of Coase's work, ibid., and Casson, *Information and Organisation – A New Perspective on the Theory of the Firm* (Oxford University Press, 2001). Casson, like Sautet, *An Entrepreneurial Theory of the Firm* (Routledge, 2000), favours an entrepreneurial view of the firm. For the purposes of this article, the interest is in what unites the modern variants on Coase rather than what divides them. In this view they are able to stand together in the sense that they identify a number of features which are characteristic of firms. No attempt is made here to rank or critique the variants; rather existing transfer pricing rules and their development are examined to see whether they fit with the theory and what the implications of the theory are for taxing international business income.

7. Thus the theory has been influential in discussions of MNEs and the location of FDI – for example, Buckley and Casson, *The Multinational Enterprise Revisited* (Palgrave Macmillan, 2010), and the papers in Brakman and Garretsen (eds.), *Foreign Direct Investment and the Multinational Enterprise* (MIT Press, 2008). For this purpose an MNE is a firm that has FDI, that is, operations within the boundary of the firm in more than one country. A firm that simply exports to other countries is not an MNE; it is required to have operations in another country (which is the FDI). For a more precise definition of what constitutes an MNE and FDI, see 3.1. The original source of much of the thinking about these topics is Dunning, "The Determinants of International Production", 25 *Oxford Economic Papers* (1977), p. 289, *International Production and the Multinational Enterprise* (Allen & Unwin, 1981).

8. Work which links the theory of the firm directly to transfer pricing can be found in various disciplines: Holmstrom and Tirole, "Transfer Pricing and Organizational Form", 7(2) *Journal of Law, Economics & Organization* (1991), p. 201; Fris, "Dealing with Arm's Length and Comparability in the Year 2000", 10 *International Transfer Pricing Journal* (2003), p. 194; Musselli and Musselli, "Stripping the Functions of Producing Affiliates of a Multinational Group: Addressing Tax Implications via Economics of Contracts", 15 *International Transfer Pricing Journal* (2008), p. 15.

and shareholder levels.[9] There are important theoretical challenges to this approach to corporate-shareholder taxation but discussion of them is postponed to the next section as the challenges have much to do with international taxation.

The "problem" of integration would not arise if the only tax on income derived through corporations were at the ultimate individual shareholder level. The usual explanation why corporations are taxed in a domestic setting is that income of necessity is generally taxed on a realization basis and that conduit or look-through taxation of income of widely held corporations is not practically possible or at least is administratively burdensome. As a result a levy of income tax at the corporate level is necessary, otherwise there would be potentially infinite deferral of income tax by retention in the corporation of the income realized at the corporate level.[10]

Most international business income is derived through widely held MNEs, which generally have their headquarters in one particular country and increasingly are owned by shareholders from many countries. If shareholder, corporation and income may be located in different countries and there is to be a corporate tax on income derived through the corporation, the major question is which country or countries should levy the corporate level tax. It is the major question because little income tax is collected from ultimate shareholders under the usual kinds of corporate tax integration – the main tax on the income is at the corporate level. A more detailed explanation of this outcome can be found in Part I of the Appendix.

The deferral justification for the corporate tax only requires levy of the corporate tax on any retention of profits. Moreover, it suggests that corporate tax should be levied by a country with respect to the proportion of the corporation's retained income attributable to shareholders in the country. Levy of corporate tax only on retentions and in the country of the shareholder are not the international norms (assuming that corporation and income are located elsewhere). The norm is that income of corporations is (mainly) taxed in the country where the business operations giving rise to it occur.

Taking the point about not taxing in the country of the shareholder first, there are obvious practical reasons for this result. It is difficult to enforce the tax against the corporation if it has no links with the jurisdiction of the shareholders and to detect the proportion of shareholders in the country, especially if the concern is to find the ultimate individual owner of the shares and there are interposed entities. Relatedly and more fundamentally, such a tax would contradict the underlying assumption of the system already noted that it is not feasible to tax corporate income on a look-through basis. Although the tax would be on the corpora-

9. See Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries: A Comparison of Imputation Systems* (IBFD, 1996); Graetz and Warren, *Integration of the US corporate and individual income taxes: The Treasury Department and American Law Institute reports* (Tax Analysts, 1998); Vann, note 3.

10. Realization at the shareholder level is generally taken to mean taxation of dividends and of realized gains on corporate shares. The income realized by the corporation is, if retained in the corporation, only realized when the shareholder disposes of the shares. It will be noted that this is a different concept of realization to that which applies at the corporate level, so that it is possible to have income realized at the corporate level but not at the shareholder level. One of the appeals in a domestic setting of a system under which income realized at the corporate level is attributed and taxed to shareholders whether or not distributed is that it aligns the concepts of realization at the corporate and shareholder levels. As noted in the text, for widely held corporations such a system is not regarded as feasible but it is generally applied in most countries through a variety of means to closely held businesses and to collective investment in a widely held setting.

tion, the amount of tax levied in the country could only be determined by looking through the corporation and in effect attributing retained income to shareholders.[11]

Similarly corporate taxes focused on retentions (systems which give tax deductions for the payment of dividends or apply reduced rates of corporate tax on distributed income) are rare historically and apparently extinct. A number of reasons explain the levy of corporate tax on all corporate income, not just retained income. Most obviously it is a convenient administrative device to ensure effective collection of tax on distributions as well as retentions. Further, if the shareholder is in one country, and the corporation and its income in another country, a dividend deduction or similar system would mean that the tax take of each country and its timing would be affected by the amount of profits distributed. The corporation could shift tax between the countries at will. Apart from the potential for manipulation, it is not evident what policy would be served by making revenue division between the countries depend on the level of corporate distributions.[12]

While these are negative reasons for taxing corporations without reference to the location of shareholders or level of distributions, there are a number of indications that there is more to the tax on corporations. Specifically the theory of the firm as already noted points to taxation of the firm in the countries where it operates. That this is the underlying reason for the corporate tax in an international setting is the subject of the next heading. Here other features of the typical income tax system are noted which indicate that indeed the theory of the firm underlies the taxation of income derived through legal entities.

Most noteworthy is the contrasting tax treatment of collective investment vehicles (CIVs). Here the generally accepted policy is that the tax should be levied on the ultimate investor and that the taxation treatment should be the same as if the investment had been made directly by the investor.[13] Even though such vehicles are commonly widely held, countries go to considerable lengths to carry out that policy despite the administrative difficulties both domestic and international that taxing the ultimate investor entails in such cases.[14] In this

11. It has long been recognized that it is possible to levy an accruals income tax on portfolio shareholders in listed corporations by taxing dividends received plus or minus the annual change in value of the shares. The difficulty is that an accruals system is not practical for other assets, such as closely held businesses and real estate, because of valuation and other issues, with the result that there would be discrimination in the taxing method among different classes of assets.

12. The result could be offset by the levy of a dividend withholding tax on the shareholder in the country of the corporation equal to the corporate tax rate, but from that country's perspective such a complication hardly seems worthwhile compared to taxing the corporation on all its income and it is contrary to the way in which the international regime is structured through tax treaties which limit the rates of such withholding taxes. It is possible to separate the methods of taxation of corporation and shareholder from the division of the resulting revenue between countries by using treasury-to-treasury transfers of tax revenue. While such approaches have been used in the past, they have not been particularly successful and have not survived.

13. See, for example, Coates, "Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis", 1 *J Legal Analysis* (2009), p. 591, Board of Taxation, *Review of the Tax Arrangements applying to Managed Investment Trusts* (2009), available at <http://www.taxboard.gov.au/content/managed_investment_trusts_review/downloads/Review_Managed_Investment_Trusts_Report.pdf>.

14. For the recent OECD work in this area, see OECD, "Tax Treaty Issues related to REITs Public Discussion Draft" (2007), available at <http://www.oecd.org/dataoecd/23/44/39554788.pdf> (the results of this work were included in the OECD Commentaries in 2008); OECD, "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles" (2010), available at <http://www.oecd.org/dataoecd/59/7/45359261.pdf> (the results of which will be included in the OECD Commentaries in 2010). For the most recent developments in the ongoing OECD work on devising workable administrative systems for achieving the policy result internationally, see <http://www.oecd.org/document/8/0,3343,en_2649_33747_44550152_1_1_1_1,00.html>. Increasingly portfolio investment will be intermediated through more than one level of CIV, with wholesale CIVs focusing on the invest-

case the theory of the firm contributes negatively to the result, that is, the collective investment activity is not a firm in the sense of seeking greater returns by direction of personnel and resources than those available in the market. Here the investor rather than the funds manager is seeking to save the transaction costs entailed in carrying out a sensible portfolio investment strategy, involving spreading of risks through a range of investments (the costs being ones of discovery and executing and monitoring multiple small-value transactions) by using the manager.

While the activities of the funds manager will usually amount to a firm in the sense of the theory of the firm and the manager will be a corporation and taxed as such on the profits from its services to investors, the activities of the manager are distinct from the investor, as is reflected in various features of the regulatory and tax systems applying. With regard to regulation, CIVs are typically subject to much stricter regulatory controls than corporations, with assets being trusteed and protected from bankruptcy of the manager or similar protections achieved through other means (in a broad sense dealing with agency problems in relation to the funds manager).

So far as tax is concerned, two features among many may be noted. In relation to collective investment in real estate (the CIVs concerned commonly being called REITs after the US real estate investment trust), tax systems typically contain rules limiting the activities of the manager essentially to passive investment rather than active development of real estate. If the borderline is passed corporate tax is applied at the level of the REIT.[15] In relation to the manager, a number of countries are enacting a so-called "investment manager regime" designed to make clear particularly in the international setting that the income attributable to the investors is not to be treated as part of the income of the firm constituted by the manager's activities and so is not subjected to tax in the country where the fund manager carries out its activities if the income arises and the investor is resident elsewhere.[16]

In a positive sense, the theory of the firm also explains the tax treatment of closely held firms to which transparent taxation is commonly applied under domestic tax systems (that is, the tax is not levied on the firm as such but on its members). Although there is no entity-level tax, in various ways the tax system recognizes the separateness of the firm from the members of the firm (who generally combine in one or a few persons the functions of owners, managers and employees in the widely held corporation). This separateness is particularly noticeable in the international context and is discussed in 2.4.4.

In summary of this section, corporate tax is often regarded as necessary in a domestic context because of the problem of deferral of tax on retained earnings at the shareholder level under a realization-based income tax, though the general policy objective is to achieve at least approximate integration of corporate and shareholder tax. In the international context, apart from practical difficulties of levying tax on corporate income in the country of the investor, the idea of the firm generating profits beyond market returns by the direction of resources

ment side and retail "fund of funds" CIVs focusing on choosing investment managers, marketing to the public and investor relations.

15. Ernst & Young, *Global Real Estate Investment Trust Report 2010: Against All Odds* (2010), available at <http://www.ch.ey.com/Publication/vwLUAssets/Global-REIT-report-2010-Against-all-odds/$FILE/Global_REIT_report_2010_Against_all_odds.pdf> for country descriptions, both regulatory and tax, pp. 36-61.

16. Australian Financial Centre Forum, *Australia as a Financial Centre* (2009), available at <http://www.treasury.gov.au/afcf/content/final_report.asp>, at pp. 54-56, 58-60.

has provided the justification for taxing the corporation on all its profits in countries other than the residence of the shareholder. Various features of countries' tax systems indicate that the theory of the firm underlies the taxation of MNEs, but taxation in a country other than that of the shareholder does not mean that attempts to integrate the corporate-shareholder tax should be abandoned in the case of MNEs.

2.3. Source and residence taxation

While the theory of the firm does not mean that the firm should be taxed separately and without regard to taxation of its owners, it suggests that tax is appropriately levied where the firm operates. To this point the article has referred to the income, corporation or shareholder being in a particular country. The terms used in international taxation for such locations are source and residence but the focus above was corporate-shareholder taxation and so far as possible source and residence issues were suppressed.

2.3.1. Source taxation

In a broad sense, an income's source is the country with which the income has the closest connection. The current international norm is that the source country taxes only the income of foreign resident taxpayers that is sourced in that country. There is general agreement in most areas in practice internationally on source rules. In relation to the income of a foreign firm, the income from FDI in that country is regarded as sourced there. What this means and how it is achieved is discussed in 3. Labour income of individuals is sourced where the labour occurs. In relation to passive income outside the context of the firm, income from the use of a foreign taxpayer's assets is regarded as sourced where the asset is used, including real estate rentals, mineral royalties, chattel rentals, royalties on intangibles and interest on money lent. There is less agreement on the source of income from the sale of assets inside and outside the context of the firm, with countries variously using place of contract, place of transfer, asset location, or location of the seller and typically having different rules for different types of assets.

While there is discussion of the policy justifications for source taxation, it tends to take the source of the income as given and to ask whether and on what basis the source country can or should tax. In broad terms the reasons for source taxation can be summarized as economic rents and benefit taxation (the amount a taxpayer pays for the benefits received in a jurisdiction),[17] though depending on how they are interpreted the latter can encompass the former.

In relation to whether it is possible to tax the income derived by firms from FDI at source, there was a strong strand of economic thought that tax competition would reduce the corporate tax (which is essentially a source basis tax as explained hereafter) to zero – the end of the world in terms of the article's title. When the corporate tax proved remarkably resilient, alternative explanations were sought to argue that the corporate tax as an income tax indirectly on shareholders was doomed. One approach was to argue that the corporate tax was substantially shifted from shareholders (the suppliers of mobile capital) to immobile factors, partic-

17. The literature is conveniently collected in Arnold, "Threshold requirements for taxing profits under tax treaties", in Arnold, Sasseville and Zolt (eds.), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003), [page] note 4, and see Pinto, "The Need to Reconceptualize the Permanent Establishment Threshold", 60 *Bulletin for International Taxation* (2006), p. 206.

ularly labour. A related approach was to argue that it was possible to tax location-specific rents, as the tax on such rents could not be shifted, but not other income of the firm at source.

There is no doubt some truth in all these arguments. Developing countries have for many years granted tax holidays and other concessions to attract FDI, as tax competition clearly affected the location of FDI between such countries, though the main issue for developing countries is the general tendency for firms to allocate FDI to developed or very large developing countries. Some small developed countries have been successful in competing on tax though without too great an impact on large developed countries. More recent literature suggests that the tax competition story is more complex than a race to the bottom.[18]

The incidence of the corporate tax has always been an issue – but the same is true for all taxes collected from corporations as the ultimate incidence of all such taxes is elsewhere. It is possible to observe clearly in a limited number of cases the shifting of corporate tax on firms, such as in international lending and leasing agreements to increase the interest rate or rent by the amount of any gross-basis source tax,[19] but otherwise such shifting of the corporate tax away from the owners of the firm remains contested theoretically and empirically.[20]

The argument that it is possible to tax location-specific (immobile) rents but not other income from firms has been one of the mainstays for advocating the allowance for corporate equity (ACE). As in theory it is possible to have higher rates of tax on rents, any loss of revenue through narrowing of the tax base can be made up for through higher tax rates. Given the apparent success of the converse strategy over a number of decades (base broadening and rate reduction for taxation of firms), the relatively simple model underlying the ACE and the lack of evidence for substantial economic efficiency gains for the few countries which have experimented with versions of the ACE, it requires a "brave" government to abandon the current corporate tax in favour of an ACE.[21] Again closer examination has suggested a more

18. Amerighi, "Transfer Pricing and Enforcement Policy in Oligopolistic Markets", in Brakman and Garretson, note 7, p. 117.

19. The problem is most evident for interest on loans from financial institutions. If the country of the borrower levies a flat-rate gross withholding tax on the interest even at a low rate, the tax will exceed the bank's gross profit on the loan, that is, its spread between its borrowing and lending interest rates. International lending agreements therefore typically contain a clause that grosses up the interest rate by any interest withholding tax at source and shifts the tax to the borrower. Similarly, widespread tax planning by non-residents to avoid source tax may be a signal that shifting is not occurring. Conversely, if such tax planning is by residents of the source country dealing with the non-resident (as commonly occurs in international lending transactions), this is an indicator that shifting has occurred. The studies about loss of revenue referred to in note 1 may indicate that shifting does not generally occur in large developed countries. In the end, however, we do not know to what degree shifting occurs. Even if tax is shifted, the nominal taxpayer will often benefit if the tax can be avoided, which explains why some corporations seek to avoid sales taxes.

20. For a survey of shifting and related issues, see Sørensen and Johnson, "Capital income taxation – Options for reform in Australia", paper prepared for Australia's Future Tax System Review, Tax and Transfer Policy Conference, Melbourne, 2009 (forthcoming in published form 2010), available at <http://taxreview.treasury.gov.au/content/html/conference/downloads/attachment_08_Draft_Peter_Birch_Sorensen_paper.pdf>; for the contrary view, Gravelle, "Corporate Income Tax: Incidence, Economic Effects and Structural Issues", in Head and Krever (eds.), *Tax Reform in the 21st Century* (Kluwer, 2009), p. 355.

21. Hence, although the ACE was given some airplay in a recent large-scale tax reform report in Australia, it was not accepted as justified in the present; the report recommended that the current Australian full imputation system be retained but if it becomes clear that the assumptions underlying the efficiency arguments for the ACE are reflected in the real world, Australia should be an early adopter, Henry et al., *Australia's Future Tax System: Report to the Treasurer* (2009), Part, 2 Vol. 1, Secs. B1 and B2. The report recognizes the continuing downward drift of corporate tax rates and proposes a target rate of 25% from the current 30%; for the taxation of probably the most obvious case of immobile rents (from natural resources in the mining and oil and gas industries), the report recommended the generalization of the current 40% rent tax on offshore petroleum to all such natural resources (effectively replacing

complex position, where there are offsetting factors that keep the source income tax on FDI effective, such as benefits of agglomeration and infrastructure, etc. that are likely in countries with higher levels of taxation of firms.[22]

In fact the corporate tax has remained remarkably buoyant amid the predictions of its demise. After some earlier declines, corporate tax has produced increasing revenues in the last decade to 2008.[23] Since then the global financial crisis has led to reduction in corporate tax collections but there is no reason to suspect that this is permanent and revenues are already recovering in many countries.

In the case of international portfolio investment a similar kind of reasoning to the tax competition argument based on mobility of capital has suggested that source taxation of income from capital is similarly doomed (apart from portfolio investments in firms' equity, where the issues canvassed about the corporate tax are relevant). The issue is not as significant, as tax treaties typically provide for low rates of source tax on such income under the international norms struck in the 1920s.[24] The benefit principle and economic rents do not provide as strong an argument for taxing portfolio investment income as for income from FDI. As the argument about shifting mainly relates to the combined taxation treatment in the source and residence countries, it will further be considered in relation to the interaction of source and residence taxation in 2.3.3.

Here it can be observed that even against the background of international norms for low rates of tax on such income, there is a trend to even lower source taxes on portfolio income both through tax treaties and through unilateral country action. The current international standard of 10% gross source tax on interest is gradually being replaced by a zero rate.[25] Even for income from real property, where the economic rent argument for source taxation would seem to be strong, countries are currently competing to lower rates of tax for intermediated investment via local REITs.[26]

the current state-based royalty regimes for onshore resources). When the government released the report, it announced a lowering of the corporate tax to 28% by 2014 and the effective adoption of the report in relation to natural resources; see Australian Government, "A tax plan for our future: Simpler. Fairer. Stronger" (2010), available at <http://www.futuretax.gov.au/pages/default.aspx>.

22. See, for example, Brakman, Garretson and Marrewijk, "Agglomeration and Government Spending", in Brakman and Garretsen, note 7, p. 89. This discussion has been cast in terms of economic efficiency. There is also an equally important equity (fairness) dimension, which in international taxation points in the same direction; Musgrave and Musgrave, "Inter-nation Equity", in Bird and Head (eds.), *Modern Fiscal Issues: Essays in Honour of Carl S Shoup* (Toronto University Press, 1972); Brooks, "Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Policy Objective", in Head and Krever, note 22, p. 471.

23. OECD, *Revenue Statistics 1965-2008* (2009), p. 22, "Over the last decade, the share of the corporate income tax in the tax mix has increased by about 3 percentage points of total taxes (unweighted average), to exceed the 9 per cent level of the 1960s."

24. The problem of shifting of source tax in relation to capital income was a concern from the very beginnings of the coordination of the international system and was raised in the report of the four economists which effectively inaugurated international tax cooperation; see Economic and Financial Commission (Bruins, Einaudi, Seligman and Stamp), *Report on Double Taxation*, submitted to the Financial Committee Economic and Financial Commission (League of Nations Document EFS73F, 1923), at pp. 7-16, available at <http://setis.library.usyd.edu.au/oztexts/parsons.html>, item 3, first document.

25. Most large OECD countries now seek a general zero tax rate on interest under treaties and, if that is not acceptable to the other treaty partner, propose a number of specific cases for zero taxation; reflecting this trend in 2005 the OECD gathered the common provisions being used in treaties (OECD Commentary on Art. 11, Paras. 7.1-7.12). Many countries include such provisions in domestic law, even if they are not found in their treaties.

26. This competition is not occurring for direct investment in local real property by foreigners. For direct investment in real property, countries typically levy quite high rates of tax as international norms permit. This difference

2.3.2. Residence taxation

In a general sense an individual taxpayer's residence is the country with which the taxpayer has the closest connection. The current international norm is that the residence country taxes the worldwide income of the taxpayer. The justification for worldwide residence taxation is that the residence country, being the country to which the taxpayer is most closely connected, is the one that properly takes account of the personal circumstances of the taxpayer and provides redistribution to or away from the taxpayer under its tax and transfer system. Hence personal tax benefits of various kinds are confined to residents and the progressive income tax rate schedule is applied to residents. To make sensible decisions about distribution it is necessary to take the full circumstances of the taxpayer into account, which includes their full (worldwide) income.

By contrast, because source taxation does not reflect the full circumstances of the taxpayer, it is generally accepted that issues of progressive taxation (or not) are irrelevant and that tax should be levied at flat rates. For similar reasons, the tax levels should be lower than the highest individual tax rates of progressive tax systems in residence countries, as the higher rates are there for redistribution purposes. The corporate tax on FDI of firms is the main form of source taxation for reasons noticed above and typically it is flat rate and lower than the top individual tax rate.[27] Similarly source taxes on portfolio income are very low and flat rate. This prescription for source taxation fits best for with the benefit principle in the source context, rather than the taxation of economic rents.[28]

Due to most countries' restrictive immigration laws, individual taxpayers are not very mobile in the sense that they cannot be resident or earn labour income wherever they like.[29] In terms of portfolio capital income individuals can invest wherever they like, but at the individual level they are much more likely to invest domestically for the same reasons they use CIVs –

probably arises because portfolio investment in real estate (meaning a non-controlling securitized interest in income from real estate) seems to be characterized by the markets as midway between debt and equity; European Public Real Estate Association, *Correlations of Property Stocks with Other Asset Classes* (2007), available at <http://www.epra.com/media/EPRA_BIB_april_2007.pdf>, probably because the rents are largely captured by the funds manager, which will then be taxed at source as part of the income of the firm providing the fund management services. For investment intermediated by local REITs, the OECD moved in 2008 towards a 15% rate as the international norm on net rent (Commentary on Art. 10, Paras. 67.1-67.7), and some countries have unilaterally adopted lower rates, notably a 7.5% rate in Australia under domestic law for residents of countries that meet the OECD international information exchange standards (for a description of these standards, see OECD, "Promoting Transparency and Exchange of Information for Tax Purposes" (2010), available at <http://www.oecd.org/dataoecd/32/45/43757434.pdf>).

27. A standard policy prescription in a purely domestic context is that the corporate tax rate should be equal to the top marginal tax rates for individuals, to eliminate deferral which undermines the progressivity of the individual tax rate scale. Nonetheless, over long periods of time and in most countries, the corporate tax rate has typically been significantly lower than the top individual marginal tax rate.

28. Quite high tax rates are possible for location-specific economic rents and are often used for taxes directed specifically to rents on mineral resources (see note 21 and text). Such taxes are in effect for the purchase of the rent from the local citizenry and can be used for redistribution to the citizenry, as well as providing services to the taxpayers concerned. That is explicitly what is happening with the new Australian tax referred to in note 21. By contrast, the benefit principle, which focuses on infrastructure, etc. provided to foreign firms, suggests a lower tax rate with higher individual rates used for financing progressivity. Current corporate taxes probably represent a combination of covering the services provided and taxation of all rents (not just immobile rents).

29. The main exceptions are executives and other individuals with skills in high international demand. Countries are increasingly modifying the black-and-white operation of the residence tax principle in such cases.

the costs of discovery and of executing and monitoring investments offshore.[30] Hence they tend to invest in local firms, CIVs or pension funds, make deposits in local banks or own local investment real estate. Most of the investment of individuals' savings offshore will thus be locally intermediated in one form or another. The rapid growth of CIVs and pension funds in recent years has, however, produced significant cross-border portfolio investment in foreign firms.[31]

The lack of mobility of individuals makes the residence tax base relatively robust for them – it is hard to avoid by changing residence. The main tax policy issues for individuals are thus the efficiency and equity effects of taxation of labour income in a domestic setting and capital income within a very constrained international setting (the individual cannot change residence but can change the location of investment, though there is a strong home investment bias). These issues are quite different to the policy framework that applies to taxing the income of firms, even though tax on that income is ultimately borne by individuals (and in the author's view generally by the ultimate owners of firms). That framework is quite complex in terms of the way that the operative international rules reflect the policy of taxing the income of firms at source and is elaborated in 2.4.

2.3.3. Interaction of source and residence taxation

Where income is taxed on a source and a residence basis, double taxation would be a considerable barrier to direct and portfolio cross-border investment in the absence of some form of relief. The international norm is for the residence country to provide relief to prevent international double taxation. The literature on the interaction of residence and source taxation in the past addressed two main issues: (1) whether residence-only taxation is the appropriate policy and (2) the appropriate method of relief in the country of residence for source taxation.

The argument for residence-only taxation is that source taxation is shifted to immobile factors and/or residents of the source country and so does not achieve its purpose of taxing the non-resident.[32] The literature essentially assumed that firms did not exist, for as noted above the argument has much more traction for portfolio investment than for FDI through firms. And for portfolio investment the argument depends crucially on the tax treatment in the residence country. To the extent that individuals derive foreign-source income from capital directly or intermediated through CIVs, the income will usually be taxed with a credit for any foreign tax on the income.[33] As the source tax will generally be low, the residence tax rate on the income will mean that investment choices of the individual or CIV will be little influenced by the source tax rate.

30. For a summary of the literature on this home bias, see Mishra, "Australia's Equity Home Bias", *Australian Economic Papers* (March 2008), pp. 53-73. Within the European Union there is considerable cross-border investment in CIVs, which are principally located in Ireland and Luxembourg.

31. See note 38.

32. The literature is briefly summarized in Kaplow, "Taxation", in Polinsky and Shavell (eds.), *Handbook of Law and Economics* (Elsevier, 2007), Chap. 11, Sec. 5.5. For criticism of this view, see Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies", 54 *Tax Law Review* (2001), p. 261.

33. This result will generally apply even in so-called exemption countries, as the exemption is typically applied only to business, employment and real property income, and often limited to corporations, with a foreign tax credit in other cases (see 2.4.3. and 2.4.4.). Even in cases where countries apply an exemption system for individuals, typically it is an exemption-with-progression system that increases tax on domestic income as foreign income increases, even though the foreign income is exempt, and in that sense takes account of the worldwide income of the individual.

To the extent that the investment is intermediated by a pension fund which is tax exempt in the residence country but not the source country, the position is otherwise. Here any source tax reduces the rate of return of the fund and so taxation will influence investment in favour of the residence country or source countries with zero tax rates, whatever system of international double tax relief the residence country adopts.[34] The same applies to income of tax-exempt not-for-profit funds and sovereign wealth funds. In many countries, together these kinds of funds will represent a significant proportion of portfolio investment. It is possible to solve this problem without giving up source taxation entirely by exempting such funds from source taxation of portfolio income while maintaining the source tax in other cases. This approach is increasingly occurring in domestic law and tax treaties.[35]

Apart from pressures on source taxation discussed above, there are other reasons why at a more practical level, residence(-only) taxation is preferable to source taxation. One such argument is the compliance burden created for individuals in dealing with a number of tax systems. This is one of the reasons given by the OECD, for example, for taxing occupational pensions only in the state of residence of the recipient under tax treaties.[36]

Source taxation in the absence of a substantial presence of the taxpayer in the country tends to be on the basis of gross withholding taxes, which can be very distorting because they ignore expenses incurred in earning the income even when levied at low rates in some recognition of expenses. This is particularly true for income derived by firms, where typically there will be a higher level of expenses to revenue compared to a portfolio investor. If a taxpayer makes a loss in one source country and a gain in another source country, the taxpayer will end up paying tax on the gain and not offsetting the loss as would be the case if the income were derived from the same country or if the only tax were levied in the residence country. For the same reason as with gross withholding taxes, this is more likely to be a problem for firms and FDI than for portfolio investors.[37]

As residence taxation is generally more easily levied than source country taxation, tax treaties often give up source taxing rights on the basis that there will be no significant impact on tax revenue in either country if income flows between the treaty partners are in balance (or likely to be in the foreseeable future). This balance argument assumes considerable significance in relation to taxation of portfolio income at source,[38] but is much less influential in relation to

34. The effective consumption tax treatment represented by these funds is nowadays often generalized to an argument of consumption tax treatment for all income from capital, that is, exemption of income from capital from tax. While that view has been dominant in recent years, it is not convincing for a variety of reasons; see Apps and Rees, "Labour supply and saving" (2010); Apps and Rees, "A new perspective on capital income taxation" (2010), Conference on the Henry Tax Review, Sydney. What is important to note here is that to the extent that the shifting argument is driven by the non-taxation of income from capital in the country of residence, this is not really an argument for residence-only taxation of portfolio investment income but a consequence of consumption tax treatment.

35. The OECD has been active in this area, suggesting exemption for foreign pension funds that meet certain tests in 2005 (Commentary on Art. 18, Para. 69) and providing some guidance on sovereign wealth funds; OECD, "The Application of Tax Treaties to State Owned Entities including Sovereign Wealth Funds" (2010), available at <http://www.oecd.org/dataoecd/59/63/44080490.pdf>, which will be included in the Commentary in 2010. The treatment of sovereign wealth funds involves the application of sovereign immunity under international law, as well as specific tax treaty provisions often designed to clarify the position under international law.

36. Commentary on Art. 18, Para. 1.

37. The OECD has deployed this argument in its debate about the use of the services permanent establishment (Commentary on Art. 5, Para. 42.19).

38. Major differences between the OECD Model and the UN Model Double Taxation Convention for Developed and Developing Countries (2001), available at <http://www.un.org/esa/ffd/tax/index.htm>, occur for the source

the taxation of firms for reasons explored in 3.1. In the case of firms the international system proceeds on the exact opposite basis and collects most of the tax at source despite the practical arguments favouring residence taxation over source taxation.

The literature on the method of relief often was cast in terms of the income of firms from FDI, but without distinguishing taxation of corporations and taxation of individuals (or assuming that the owners of the corporation were resident in the same country as the corporation). The arguments over the method of relief of double taxation revolved around whether the preferred policy was capital export neutrality, capital import neutrality and national neutrality.[39] The double tax relief systems associated with these concepts are the foreign tax credit, exemption of foreign income from tax and deduction of the foreign tax, respectively. Discussion of this issue is postponed to 2.4., but it should be noted that by eliding the residence of the corporation and its shareholders, the increasingly common case where a corporation's shareholders are not necessarily resident at the location of the corporation (mainly as a result of CIVs and pension funds) is not dealt with.[40]

Moreover, even if the corporation and shareholder are in the same country, the ultimate result at the shareholder level is what is important and will often vary from that at the corporate level. The result at the residence of the shareholder, wherever it may be, has as much or more to do with the method of corporate shareholder taxation as the international double tax relief in the country of the corporation. Imputation systems generally provide the national neutrality (deduction) result at the shareholder level, whatever form of international double tax relief is provided at the corporate level, though a capital export neutrality (credit) result can be achieved if the imputation system recognizes foreign tax. The more recent forms of corporate-shareholder taxation generally provide the capital export neutrality (credit) result at the shareholder level, though here the result requires a similar level of foreign corporate tax as domestic corporate tax or the use of the credit system at the corporate level. None of the systems currently in use in major countries produces the capital import neutrality (exemption) result at the shareholder level. Part II of the Appendix provides more details of these results. To put it another way, the traditional residence source analysis only makes sense

taxation of portfolio investment income, with the UN Model permitting higher rates (though the rates are not specified) on dividends, interest and royalties and broader taxation of capital gains. Among developed countries it is much more likely that flows will be in balance over the longer term, while as between developed and developing countries flows will generally not be in balance.

39. Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (John Hopkins, 1963) developed by her in Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Harvard Law School, 1969). Following Musgrave's lead, US authors usually came down in favour of capital export neutrality, while Europeans favoured capital import neutrality.

40. An estimate for 2001 indicates that, apart from the two biggest economies (the United States and Japan), domestic widely held firms were owned for more than 15% by foreigners, with the typical range being 25% to 40%; Mishra, "International Investors' Home Bias in Portfolio Equity Investment", 14th Global Finance Conference, La Trobe University (2007), available at <http://eprints.usq.edu.au/2176/>, drawing on IMF data. This probably understates the impact of CIVs as official statistics may not capture ownership by foreigners through domestic CIVs, as is the case in Australia, Board of Taxation, note 12, *Taxation of Managed Investment Trusts Discussion Paper* (2008), at p. 7, available at <http://www.taxboard.gov.au/content/managed_investment_trusts_review/downloads/Review_Managed_Investment_Trusts.pdf>. In the most recent IMF data available at <http://www.imf.org/external/np/sta/pi/datarsl.htm>, Ireland and Luxembourg are shown near the top in the top-10 tables for portfolio equity investment, which would seem to be explained by not looking through CIVs (these two countries having the largest amount of investment controlled by local CIVs after the United States and most of the investment in their local CIVs coming from foreigners; see Coates, note 12).

in the case of individual taxpayers. More recent literature on capital ownership neutrality[41] has recognized the significance of the firm and, to a lesser extent, the corporate-shareholder tax dimension – this issue is returned to in 2.4.

2.3.4. Summary

Source taxation of a firm's profits is justified by economic rent or benefit principles. Contrary to gloomy predictions the corporate tax and the source tax on such profits have not disappeared but remain buoyant. Portfolio investment income is more difficult to tax on a source basis, but this has to do more with the tax treatment in the residence country than the source country. Nevertheless the norm since the outset of the international tax system has been very low taxation of such income and there is a tendency to further decline in source taxation in this case.

The theoretical arguments for residence-only taxation, whatever their validity for individual investment income, do not apply to the income of firms and the practical arguments which do have more application to income derived by firms have not had any significant impact of taxation of the income at source. The theory underlying systems for relief of international double taxation did not originally take account of the nature of firms and corporate-shareholder taxation. It is necessary to combine several elements of corporate-shareholder and source and residence taxation to evaluate the final result even in terms of the traditional theory.

2.4. Transfer pricing

Accepting that policy points towards taxation of the firm's income at source, three issues arise out of the previous discussion: how is the source (and the amount) of the income determined, what is the role of the corporate tax in the country of headquarters of the MNE and which country should provide the integration of the corporate and shareholder tax? To answer these questions, it is necessary to explain the operation of the international tax rules for MNEs and how they assign roles among the source country, the headquarters country and the shareholder residence country.

2.4.1. Transfer pricing rules

The first question of the source of business income and its amount is dealt with by the transfer pricing rules. These are built on two concepts: corporate residence and the permanent establishment[42] (PE). The latter under the OECD Model means a corporation having in a country a fixed place of business or dependent agent that carries on (part of) the corporation's business.

41. Desai and Hines, "Evaluating International Tax Reform", 46(3) *National Tax Journal* (2003), p. 487; Hines, "Reconsidering the Taxation of Foreign Income", 62 *Tax Law Review* (2009), p. 269.

42. This term is not very "English" in any version of the language. That is because it is a (bad) translation derived from German via French; see Avery Jones et al., "Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States", 60 *Bulletin for International Taxation* (2006), pp. 220, 234-235. The PE terminology is standard in international tax language (which courts have recognized as a specialist language) and is used here.

The transfer pricing rules then provide as follows:

(1) A corporation may not be taxed in a country other than its residence unless it has a PE there.

(2) The profits which a corporation makes at its residence in relation to its dealings with associated corporations resident in other countries are determined on the basis of the profits it would make if it were an independent corporation dealing on normal market terms with the associated corporations.

(3) The profits which a corporation makes at a PE (and which may be taxed in the PE country) are the profits which the PE would make if it were an independent corporation dealing on normal market terms with the rest of corporation of which it is a part.[43]

In short the firm, whether constituted by a group of corporations each operating only in its country of residence, or by a single corporation with PEs in other countries, or by a combination of corporations and PEs, is effectively divided up among the countries where it operates. The profits that are treated as arising in each country are those that would arise if the various parts of the firm were independent and dealing with each other in the market on ordinary market terms. To take a very simple example, if a parent corporation in one country manufactures goods there and transfers them to a subsidiary in another country which sells the goods in that country, the manufacturing profit will be taxed in the country of the parent and the selling profit in the country of the subsidiary as a result of rules (1) and (2). If instead the goods were manufactured at the headquarters of a corporation and transferred to a PE in another country and sold there by the PE, the manufacturing profit would be taxed in the country of the headquarters and the selling profit in the country of the PE as a result of rules (1) and (3).

In recognition of the two critical aspects of the rules they are often referred to collectively as the "separate enterprise arm's length" principle or variants thereon. "Separate enterprise" recognizes that the MNE firm is effectively divided up on geographical lines (whether the MNE is constituted by a single corporation or by many corporations). The separate enterprise principle means that the international tax system is premised on taxing each corporation sepa-

43. The typical tax treaty provisions as stated in the OECD Model provide as follows:

"*Article 7 – Business profits*
1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. [W]here 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.

Article 9 – Associated enterprises
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 participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

rately and accordingly recognizing each corporation's separate residence; and treating PEs as quasi-separate corporations resident in the country of PE location. The separate enterprise principle is effectively the sourcing rule for business profits, or, to put it another way, the tax definition of FDI. "Arm's length" refers to the use of market prices between the parts of the firm to allocate profits and is the principle that determines the amount of income from the FDI in each country where FDI occurs.

In terms of the theory of the firm, the location of the value generated within the firm is seen as an attribute of the firm's activities more generally and so spread over the firm wherever its resources are being directed. In that sense, the allocation of income under the transfer pricing rules across countries where the firm operates fits with the theory. The use of a standard of profits earned on market transactions to allocate that value, however, seems to contradict the theory which is generally premised on the use of the firm to earn additional profits compared to what is available from market transactions. This issue is discussed in 3.2.

2.4.2. Residence of corporations

Rather than allocating taxing rights over a firm's profits to countries directly, the transfer pricing rules rely on the residence of corporations to do part of the work. The corporation was fitted into the residence and source framework that applies to individuals and given a residence, but as the following discussion shows the residence rule for corporations serves other purposes than the residence rule for individuals.

The apparent assimilation of individuals and corporations in international tax rules might be explained on the basis that most or all of a widely held corporation's shareholders are resident in the same country as the corporation, but that is less and less true for listed corporations and the discussion that follows focuses on this development by assuming that the corporation is headquartered in a different country from the residence of at least a significant number of its shareholders. If assimilation of corporate and shareholder residence were the purpose, one would expect the corporate residence rule to reflect that idea, such as a majority of shareholders being resident in the country. Residence rules of this kind are in fact very rare. This rarity may be explained by the practical considerations discussed in 2.2. for taxing the corporation in the country of residence of the shareholder, with the difference that the problem of detecting the proportion of shareholders, including tracing through interposed entities, would arise in the residence rule rather than in calculating income subject to corporate tax in the country of residence of shareholders. As suggested there, however, it is considered that the real reason has to do with the theory of the firm.

At the level of the widely held corporation, corporate residence rules effectively instead adopt the location of the corporate headquarters, that is, the country with which the corporation's activities (not its ownership) have the most significant economic connection.[44] This is more evident in civil law countries where tests more or less directly refer to the headquarters. In countries influenced by the United Kingdom, the test is central management and control, which are generally taken to mean where the board of directors takes its decisions but this usually equates to the corporate headquarters for the parent company. Many countries include a place-of-incorporation test as well as a headquarters-type test, but generally listed

44. As will become apparent, while the test of corporate residence generally is robust for the parent in an MNE group, it is much less robust in the case of subsidiaries.

corporations will ensure that these coincide to avoid dual-residence problems in relation to tax, conflict of laws, securities regulation and corporate governance.[45]

A headquarters test may reflect a relatively unthinking anthropomorphic view of the corporation as a person[46] and on its own would suggest that the country of the corporate headquarters taxes the corporation on its worldwide profits (or at least takes account of such income in taxing the corporation), as for individuals. Under the theory of the firm, it is possible to construct a (fairly weak) justification for worldwide taxation by the country of the headquarters of a corporation. The justification would see the direction of the firm's resources driven by the corporate headquarters as supporting corporate tax on those profits by the country of the headquarters even though the activities directed may have occurred in other countries (FDI). A result which allocates taxing jurisdiction for headquarters activities can be achieved more directly as noted below and in a way which fits better with the theory of the firm and the actual operation of the international rules for taxing business income.

2.4.3. Relief of international double taxation for corporations

Very few countries really tax resident MNEs on their worldwide profits by reference to the notional residence of the corporation based on its headquarters, even though most countries nominally tax corporations on a worldwide basis. The route by which this result is reached varies from country to country. Most directly, many countries use a (more or less) comprehensive exemption system for corporations so that profits of PEs, dividends from foreign subsidiaries and capital gains on shares in foreign subsidiaries are exempt from tax in the country of the headquarters (in the case of foreign PEs) or residence of the parent (in the case of foreign subsidiaries).[47]

To the extent that a country uses a foreign tax credit for FDI of corporations (such as only the United States now, among major developed economies), the lack of tax in the country of the corporation's residence arises in the case of PEs generally because of the rough equivalence of corporate tax rates around the world in major FDI locations combined with considerable foreign tax credit tax planning. For foreign subsidiaries, tax in the country of the par-

45. The United States is the best-known contrary example of a country using only a place-of-incorporation test for corporate residence. Even for the United States, in practice for listed corporations the place of incorporation coincides with corporate headquarters. As was seen recently in the case of corporate inversions, the United States is likely to intervene if attempts are made to separate the place of incorporation of widely held corporations from US-located corporate headquarters; Internal Revenue Code §7874. The tiebreaker in tax treaties for dual-resident corporations is the "place of effective management"; see OECD Model Art. 4(3), but increasingly treaty benefits are being denied in dual-residence cases, which is one tax reason for avoiding dual residence (Commentary on Art. 4, Paras. 24-24.1). Avoidance of application of multiple countries' rules on securities regulation and corporate governance is becoming more difficult, especially as MNEs increasingly list on several stock exchanges (partly in recognition of the diversification of shareholder residence and partly to encourage that diversification).

46. The classic UK case on residence of corporations, developing the "central management and control" test as a judge-made rule, *De Beers Consolidated Mines Ltd v. Howe* [1906] AC 455, may fall into this category: "In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad."

47. Some countries use exemption fairly generally for foreign income, while others use it only for corporations. Even in the countries which use the system more generally there is usually different treatment for corporations compared to individuals.

ent is generally only triggered when the subsidiary pays dividends or the parent sells shares in the subsidiary. Moreover, in the case of dividends, the foreign tax credit is extended to the corporate tax paid by the subsidiary; not just to source taxes on the dividends. Foreign tax credit planning is thus available for dividends in the same way as for PEs. Moreover, as both payment of dividends and sale of shares are in the control of the parent, it is possible to postpone tax in the country of the parent, which is generally referred to as deferral.

As already noticed, deferral is really an issue with respect to tax on the ultimate shareholder. Deferral is only a problem in the country of the parent corporation's headquarters if the shareholder is resident in the same country. Otherwise application of the foreign tax credit in this country does not make much sense as the residence rule for the corporation is essentially operating through the transfer pricing rules to locate income in the country, not to tax worldwide income. If it is thought that the activities of the headquarters deserve special recognition, because, for example, the headquarters is responsible for the strategic direction of the firm, that can be more clearly achieved by allocating more of the firm's profit to the headquarters directly under the transfer pricing rules rather than residual taxing rights under the foreign tax credit mechanism.[48] There is a noticeable trend around the world to exemption systems for relieving international double taxation of corporations.[49]

The often complex arguments for the exemption system, such as those based on capital ownership neutrality,[50] seem unnecessary in the current framework of the shareholder being resident in a country other than the firm's headquarters. Although the arguments recognize the importance of the firm to the analysis and may provide reasons for an exemption system at the corporate level even where shareholders are resident in the same country, they do not fully recognize the separate residence of shareholders. If the country of the headquarters has been able to tax its appropriate share of the firm's income (including any profit attributable to headquarters activity), why should it levy any additional tax on the firm's income from FDI appropriately allocated to other countries?

In addition to the participation exemption, many countries structure other aspects of their tax systems to avoid taxation in this situation where the shareholders and the income are based elsewhere (sometimes referred to as conduit income), which indicates that it is the residence of shareholders that is increasingly driving policy underlying the exemption system rather than the location of the firm.[51] There are two elements to such systems in many countries, though it is possible to achieve the conduit result in a single system. The additional element in both cases is to deal with taxation on the shareholder as well as on the corporate side in the country of residence of the corporation and involves giving up tax on dividends or capital gains on shares in that country. If the company is a subsidiary, this result largely flows

48. At least one country, Switzerland, has long expressly incorporated a return to management at the headquarters in its tax system. The quote from Carroll, note 80, adopts a similar view.

49. Including in the United States, though only for the calendar year 2005 for dividends from subsidiaries (Internal Revenue Code §199). The push for a general exemption system for corporations in the United States remains an important agenda issue, but whether the United States will react to the recent (but still incomplete) moves by Japan and the United Kingdom to join the exemption club remains an open issue. Countries often start with an exemption for dividends from subsidiaries, but given that dividends can be substituted for capital gains on shares and subsidiaries can be substituted for PEs, the trend is to extend the exemption to all three cases in order to avoid biases in the method of repatriating income from FDI and in operational form.

50. See note 41.

51. Additional reasons, having to do with the lack of robustness in corporate residence tests and biases in choice of entity form, are considered below.

from the provisions of tax treaties.[52] Even where tax at source would otherwise be permitted under treaties or there is no treaty, domestic law conduit regimes (often in this particular context referred to as headquarters or holding company regimes) ensure that there is no tax in the residence country of the subsidiary on dividends or capital gains on shares in the subsidiary. If the company is the parent of the MNE group, the same result generally obtains for capital gains but oddly, in many countries, not for dividends.[53]

If cross-border investment in the parent companies of MNEs occurs through CIVs, as is common, a separate conduit regime will often be necessary to ensure that the country of the CIV does not levy tax on the CIV or its investors if the investors are resident outside the CIV country. A considerable amount of effort, both domestic and international, is currently being devoted to this problem.[54] Conduit regimes reinforce the point that much of the current debate over exemption is misdirected to the extent that it ignores the residence of the ultimate shareholder.[55]

By this process the residence country of the corporation collects what is effectively a source tax on the operations of the firm in that country, just as do other countries where the firm operates, whether in the form of subsidiary or PE. The recognition of corporate residence as a sourcing device throws light on another common criticism that the separate enterprise part of the transfer pricing rules fails to recognize: the economic unity of the corporate group. If corporate residence is viewed as a true residence rule, as the formal nature of the rule for corporate residence rule suggests, then it is artificial to break up the residence of members of the group based on whether there are separate corporations or not. We do not divide up the residence of an individual based on where the individual's income earning activities occur – that is the function of source principles. If we recognize the corporate residence rule as at bottom a sourcing rule like the PE rule, this form of the criticism is not compelling.

2.4.4. Integration relief, transparent taxation and residence and source

It follows from the conclusions of the previous sections that the corporate tax on listed corporations is essentially a source tax, even in the residence country of the corporation. As already noticed, the pitching of the corporate tax rate around the world at flat rates lower than top individual marginal rates is consistent with this characterization. Progression and redistribution are generally for the country of residence of individuals, and that residence may be different from the residence (headquarters) of the firm and other places of operation

52. Under the OECD Model, dividends from subsidiary to parent are only subject to a tax of 5% in the country of the subsidiary (Art. 10(2)(a)). In the European Union this has been reduced to zero under the Parent-Subsidiary Directive and the same result is increasingly being reflected in tax treaties since 2001; remittances from PEs are likewise exempt from tax in the PE country (OECD Model Art. 10(5)). Capital gains on shares are exempt from tax under the OECD Model, except in the case of land-rich countries (Art. 13).

53. The OECD Model allows 15% tax in this case (Art. 10(2)(b)); the different treatment of capital gains invites tax planning to avoid the dividend tax and, depending on the country, that planning may use various forms of derivatives or assignment of the dividend stream. A few countries give up this taxing right entirely or substantially under domestic law.

54. See note 14; Board of Taxation, note 13, pp. 79-88; Board of Taxation, *International Taxation* (2003), Vol. 1, pp. 123-129, available at <http://www.taxboard.gov.au/content/reviews_and_consultations/international_taxation_arrangements/report/downloads/ international_taxation_arrangements_report_volume_1.pdf>.

55. There is brief discussion of the issue in Slemrod, "Free Trade Taxation and Protectionist Taxation", 2 *International Tax and Public Finance* (1995), p. 471, at pp. 481-482, and more extended treatment in Devereux and Pearson, "European tax harmonization and production efficiency", 39 *European Economic Review* (1995), p. 1657, but without apparently making the point in the simple form in the text.

of the firm (FDI). What does this imply for the roles of relevant countries in integrating corporate and shareholder taxes? In discussion of this issue it is useful to start with transparent taxation of firm income, which in most countries is available for closely held firms by election.[56]

If individuals resident in one country form and headquarter a partnership in another country and that partnership has operations in its country of formation and in a third country, the general outcome under current international norms is that:

- the third country will tax on a source basis (using the PE rule, which applies whether the firm is a corporation or not);
- the country of formation/headquarters will also tax on a PE basis for income attributable to the operations in that country only (the "residence" of the partnership is not generally relevant as it is being taxed on a transparent basis, so that in a sense the country of the partnership is applying an exemption system to the third-country income); and
- the residence country of the partners will tax each partner on the relevant share of the worldwide income of the partnership at progressive rates and provide relief for tax in the other countries.

In terms of the previous discussion, this treatment reinforces the reasons for an exemption (and conduit) system where a corporation is used instead of a partnership to carry on the business of a firm, as otherwise there will be a bias between organizational forms. The tax rates applied by countries in this kind of case vary. The policy discussion earlier suggests that both the third country and the partnership country should tax the income derived by the PEs there on a flat-rate basis at less than the top individual tax rate. A number of countries reach that result by a variety of routes, but a number of countries would apply individual progressive rates to the income.[57]

The major point, however, is that the residence country of the partners is the major one that deals with progressive taxation and redistribution and with relief for tax in the other countries. International norms would require at least a foreign tax credit for the tax paid in the partnership country and the third country, though some countries would use exemption with progression in such cases. Generally it is not suggested that the partnership country or third country should give up some of their taxing rights over the firm's income, whether arising from the infrastructure they provide to the firm or from rents there to overcome international double taxation, as that would seem to contradict the rationale for taxing a firm's income at source.[58]

56. The election may be explicit (most obviously in the United States under the check-the-box and Subpart S corporations rules) or more commonly by election through choice of entity form (partnerships are typically taxed on a transparent basis). For simplicity in the following discussion it will generally be assumed that a partnership is treated as transparent in all countries concerned.

57. In the normal closely held partnership, the partners would be active in the country of the partnership and/or the third country carrying out its activities. In that event they may well become a resident there or at least enjoy some of the redistribution benefits that progressive rates are intended to finance, so that the case for progressive or flat rates is not as clear cut as for large corporations. Even if applying progressive rates, the third country and partnership country would only be taxing part of each partner's income, with the result that the average rate there would likely be lower than the average rate in the residence country.

58. To some extent the system of dominion tax relief operated in the British Empire for the period 1920-1945 (or later in some cases) was a system of this kind. That system was very much driven by the UK view that residence-only taxation was the appropriate policy, though this policy was never pursued strongly in the case of profits of firms.

In terms of integration of corporate and shareholder taxation, this discussion points inexorably to the shareholder residence country as the one to provide integration relief. Although there are efficiency dimensions in relation to the shareholder taxation system adopted by the residence country, equally there are individual equity issues (progressivity and redistribution), unlike in the country of residence of the corporation and the country of source of the income.

There was a time when it seemed to be accepted by countries with imputation systems that they should grant relief to non-resident shareholders of resident companies with respect to the companies' operations in the country of residence, initially to portfolio shareholders and then to direct corporate investors. In the case of portfolio shareholders this acted as a rough offset to the oddity already noted of levying dividend withholding tax on portfolio investors. In the case of direct corporate investors it was generally a surrender of part of the source corporate tax base without any obvious tax justification (though there may have been broader international relations issues involved – or devious dipping into the Treasury of the shareholder residence country for the benefit of the shareholder). But this policy aberration, which seemed to be based on unlikely non-discrimination grounds, has now largely passed with the general abandonment of the imputation system.

The residence country of the shareholder is more or less unconstrained by international tax norms as to the type of corporate-shareholder tax system that it operates. What system the shareholder residence country chooses to adopt will depend on a number of policy considerations. One possible issue is bias in choice of entity form. As the international tax system locks most countries into a foreign tax credit result in the partnership example above, a system which produces (roughly) that outcome for individual shareholders would deal with the bias. Countries which believe in the foreign tax credit based on the arguments in favour of capital export neutrality (at the individual level, not the firm level) would do likewise. Other policy stances may lead to dividend exemption or full individual taxation of dividends in the shareholder residence country. In the last decade the major countries have converged on a system that produces the general foreign tax credit result (often without an actual credit) at the shareholder level, whether the parent corporation of the MNE group is a resident of the same country or another country and wherever the firm's operations are located. This has a similar degree of international neutrality as the classical system but without the "double taxation" that the latter system may involve.

Whatever the system adopted in the shareholder residence country, the revenue collected from shareholders will tend to be small. The main reason is that the corporate tax rate in major FDI locations tends to be significant compared to the average tax rates of individuals and even the top individual tax rate. Further the result will tend to be the same whether the firm is subject to corporate tax or whether the firm's members are taxed on a transparent basis. Both these results stem from the view that firms provide a relatively robust source tax base because of the nature of the firm being able to make additional profits by the direction of resources rather than leaving the allocation of resources to the market place, especially where the firm is constrained in its choices of where to conduct particular activities.

2.4.5. Summary

This section has introduced the transfer pricing rules in international taxation. Contrary to the appearance of a residence rule based on the headquarters of widely held corporations,

leading to similar treatment as resident individuals, corporate residence and PE rules in fact provide sourcing rules which allocate business income between countries while the arm's length principle determines the amount of income in each country. The effect, when combined with mechanisms for relief of international double taxation, is that most corporate tax is collected in the country to which income is allocated under the transfer pricing rules. Relatively little, if any, tax is collected by the country of (nominal) residence of the corporation for income allocated elsewhere.

While the country of the ultimate individual shareholder provides whatever kind of integration relief it considers appropriate, more or less unconstrained by international norms, it collects little tax if the transfer pricing rules allocate the income elsewhere. Hence the effectiveness of the transfer pricing rules is central to the operation of the corporate tax in relation to MNEs.

3. Operation of the Transfer Pricing Rules

Although the end of the corporate tax world has not come to pass despite some gloomy predictions, there are many pressures on international taxation and the revenues from FDI. One of these pressures comes from transfer pricing, which undoubtedly erodes tax revenues in many developed countries, without, however, putting the corporate tax under threat of extinction. This section describes current transfer pricing principles in more (but not exhaustive) detail and in doing so seeks to isolate the structural issues that make them ripe for tax planning. Over recent years the detail of the rules has expanded considerably as a result of OECD work and parallel elaboration in national legislation and practice. This process is ongoing, with further evolution of the international rules in train.

The discussion starts with the significance of two key aspects of the arm's length principle: first the definition of FDI, which turns critically on the use of the PE concept for setting the boundary of the firm; and secondly the place of market prices and mechanisms in allocating business profits among countries, particularly using legal transactions (contracts) between separate legal entities (corporations) and notional contracts (dealings) between parts of the same legal entity (quasi-corporations) as the basis of the rules. Then the functional analysis at the heart of modern transfer pricing practice is examined. This practice requires that profits be allocated among countries on the basis of the "functions performed in the light of the assets used and risks assumed" (commonly referred to as FAR for functions, assets, risks). Rather than being a unifying and robust methodology as intended, it has been at the centre of much of the tax avoidance activity. The treatments of the following areas are considered in relation to the functional analysis: risk, personnel, assets and sales. In each of them the methodology has been manipulated in practice to allow diversion of profits to low-tax jurisdictions.

The defenders of the current system in the private sector insist that it produces results in line with economic realities, despite widespread evidence to the contrary that significant profits from FDI end up in tax havens of one kind or another where little real activity in fact occurs. Similarly the importance of the market is constantly emphasized by administrators, but then often subverted by various devices in an apparently haphazard fashion. This section tries to explain how we can escape from this hard-boiled wonderland to a more sensible system.

3.1. Defining the boundary of the firm and FDI

In order to operate the transfer pricing rules it is necessary to define the boundary of the firm in a geographical sense (or when FDI is occurring). As outlined above this borderline depends in tax terms on the residence of corporations and the existence or not of a PE. Statistics for FDI use a similar construct and so a comparison of the policies and rules underlying the tax and statistics definitions provides a useful method of testing the factors which influence the content and limits of the definitions of the boundary of the firm. Accordingly discussion starts with such a comparison and then moves on the application of the tax rules and their structural problems that encourage tax planning.

3.1.1. Policy and its limits

The OECD provides little economic policy guidance as to what constitutes FDI for tax purposes; indeed it does not use the term FDI for describing the transfer pricing or international tax rules in its major tax-technical work. The nearest it gets is in relation to the PE definition, where it refers to "participating in the economic life of the other State to such an extent that it comes within the jurisdiction of that other State's taxing rights",[59] which is circular if what gives rise to the taxing right is that FDI is involved. The discussion of FDI used for statistics purposes is more to the point, identifying it as "a means for creating direct, stable and long-lasting links between economies" and listing the various specific economic benefits that flow for firms and countries from such investment (compared, say, to portfolio investment).[60] The tax definition includes the stable and long-lasting elements through the concept of permanence implied by the PE term.[61]

In terms of FDI definitions for tax purposes, the OECD refers to a resident of one country that "participates directly or indirectly in the management control or capital" of a resident of another country. There is no requirement of a voting interest, but it is generally accepted that some kind of control is required.[62] The definition for statistics purposes is much more specific, being based on 10% for associates and 50% for subsidiaries, with detailed rules about tracing of interests. The less precise tax definition may prevent tax planning of the usual kind that arises to avoid precise thresholds. If, however, the second strand of the FDI definition

59. Commentary on Art. 7, Para. 9.

60. *OECD Benchmark Definition of Foreign Direct Investment* (4th ed., 2008), p. 14 – the definition is spread over several places (Chaps. 3, 6, Annexes 3, 7, 8); see also IMF, *Balance of Payments and International Investment Position Manual* (6th ed., 2010), Chap. 4. The material on the statistics definition of FDI in the following paragraphs is drawn from these publications. The term used in this context is "branch", which is a species of "quasi-corporation", though it is noted that the term has a variety of other meanings which are not relevant in this context. The previous 1996 version of the OECD Benchmark, available at <http://www.oecd.org/dataoecd/10/16/2090148.pdf> used the term "permanent establishment" as one of the cases of branches, but the term has disappeared from the current version. Here the tax terminology is used for both cases. The economic benefits are described by the OECD as follows: "Under the right policy environment, [FDI] can serve as an important vehicle for local enterprise development, and it may also help improve the competitive position of both the recipient ("host") and the investing ("home") economy. In particular, FDI encourages the transfer of technology and know-how between economies. It also provides an opportunity for the host economy to promote its products more widely in international markets. FDI, in addition to its positive effect on the development of international trade, is an important source of capital for a range of host and home economies."

61. The notion of permanence implied by PE terminology generally is read as six months (Commentary on Art. 5, Paras. 6 and 33.1), whereas for FDI purposes generally a 12-month rule is used. The tax definition in the OECD Model uses a 12-month limit only for construction sites.

62. Guidelines, Para. 13.

involving PEs is done properly, concerns about thresholds for associates and subsidiaries should not be a problem.

The PE definition is critical for tax and statistics purposes because it sets the boundary of the firm in the sense that it determines to what extent the firm has FDI in a country when a legal entity which is (part of) the firm is not resident there. In this case the relationship of the FDI definitions is the other way around. The tax PE definition is relatively specific and limited, requiring that a firm have a fixed place of business or a dependent agent habitually contracting on behalf of the firm in the country. The statistics definition is more general, referring to the need for several indicators of substantial economic activities and recognizing that a fixed place of business is not required. On the other hand it is indicated that having a PE for tax purposes is a significant guide for FDI so that in most cases the definitions will coincide in practice.

In the PE case it is possible for planning to be directed to avoiding the tax threshold; indeed the OECD recognizes that it is possible for a firm to "do large-scale business in a State without being taxed".[63] The UN notes that there are "many other ways in which foreign investors may acquire an effective voice" and lists a variety of cases – "subcontracting, management contracts, turnkey arrangements, franchising, leasing, licensing and production-sharing" – which some countries are considering to include in the FDI definition for statistics purposes.[64]

In both cases there is an administrative/compliance influence which may place some limitation on basic policy underlying the PE definition. For statistics purposes, one of the components of the PE definition not mentioned above is the existence of accounts for the economic unit constituted by the PE (or alternatively whether it is possible and meaningful to compile such accounts), as it is not feasible to prepare statistics without appropriate records. In part this limitation is offset by the concept of multi-territory enterprises referred to below. Accounts receive similar emphasis in the tax context, though not as a part of the definition; in addition the (relatively narrow) place-of-business test is justified on the basis that it is facilitates enforcement of tax liabilities and net basis taxation.[65]

63. Commentary on Art. 5, Para. 39, referring to insurance; for recent examples see the Canadian Tax Court decisions in *American Income Life* [2008] TCC 306, *Knights of Columbus* [2008] TCC 307, where two US insurance companies had substantial numbers of Canadian resident salesmen (over 200 in the latter case) and a variety of other representatives but were held not to have PEs in Canada because they did not have offices of their own and the salesmen could not finalize the issue of policies as underwriting decisions were taken in the US head office.

64. UN, "Definitions of FDI", available at <http://www.unctad.org/Templates/Page.asp?intItemID=3147&lang=1>.

65. The importance of accounts in the tax context mainly relates to the measurement of business profits, rather than the existence of a PE (see Commentary on Art. 7, Paras. 16, 19 and 51; this will not appear in the 2010 Commentary on the new Art. 7, but appears in the Attribution Report, Paras. 39, 212 and 283, on which the new article is based). The issue is addressed in the discussion of the policy of the PE definition added in 2008 in relation to the services PE (Commentary on Art. 5, Paras. 42.12-42.18), which also discusses administration/compliance and net basis taxation issues. With the new standards for tax transparency (exchange of information), which are now virtually universal (see OECD, note 26), and the increasing use of assistance in collection provisions in tax treaties, the enforcement arguments are less convincing than in the past. For similar reasons the net basis arguments do not have the administrative weight that they may have had in the past, as even if tax is initially collected on a gross withholding basis, the opportunity to file a tax return and obtain a refund if appropriate overcomes the problem; the remaining problem is a compliance one for MNEs but it seems unlikely that an MNE (as compared to a portfolio investor) would not avail itself of this opportunity if the amount involved is significant. The accounts requirement in relation to the statistics FDI definition mainly serves a different and important function of preventing the multiplication of branches (see note 74 and text).

Whether these are convincing arguments in the modern era of tax transparency, the balance of flows argument referred to earlier offers another reason why for tax purposes a limitation on the PE definition may be justifiable – namely, if FDI flows are in balance between countries then the source country can give up taxing rights on inbound FDI as the revenue will be made up by levying tax on a residence basis on outbound FDI. That argument assumes both that tax is being levied on a residence basis at the corporate level in the case of outbound FDI and that the residence definition is effective to identify the outbound country of the FDI. Neither of these conditions holds in practice, so the balance argument has little influence in the case of firm income. As to the first, it is noted above that an exemption system effectively applies for tax purposes in the residence country of the corporation.

In the case of the definition of residence, there is some divergence between the tests for the different purposes. Like the tax test, the FDI test is not based on the residence of shareholders but on the activities of the firm – the "centre of predominant economic interest", with economic interest including "current production, consumption, acquisition of assets and incurrence of liabilities, asset-holding, place of incorporation or registration, and the origin of applicable taxation and regulation". Unlike the tax tests for residence of corporations, there is much more of an effort to identify the country with which the relevant unit has the strongest connection.[66]

It was noted above that at the parent company level in an MNE group the residence country will usually coincide with the headquarters, despite the variety of expression of corporate residence rules. The problem is the lack of robustness of the corporate residence tax rule *within* the group. All forms of corporate residence rule are the subject of tax planning in this case, because the place of incorporation, headquarters or board meetings of subsidiary corporations can be easily manipulated, especially if the corporation in question carries out few activities. Hence the creation within the corporate group of corporations resident in tax havens is easily organized. Even if the corporation has substantial activities, it is usually possible to place its residence for tax purposes in a country where it has no real presence.

The FDI definition deals with both cases much more satisfactorily. In the case of corporations with no real substance, it uses a concept of special-purpose entities which are effectively eliminated from FDI statistics, examples being "financing subsidiaries, conduits, holding companies, shell companies, shelf companies and brassplate companies". For corporations with real activities, the "centre of predominant activity" test prevents separation of residence and activities. In this latter case the tax definition of residence is particularly problematic when combined with the relatively narrow and specific PE definition, as it is possible to place tax residence in a low-tax country and then avoid a PE in the country where the real operations occur.

For tax purposes a less than satisfactory indirect route for dealing with such problems is adopted – invoking rules in treaties originally designed for other purposes to prevent abuse or adding treaty abuse rules to treaties.[67] These approaches are unsatisfactory because they

66. PEs are treated as quasi-corporations for FDI purposes and accordingly also have a residence, unlike the tax test, though the tax test has several residence overtones.

67. The OECD utilizes a rule in the definition of residence and the concept of beneficial ownership in the current Model to try to eliminate inappropriate treaty protection (Commentary on Art. 4, Paras. 8.1-8.3; Commentary on Art. 10, Paras. 12-12.1; Commentary on Art. 11, Paras. 9-10; Commentary on Art. 12, Paras. 4-4.1). Furthermore, extensive additions to the Commentary on Art. 1, Paras. 7-26 in 2003 provide specific drafting to deny treaty benefits in such cases, which are being increasingly utilized in tax treaties.

often simply deny treaty benefits. Further, they often default to domestic law, when international norms should be trying to provide universal rules, and if domestic law is following international norms it may prove ineffective. Like FDI statistics rules, tax treaties should identify the relevant taxpayer/investor rather than just excluding inappropriate taxpayers/investors.

The FDI definition also has a concept of multi-territory enterprises which "operate as a seamless operation" over more than one country, such as "shipping lines, airlines, hydroelectric schemes on border rivers, pipelines, bridges, tunnels, and undersea cables". These are prorated for FDI purposes over the countries where the operations are located. For tax purposes the OECD deals with two of the cases (shipping and air transport) by abandoning the PE principle altogether and effectively using residence-only taxation because of the difficulty of separating the activities.[68] Not surprisingly the shipping industry is now almost entirely haven based and countries are having to exempt shipping companies from tax or subject them to low-level tonnage taxes to entice them back again. Airlines may well go the same way if government ownership disappears and freedom of the skies becomes established as the international norm. The FDI definition does not accept the haven residence in such cases and deals with the difficulties of segregating activities directly.

Overall the FDI definition for statistics purposes aligns much more closely with the theory of the firm in that it seeks to identify the places where the firm's resources are really located and managed. Moreover, the rules are expressed directly rather than through proxies. The divergence of the tax rules for defining FDI from the theory is a source of difficulty in current international tax arrangements for business income.[69] Two forms of tax planning emerge from this discussion. First, the residence definition for corporations is used to create tax haven residents, to which substantial income is attempted to be allocated even though there is little activity in the haven. If the transfer pricing rules are operating appropriately, then this form of tax planning would be neutralized by allocating profits to the appropriate country, assuming that the PE rule is operating sensibly. Secondly, PEs are avoided in jurisdictions where substantial activity is occurring. In this case appropriate application of transfer pricing rules could deal with some but not all of the issues, to which discussion now turns.

3.1.2. PE tax planning

The PE tax definition gets the "stable and long-lasting" aspect of FDI correct, though arguably it uses too short a period, but otherwise it fails to provide sensible rules. Its main failings are that it does not appropriately deal with mobile activities in a jurisdiction and that it segregates activities of MNEs in a country rather than judging their activities overall.

68. OECD Model Art. 8; this article uses place of effective management rather than residence directly, but the two are likely to coincide and in any event many countries use the residence test directly in their treaties in this case.
69. One difference between the tax and statistics FDI definitions is that ownership of an interest in land in a country is deemed to be a branch (PE) for the latter purpose. In one sense this deeming is unnecessary in the tax case, as the country of location has unlimited tax jurisdiction over land in which non-residents have an interest. OECD Model Art. 6(4) makes clear that this is the case even for income from land derived in the context of a firm (such as mining, agriculture and forestry). One result, however, of the tax approach is that net basis taxation is not required by treaties in OECD Model form in such cases, despite the emphasis placed on it by the OECD for business income; a number of countries seek to ensure in actual treaties that net basis taxation applies in such cases.

To understand the nature of PE tax planning it is necessary to expand on the tax definition of the concept.[70] It includes only fixed places of business in a country occupied by the corporation itself and not fixed places of business of others which are an integral part of the corporation's business. A number of "minor" activities are expressly excluded from the definition. A dependent agent who habitually contracts on behalf of the corporation in respect of its core activities is included. Each fixed place of business or agent is judged independently.

Under current interpretation, mobile activities in a country are not covered by the definition unless conducted by an agent in relevant form (and the exception is doubtful).[71] There are various forms of FDI that are excluded by this approach, including mobile substantial equipment that is used in a country and other services which are performed in a country by a firm for a significant period without a fixed place of business.[72] The theory of the firm suggests that activities in a country are necessary for FDI to occur and the OECD is strongly supportive of this view. It is not suggested here that a corporation should be taxable in a country on mere exports to the country and in that sense the current OECD view is supported. But what constitutes activities in the country and how profits are attributed to such activities is another matter. The hot issue in this context (although now getting a bit cooler) is e-commerce. If a

70. OECD Model Art. 5 provides as follows:

"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. [Examples of Para. 1.]
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b)-*d*) [further examples]
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a*) to *e*), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.
5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
6. An enterprise shall not be deemed to have a permanent establishment 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.
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

Two of the important limitations are less than clear from this definition but are stated in the Commentary at some length, namely that a fixed place has to belong to the corporation and not someone else, and that each place or agent is judged separately.

71. As argued in Vann, "Travellers, tax policy and PEs", *British Tax Review* [2009] (forthcoming), the extension of the dependent agent PE to cases where there is no fixed place of business of the agent in the country contradicts both the OECD-proclaimed tax policy regarding PEs and the history of the PE rules. In terms of the discussion here, the current OECD view can lead to taxation of exports rather than FDI and ignores the relevant issues for defining FDI.

72. The services PE rule included as a possible provision (with many arguments against it) in Commentary on Art. 5, Paras. 42.23-42.48 in 2008 (partly) covers the former case and a few countries include operation of substantial equipment for a substantial period as PEs under tax treaties (most notably Australia, although until recently the Australian provision was too broad by including finance leasing and usually not containing a time limitation).

firm simply exports through website activities, that should not be sufficient to be treated as giving rise to FDI (or source taxation), but e-commerce is rarely so simple and should be judged by the general principles discussed here. Unfortunately much of the recent debate has been on an issue-specific basis that has not recognized that FDI and not sales alone should be the trigger for source taxation of business income, including e-commerce, as suggested by the theory of the firm.

The separation of activities in determining PE (and FDI) status under tax rules is the more important problem. It encourages tax planning by artful segregation of activities and reliance on the implied or express limitations in the fixed place/agency/minor activities rules, which the OECD tries to counter in various (half-hearted) ways. More significantly, separation of activities pervades the whole tax transfer pricing mindset by shifting the focus from overall to individual activities of the firm in a country. The shift affects both the determination of whether there is a PE and how profits should be attributed to FDI. As regards the first, the construction site and services PE situations provide good examples. Both of these cases have an express time limitation to ensure that the presence in the country is sufficiently long to justify characterization as FDI. The problem is the requirement that this presence be in relation to the same (or a related) project.[73] If a firm operates in a country for a substantial period that should be sufficient to constitute a PE/FDI whether the presence relates to a specific project or not, as the FDI statistics rules recognize.[74] As regards attribution of profits, many examples of problems being created by separation of activities appear hereafter.

The dependent agency PE is a tax oddity which finds no direct recognition in the FDI statistics definition but nonetheless provides an important key to the underlying policy. The definition covers employees and non-employees habitually acting as a contracting agent, including other corporations. The dependency test turns on whether the agent is legally and economically independent of the principal or not. The idea is one of a dependency attachment to the principal and corresponds to the "direction of resources" idea in the theory of the firm.[75] In the case of separate corporations, the required relationship is that the corporations

73. Commentary on Art. 5, Paras. 16-20, 42.40-42.41; for commentary on the artificial separation of activities, see Paras. 18 and 27.1. Another significant example is the exception for minor activities, which was originally intended to be *de minimis*, as indicated by the description of "preparatory or auxiliary." While the exception does not cover firms whose very business is the activity in question, it is not clear if there is an overall preparatory or auxiliary limit on the exceptions, and nowadays the listed activities include significant value-adding elements – purchasing, warehousing, delivery, advertising, collection of information and market research.

74. They seek to avoid the multiplication of PEs in a country by focusing on the appropriate accounting unit rather than particular activities in defining FDI through PEs. In fact the separation approach is not applied at the compliance level of the tax system. Countries require only a single tax return from a corporation for all its PEs in a country, and there is a sleight of hand when moving from the PE definition to profit attribution by focusing on accounts (and thus the accounting unit) rather than separate activities. The tension between the PE definition and its attribution approach based on accounts for tax purposes goes unnoticed by the OECD. The multiplication issue was dealt with in one of the *National Westminster Bank* tax cases in the United States, where the court treated the six separate branches of the bank in the United States as one PE ((2005) 69 Fed Cl 128), even though this seems contrary to the definition (Commentary on Art. 5, Para. 5.1).

75. The distinction can be seen clearly in two extremes. If a firm uses a large stockbroker with many clients to sell some of the firm's portfolio shareholdings in listed corporations, then assuming that the broker is acting legally as agent, which is the case in some countries at least, the broker would not constitute a dependent agency PE as the broker is independent. Both the broking and the sale transaction are normal market transactions. By contrast, if a firm which manufactures unique goods sells them through agents in various countries and the agents only act for that firm and under strict guidelines, the agents will be dependent agents as they are a part of the firm not much different from employees. The agency contract will not be a normal market transaction in the sense that the firm expects to make at least some of its profit out of its direction of the selling activity of the agent, in addition to its

be "associated enterprises", which as already noticed is expressed in terms of control. Although control could be viewed as another way of stating the dependency attachment idea, in fact it is generally taken as an ownership test (that is, parent and subsidiary and similar relationships).[76]

There are three fault lines in these rules. Most specifically so far as the PE definition is concerned, the dependency attachment test only appears in and is subordinate to the agency test, so that if agency is avoided (and agency here is the legal concept, not the commercial concept of the term), it does not matter if there is dependency. Secondly, while ownership in the case of the associated enterprises will usually imply a dependency attachment, it diverts attention from the important issue. The existence of a resident subsidiary means that there is FDI in a country, but it is the dependency of the subsidiary on the parent that should inform the amount of profits that is regarded as produced in the country, a point elaborated further below. Finally, dependency is possible without ownership. It is obvious in the case of employees that "ownership" by the firm is not required for the employee to constitute part of the firm. The direction of the supply of the employee's labour is sufficient. Coase came to regret that employees loomed so large in his original exposition of direction of resources being the hallmark of the firm, as attention was diverted from other relationships in which the necessary direction was present.[77]

The combination of these fault lines means that some dependency situations will fall outside the boundary of the firm as defined in the international tax rules. Some possible examples are certain kinds of franchise and distribution arrangements. If the franchisee or distributor is a separate corporation, it will not be viewed as part of the firm constituted by the franchisor or producer if it is not owned by the franchisor or producer of the products being distributed and is not a dependent agent. As franchisees and distributors typically sell in their own right and not as agent, the test essentially comes down to ownership. The significance of this structural problem in the rules will become evident as we proceed, particularly regarding the significance of freedom of contract.[78] While it is possible to posit some cases where dependency is present but ownership and agency are not, it is more problematic to provide a direct test of dependency that is sufficiently detailed but not subject to manipulation. At the moment neither the tax nor the statistics definition begins to attempt a solution to this definitional problem, although it has been noted in the statistics context. The theory of the firm will not necessarily provide clear guidance in such cases, as it is recognized that the borderline between firm and market is not black-and-white but often shades of grey; that is, there are some arrangements that are intermediate cases between the firm as generally understood and the market. Franchises, distribution arrangements and like cases are potentially of this intermediate kind.

manufacturing profit. The term "integration" can be used to describe the idea as it conveys that the person or asset is part of the firm. Because the term "integration" has been used above as is also common to describe systems that try to overcome double taxation of corporation and shareholder, the terms "dependency" and "dependency attachment" are used here to describe when a person or asset is considered to be part of the firm.

76. See further Vann, "Tax Treaties: The Secret Agent's Secrets", *British Tax Review* [2006], p. 345.

77. Coase in Williamson and Winter, note 6, pp. 64-65.

78. The PE concept is frequently criticized as a threshold test for source taxation; see the work of Arnold and Pinto referred to in note 17. The criticism is not, however, formulated in the terms set out here as the PE concept is seen as all or any of mechanical, outdated, or administration based and hence a barrier to source taxation, rather than as a principled, if flawed, concept for sourcing business profits.

The result in the tax case is that countries have no tax jurisdiction in such franchise, distribution and other similar cases over the corporation which is the franchisor or whose products are being distributed. Given other problems in transfer pricing rules, it is not clear that this is a significant problem at the moment because in the MNE context there will usually be a subsidiary in a country where the franchise or distribution activities occur which either directs or actually carries out those activities, and so the right to tax is clear although the amount that is taxable is not. If, however, other problems in the transfer pricing rules can be overcome, then one possible response may be to exploit the use of franchises and distribution arrangements without having a subsidiary presence in the country. In that event the need to deal with these activities in the PE definition will become more pressing.

3.2. Market prices and mechanisms

In principle corporate residence manipulation would be overcome if the transfer pricing rules for allocating business income were robust, as little income could be allocated away from countries where business is actually done by firms to locations of corporate residence where little business activity occurs. Similarly, so long as there is a resident subsidiary in a country profits arising in a dependency case can be properly allocated whether or not there is a PE. But the transfer pricing rules are not robust both in their origin and for structural reasons that have become more apparent as the rules have developed.[79] This section considers the origins of the rules, the difficulties created by freedom of contract and issues which apply in taxing PEs in dependency cases. The next section moves on to the modern functional analysis, which in principle could solve the problems in this section, and explains why that has not been the result.

3.2.1. Origins

We can trace the origin of the transfer pricing rules to the theory of the firm, even before Coase published his theory. The author of the rules, Carroll, explained his view of them as follows:[80]

> [I]n the usual case where an enterprise has its principal establishment in one country and secondary establishment in others... the real centre of management is probably at the principal establishment. The control and management, financial and technical, are centred there. At the meetings of the directors the decisions are taken which make or break the enterprise. There the risks are centred. The profit or loss results from all the activities of the enterprise taken together, but how can the part attributable to the establishment in each country be most readily measured? If we recognise 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 or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services.

Carroll recognizes that the firm is making profits from the direction of resources above those available from the market and thus it is plausible to see the distribution of taxing rights over corporate profits among countries in terms of the theory of the firm.

79. Parts of the material in this section are elaborated in Vann, note 76.

80. Carroll, *Taxation of Foreign and National Enterprises – Volume IV. Methods of Allocating Taxable Income* (Geneva: League of Nations, 1933), at Para. 677, available at <http://setis.library.usyd.edu.au/oztexts/parsons.html>, item 5.

From the very outset, however, it is clear that the construction of transfer pricing rules is potentially flawed. Carroll assumes that the hallmarks of the firm are centred in one place and that the parts of the firm in other countries are in effect outsourced service activities to which market prices can be applied to determine their contribution to profit. As Carroll recognizes, the inevitable result is to attribute the residuum (which represents the additional profit that the firm makes compared to what market transactions would produce) to one place.

The theory of the firm as applied to MNEs by contrast explains why firms expand overseas rather than simply exporting or outsourcing – they are able to make greater profits locally by operating locally, implying as a starting point that the residuum should generally be allocated to all the places where the firm is operating (has FDI) and that the application of market prices on an outsourcing basis misallocates the residuum. Carroll's approach arguably over-rewards the headquarters and under-rewards the other locations where the firm has FDI, although – as he provides only half the facts (what occurs at the headquarters, not what occurs elsewhere) – how the residuum should be allocated in this case if it is not all to go to the headquarters is not clear.

3.2.2. Freedom of contract or incomplete contracts

It will be noted that Carroll's solution to his example creates a presumption of the kind of contract that is appropriate rather than giving the firm the choice. This may be because Carroll is considering the case of a head office and a PE and legally there can generally be no contracts in such cases. If, however, as is much more common nowadays than when Carroll was writing, associated enterprises are involved, real contracts are possible. The question in this case is whether contractual presumptions apply in one form or another or whether freedom of contract is assumed, as would be the case in the market.

After Carroll's work and the adoption of it by the League of Nations in the early 1930s, it took some time for the current rules to be accepted in actual tax treaties. The reason is likely to have been debate over whether Carroll's outsourcing approach was correct. While framed in the context of PEs, the same issues arise for associated enterprises. If a parent manufactures in one country and a subsidiary is involved in selling the goods in another country, there are two possible ways that the contracts could be constructed. The subsidiary could buy the goods from the parent and sell them to third parties, leaving the manufacturing profit taxable to the parent and the sale profit to the subsidiary. Alternatively, the subsidiary could be treated as providing services to the parent, which retains ownership. Assuming that the subsidiary does not effect a sale as agent, then the parent will not have a PE and the subsidiary profit will be based on the services rendered. At first sight the subsidiary's profit in the first case would be higher than in the second case, so that the form of the contracts affects the profit allocated to the country of the subsidiary.

The assumption of many countries in the 1930s seems to have been that the sale transaction was the appropriate benchmark in this case rather than the services approach. That was because that benchmark would effectively split the residuum between the manufacturing and selling countries rather than allocating it all to the manufacturing country. It could be argued that, so long as in each case the subsidiary was doing exactly the same activities, the amounts should end up the same for either route, and indeed Carroll took that view. The modern analysis elaborated further below recognizes that the two situations would not be comparable

and that therefore the profit attributable to the subsidiary would vary between the two cases. Freedom of contract thus often means that profit allocation is a matter of choice for firms.

The theory of the firm indicates that the source of the problem is the assumption of the market freedom of contract. The way in which the subsidiary is acting in these cases is at the direction of the parent and the subsidiary's activities are dependent on those of the parent. One way of expressing the point which is common in the literature is that firms are characterized by incomplete contracts. On the incomplete contract version, the only actual contract between parent and subsidiary here is incomplete in that it is really a contract for more than routine selling services.

Nonetheless the OECD is clear that generally freedom of contract applies between associated enterprises. In 1995 the OECD spelt out two cases where contracts could be disregarded, but it has recently emphasized that these cases are to be construed very narrowly.[81] As the firm will often be indifferent to the type of contracts made within the firm (as what generally counts for the firm overall is its relations with parties outside the firm, so that it is under no market pressures as to the nature of internal contracts), it is not clear that internal freedom of contract really reflects what would happen in external markets.

The OECD distinguishes cases where firms enter into internal contracts which have no exactly equivalent or even similar external market transactions. The contracts between associated corporations may be obviously incomplete but nevertheless are priced on the basis of a different complete market transaction. This can occur in the case of licensing of intangibles. Contracts between associated corporations may be written as non-exclusive licences so that powers of enforcement remain with the licensor (depending on intellectual property rules in different jurisdictions), but are treated by the corporations for transfer pricing purposes as if they were exclusive licences, as that is the equivalent market transaction. While it is possible in some cases to find comparable market transactions, even though they do not represent the actual incomplete contract, in other cases there will not be a comparable market transaction because separate firms would not have entered into the transaction in question as the nature of the contract depends critically on the dependency attachment of the parties to the same firm.

In these cases the OECD generally (and consistently with its position where similar transactions can be found in the market) requires that the nearest market equivalent generally be utilized, although in some fairly rare cases it recognizes that contracts within firms are incomplete and permits the construction of the missing (part of the) contract, which can only be done by some form of presumption.[82] The point for present purposes is that many contracts entered into by firms will be incomplete, whether there is a market equivalent or not, because of the different dynamics operating within the firm. The current freedom of contract is one of the most significant structural weaknesses in transfer pricing rules.

The theory of the firm is generally absent in the OECD transfer pricing work, although it appears at times implicitly. In particular it is recognized that:[83]

81. Guidelines, Paras. 1.36-1.41, Discussion draft, note 2, Issues Note 4.
82. Discussion draft, note 2, Issue Notes 1 and 2.
83. Guidelines, Para. 1.8. Immediately following this comment the nature of the firm is recognized – and brushed aside: "The arm's length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises."

> there are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialised services.

We have already seen that one variant of the theory of the firm recognizes the importance of unique property to the creation of firms and that the examples the OECD uses for situations where no similar market transactions exists involve intangibles. One way to deal with such cases and at the same time to move away from specific market transactions and freedom of contract is to utilize profit methods for allocating the firm's profits across countries, particularly profit splits. The OECD is currently in the process of revising its transfer pricing guidance to water down the current last-resort nature of profit methods by adopting the most appropriate method rule. Significantly it is noted that the kinds of circumstances referred to in the quoted passage may make profit splits the most appropriate method.[84]

There are other ways to deal with incomplete contracts besides explicit profit splits. As already demonstrated in the example discussed above, an implicit profit split can occur by particular forms of contract. Once the appropriate split has been determined (in ways to be considered below), rather than the appropriate share being taxed directly the same outcome can be achieved by working backwards to the appropriate contract form and pricing. At various points in OECD work this issue is recognized and contractual presumptions are effectively created, particularly but not only in the PE context. The attraction of such approaches is that they use actual contracts to effect the division of profits which feel more familiar to taxpayers and tax officials.

Given the nature of OECD processes nowadays, which heavily involve the private sector as well as governments in ongoing consultation, the importance attached to international consensus and the large sunk costs on the part of the private and public sectors in administering and complying with the current international tax rules, it is not to be expected that OECD views on freedom of contract will change overnight. The difficulty for the moment is that while it is possible to detect the underlying tensions around this and other issues, the same cannot be said for finding any consistent trend or direction in the evolution of the underlying policy, either directly or as expressed in the various approaches to particular transfer pricing issues. Hence in what follows concerning current practice, the process is to identify what are regarded as the most important structural problems in transfer pricing rules and to note possibilities in current guidance which may provide useful solutions. This discussion is not, however, intended to suggest that this is the direction in which the OECD is currently headed, desirable though the author may consider that to be.

3.2.3. Dealings, dependency and PE paradoxes

The previous discussion suggests that it was by no means inevitable that the same freedom of contract would be extended to PEs, given that there are in most cases no actual transactions – just what the OECD terms "dealings", meaning the activities of the PE in relation to the rest of the enterprise of which the PE is a part. For much of the history of attribution of profits to PEs, there were significant limits on freedom to structure dealings, but now as a result of a decade of recent work the OECD largely applies the Guidelines and thus freedom of con-

84. OECD, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (2009), Para. 2.3, available at <http://www.oecd.org/dataoecd/1/57/43655703.pdf>.

tract by analogy to PEs.[85] At one stage in the process it appeared that the analogy would be almost complete, but at the end a number of new limits on freedom of contract appeared. In later parts of this section of the article a number of these presumptions (new and old) will be noted, as they are the best current indication of how restriction on freedom of contract might be implemented. To the extent that these presumptions appear sensible, they should be extended to associated corporations.

That the same or very similar standards should apply to PEs and subsidiaries is necessary, as the choice of a PE or subsidiary is effectively within the election of the corporation. In recent times the electivity has become even greater because of hybrid entities. Originally these were generally exotic entities that different countries treated in different ways for tax purposes. One country treated the entity as a corporation taxable in its own right and the other country treated it as a part (and usually PE) of the entity or entities which owned the hybrid. When the United States introduced the check-the-box rules for the classification of entities as corporations or PEs, it was no longer necessary in cases involving the United States to use an exotic entity to achieve this outcome. What are two corporations for the purposes of another country under its corporate, contract and tax law, will for US purposes be two separate corporations in corporate and contract law but one corporation with a PE for the purposes of tax law if the corporations so choose. Thus it is possible to have actual legal contracts (because the corporations are separate legal persons for corporation and contract law purposes), but a single corporation with a PE for tax purposes. If freedom of contract were permitted for PEs it would be possible by this means to remove one of the difficulties of manipulating PE taxation – difficulties in establishing how the dealings are between PE and other parts within a corporation are to be analogized to contracts.

The main current problem in PE taxation under transfer pricing rules is ambiguity – indeed a number of paradoxes – when both a subsidiary and a PE are involved. If we return to the example given by Carroll, it will be recalled that the same result splitting the residuum over the countries of manufacture and sale could be reached, whether a subsidiary or PE was involved, by treating the transaction/dealing as a purchase by the subsidiary/PE from the parent/head office and a sale by subsidiary/PE to third parties. Hence equivalence in treatment was achieved. But what if the subsidiary also in effect constitutes a PE of the parent because it provides a fixed place of business and personnel for the parent to use in effecting sales or makes sales as a dependant agent (on behalf) of the parent? It may be possible for the residuum appropriate to the sale country to be taxed twice in this case or not at all, neither of which is an appropriate outcome.

The residuum appropriate to the sale country represents the amount above the profit the subsidiary would make if it were treated as a service provider to the parent and is allocated to the subsidiary in the simple parent/subsidiary case by the purchase-and-sale construction of the transaction on the basis that the subsidiary is conducting the activities in the country which in conjunction with the parent's activities in its country generate the residuum. If the service provider analogy is adopted, then none of the residuum is taxable to the subsidiary. Moving to the case where the parent has a PE through the subsidiary's activities, it may seem that the subsidiary gets taxed on the sale country's share of the residuum for its activities and the parent gets taxed again on the same amount.

85. This is one of the major outcomes of the Attribution Report.

One way to avoid this result is to say that the subsidiary has the residuum as it would have in the absence of a PE, and that the PE has zero income as its revenue from involvement in the sales equals its expense, being the amount that subsidiary effectively receives for its part in the activities. The problem with this solution arises if freedom of contract is accepted and the contract between parent and subsidiary is structured as a service contract. The subsidiary does not get taxed on the residuum as it has adopted the services contract form. The parent does not get taxed on its PE activities as its revenue once again equals its expense – and if there is no PE the result is the same for the service contract form. Such reasoning will probably strike all but international tax lawyers as sophistry, but it is a serious international tax debate and the removal of the residuum from the country of sale has been accepted by the highest court in India at least, as well as by many commentators.[86]

From my perspective the problem is that while the theory of the firm indicates that part of the residuum should be based in the country of sale in the example being used, the theory does not indicate whether it should be taxed to parent or subsidiary, as both are part of the firm and in that sense it is a matter of indifference to the theory. Partly because of the tax planning used to avoid PEs my preference would be that the residuum be taxed to the subsidiary. But so long as there is a PE, equally taxation of the parent on some or all of the residuum, if not taxed to the subsidiary, produces a sensible outcome.[87]

3.3. Functional analysis

The functional analysis is what distinguishes the transfer pricing approach in the last two decades compared to earlier practice. The analysis made more clear and precise what was often implicit previously, particularly in relation to the bearing and importance of risk. Risk further highlighted the "freedom of contract" issue and so the discussion starts by picking up this theme and then moving into the other issues that flow from the functional analysis.

3.3.1. Risk

Tax avoidance problems in the transfer pricing area are not new. As noted above the functional analysis and the accompanying FAR jargon ("functions performed in the light of assets used and risks assumed") that came into use in the late 1980s were intended to prevent, not create, tax avoidance opportunities, but the emphasis on risk had precisely the opposite effect.[88] There are two stages in the development, though historically there is considerable overlap. The first stage flowed from the failure to tackle freedom of contract between associated enterprises. As risk can be assigned by contract more or less at will, it was possible for associated corporations to move risk around a corporate group as they wished and with the risk went a substantial proportion of the profit. Some simple examples are contract manufacturing and captive insurance.

86. Morgan Stanley, (2007) ITLR; see the various discussions of this issue in "The Attribution of Profits to Permanent Establishments", Vol. 91b *Cahiers de Droit Fiscal International* (2006).

87. This is the OECD view but how it is reached is not perfectly clear; Attribution Report, Paras. 263-281; Vann, note 76.

88. In the US 1986 tax reform, some important changes were made with respect to intangibles and a study of the whole area was mandated. There followed a 1988 US Discussion Paper on transfer pricing, which introduced the functional analysis and the economist into the transfer pricing area. After this shift in transfer pricing analysis found its way into US draft regulations, the OECD got involved as many countries considered that the new US approach was not consistent with the then orthodoxy (as concerned methodologies rather than theory). The final 1995 "compromise" in the Guidelines represented a victory for the US approach, with the FAR jargon appearing prominently.

The main difference between an ordinary manufacturer and a contract manufacturer is that the latter takes no inventory risk. It manufactures to the order of another corporation, which carries the risk of being able to sell the manufactured items. Such arrangements are now commonplace between independent parties. If a member of an MNE corporate group is carrying on manufacturing activities in a country, at the stroke of a pen it can be either a full-risk manufacturer or a contract manufacturer vis-à-vis other members of the group as the group desires, even though with respect to the market generally the group is a full-risk manufacturer. Product liability and related issues have produced a whole industry of captive insurance, which pulls such major risks out of countries where they arise, generally to tax havens. The corporation which otherwise would carry such risk enters into an insurance contract with an associated corporation which thereafter carries the risk. Tobacco firms in Australia diverted 10% of sales revenue through this route[89] and, given the current litigation and insurance situation in the tobacco industry, this figure can probably be upped considerably.[90]

These kinds of tax planning had been around well before the 1980s development of the functional analysis, but the highlighting of risk in that analysis certainly gave encouragement to them and they are now standard transfer pricing tax planning fare. Appropriate limits on freedom of contract in the transfer pricing area should be enough to deal with such basic paper-shuffling devices. The Attribution Report has an approach that could be generalized for this purpose, namely that risk follows functions, so that in the PE context it is not possible to separate risk from activities as it is in the associated enterprises case.[91]

The justification for this (and some of the other limits in the Attribution Report) is that the PE is not a legal entity so that contractual separation of functions and risk is not possible. It has already been noted that this legal position is not strictly accurate in a number of cases where PEs are in fact separate legal entities and hence could outside the tax context transfer risk by contract. It was also noted that this kind of now fairly common case means that maintaining a different position for associated enterprises is difficult to justify. This is the very same justification that was used in the past for some of the limits on the application of freedom of contract to PEs and which the OECD has now abandoned, such as in relation to intangible property, discussed below.

The second stage of the developments in relation to risk is more substantive. The main impact is on the three areas to be considered next, but the development of the approach to risk is discussed here. This next stage in the rise of the importance of risk in transfer pricing can be traced to work at the OECD, though there was considerable parallel work in many OECD countries.[92] For present purposes, four developments in the approach to risk emerged. These developments occurred in the context of PEs and apparently under an assumption that

89. *WD &HO Wills* (1996) 32 ATR 168, which held that the Australian general anti-avoidance rule (which overrides tax treaties) did not apply in this situation; presumably the Revenue did not argue transfer pricing on the basis that the price was within the bounds of market prices.
90. See Vann, "Reflections on Business Profits and the Arm's-Length Principle" in Arnold, Sasseville and Zolt (eds.), *The Taxation of Business Profits Under Tax Treaties* (Canadian Tax Foundation, 2003) p. 133, at pp. 153-157 for elaboration.
91. Paras. 16-20, 24-30.
92. There were three interrelated events at the OECD during the 1990s: work on the tax implications of financial innovation, work on the taxation of PEs and work on taxation of e-commerce. The interrelationship was that the PE work was initially concerned with financiers, which were the main businesses to operate in branch form, while e-commerce raised questions about whether the PE threshold was still appropriate as the foundation of international taxation.

freedom of contract was not to be applied to PEs, even though freedom of contract for PEs was actively being contemplated.

First, analysis of financial innovation involved the decomposition of a broad range of not just financial transactions and assets into two components: a standard risk-free loan and a bet, with all the risk obviously residing in the bet. Financial innovation was generally all about the risk side of the transaction – whether taking or eliminating risk through a variety of derivatives, etc.[93] The analysis suggested that returns on assets were relatively standard and that major profits (and losses) were generated by the exploitation and management of risks related to assets and liabilities.[94]

The second development linked the exploitation and management of risk to specific personnel in corporations. The particular issue was the allocation among countries of the profits from 24-hour trading in capital markets by global financial institutions involving personnel in several countries and the profit was seen to arise largely from the activities of the traders who took or eliminated the risks involved through various trading strategies.[95] This idea was ultimately elaborated and generalized as the "significant people functions":[96]

> the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets are performed by people in the PE.

As for the rest of the firm's employees, the treatment was originally the same as assets – a basic (small) reward for routine functions. In the final version of the Attribution Report, the assumption that these other functions were routine and of low value has been relaxed and made to depend on an analysis of what exactly the functions are.

The third element links equity capital of corporations with risk (capital follows risk) in the determination of the allocation of interest deductions for firms between the countries where the firms operate. The route here was initially via capital allocation of banks and the international use of the risk weighting of assets found in banking regulation. Apparently inconsistently this approach linked risk to assets rather than people, but the fourth element seemed to eliminate the inconsistency in that it "located" assets in the country where the risk with respect to the assets was managed, that is, where the personnel performing the significant people functions were.

93. The OECD produced a 1994 report, *Taxation of new financial instruments*, which was concerned with domestic as well as international issues. Many in the academy were at the same time working on financial innovation – for example, Warren, "Financial Contract Innovation and Income Tax Policy" 107 *Harvard Law Review* (1993), p. 460; Strnad, "Taxing New Financial Products: A Conceptual Framework" 46 *Stanford Law Review* (1994), p. 569; Edgar, *Income Tax Treatment of Financial Instruments: Theory and Practice* (Canadian Tax Foundation, 2000).

94. An analogous result was reached in the area of e-commerce. Hardware is an asset which generates little return; all the profit is generated by the (writers of) software. See OECD, *Taxation and Electronic Commerce* (2001), which brought together some of the early OECD work on e-commerce; to this effect, see Chap. 4.

95. The 1994 OECD report, note 93, led to the creation of the OECD Special Sessions on Innovative Financial Transactions, which started to work on the taxation problems of global trading in financial instruments. Detailed analysis of global trading by the OECD led to two draft reports in 1997 and 1998, which emphasized the role of the traders; see *The Taxation of Global Trading of Financial Instruments* (1998). This work was folded into the attribution project and now appears as Part III of the Attribution Report.

96. Attribution Report, Para. 18, originally called "key entrepreneurial risk taking" (KERT) functions. This term is now confined to the finance sector on the basis that a wider range of functions is important outside that sector.

Inexorably it seemed that all profit derived from risk and that risk could be identified with a relatively small number of people in the firm – the significant people. Again the thinking shifted as the Attribution Report developed in a number of ways. The link between functions to risk to assets to capital allocation was relaxed outside the finance sector in that management of risk does not automatically determine economic ownership of assets. While more substantive than the freedom-of-contract approach to risk, the idea that a small group of people attracted the major share of the profit was quickly seized on by tax advisers and used in the restructuring of firms by moving such personnel to more attractive tax climates.

Such restructures were not necessarily tax driven in the sense that the structure of MNEs has continued to evolve with business conditions, new technologies and changing views on management.[97] Many manufacturing and other processes have been shifted to countries with low labour costs, and firms have increasingly adopted regional structures and the consolidation of common functions such as treasury and back-office activities. This process has involved devolution of certain functions from central headquarters to regional headquarters and the movement of particular functions that were scattered in different locations to a common, typically regional, location. That is, a new regional level of management has been created in many firms. While structural evolution in firms has been occurring for many years, the emergence of the "significant people functions" approach in transfer pricing meant that a considerable amount of tax planning has occurred under the cover of the recent restructures and significantly affected the way they were implemented.[98]

The emphasis on risk in transfer pricing reflects developments in the theory of the firm, highlighting the entrepreneur as the explanation for the existence of firms and as the generator of value within the firm which cannot be captured by market transactions. The original terminology for the significant people functions – "key *entrepreneurial risk* taking" functions – was explicit on the link but the current terminology is not much different in intent. It is natural in the light of the growth of the technology and allied sectors to emphasize the importance of key personnel to the emergence of new firms – Bill Gates and the early decades of Microsoft, Steve Jobs and Apple still – but the generalization to all firms is not so obvious either in theory or in the way it has been developed in transfer pricing.

With regard to theory it was noted above that the variants on the theory of the firm are not contradictory and it has been suggested that entrepreneurship is important to the start of the firm but becomes less important as the firm matures, or becomes dispersed throughout the firm, which leads to similar conclusions for our purposes.[99] Most, but by no means all, MNEs are relatively mature. In the transfer pricing area, the significant people are not identified as the Bill Gates or Steve Jobs of the world – the makers of the initial breakthrough or high-level firm strategy – but in a general sense mid-level personnel on the ground in management and

97. The e-commerce debate was premised on a view that business was now operating in completely different ways from the past. Restructuring of old-economy businesses to meet the challenge of the new economy was seen as natural and indeed necessary. What was and is happening is an ongoing evolution rather than a revolution, and one that is only partly related to e-commerce and new technology (for example, Sautet, note 6, pp. 108 et seq.).

98. In particular it affected the country where regional headquarters were located (countries with favourable headquarters tax regimes) and the people who were relocated to such headquarters. Tax advisers had to decide who the significant people were.

99. Baumol, "Entrepreneurship, Innovation and Growth: The David-Goliath Symbiosis", 7(2) *Journal of Entrepreneurial Finance and Business Ventures* (2002), p. 1.

operations. Why the value generation in the firm should be specifically located at this mid level has not been clearly articulated and is taken up in the next part.

In this part of the article I have argued that the growing emphasis on risk in transfer pricing analysis has been counterproductive, as it has facilitated tax avoidance rather than prevented it. The assumption of freedom of contract is a particular problem here, as it is more generally, and reinforces the conclusion in the immediately preceding part that contractual approaches to allocation of value within the firm need to be severely constrained if they are to work appropriately. To the extent that the assumption of freedom of contract is not operative (or less so), as in the PE context, the identification of value creation with risk and of risk in turn with a relatively narrow range of personnel have provided significant scope for group (re)structures that seek to identify and locate these personnel in favourable tax locations.

3.3.2. Personnel

In the theory of the firm, it is the direction of resources that distinguishes the firm's activities from the allocation of resources by the market. It is natural to conceive of this direction in terms of the entrepreneur or managers, which is probably what drives the thinking behind the significant people functions and personnel in transfer pricing. The consequences of this thinking have been spelt out above but not the structural flaw involved.

The problem with this approach is that it conceives of the firm in a very primitive form, with one or a few directing the many. The large modern firm is a series of hierarchies, with the direction of employees going far down the structure. The mid-level view reflected in the significant people approach ignores the hierarchies and direction at the top and also at lower levels of the firm. More importantly, as noted above, Coase himself regretted that the idea of directing resources was interpreted (implicitly by himself as well as explicitly by others) purely in the context of employees. It is the direction of the resources of the firm, human and otherwise, that is relevant and even low-level employees are involved in that direction of resources of the firm through the use of firm assets in their work. The quality of work on the factory floor has a significant impact on firm profit.

Another problem with the significant people approach in practice to date, if not in theory, is that it tends to ignore heterogeneity in firm structure. The structures of firms have evolved over time and at any given time there is a wide variety of firm structures, including very flat and highly hierarchical management. Trying to identify relatively few significant personnel in these structures as responsible for a major share of the profits will not reflect reality for many firms, as well as being very difficult and contentious for the firm and the tax administration.[100]

The only practical approach and one that will cohere best with the theory of the firm is to regard all employees as contributing to the profit that the firm makes. Salary levels reflect market judgements as to value contributions of particular employees and these are a more reliable guide to contribution than picking and choosing among employees depending on

100. As already noted, the attribution work broadened the relevant group as it developed, which also created somewhat of a moving target.

exactly what they do in the firm.[101] It is not only total salaries of employees that are relevant, which is why the more generic term personnel has been used in the heading. As noted above, the firm includes dependent entities which are not in the same ownership and account needs to be taken of such dependent entities' contributions. Some of these contributions will often be little distinguishable from salaries of employees and in that event should be taken into account for the purpose of using salaries if this is a key being used for the process of allocating the firm's profits among countries. The same point applies to other areas and is not repeated, except for sales, where it is most important.

There are some presumed transaction rules in this area which at first sight look to be out of line with the recent development of the idea of significant people functions but in fact provide a clue to the solution that can be generalized across several areas. In the PE area it was the case that no profits were to be allocated to internal management activities to the extent they were provided at a separate location from other activities (if provided at the same place they would generally be captured by the market pricing of the outputs there when transferred to other parts of the enterprise).[102] The OECD is proposing to change this presumption so that in future management services will be treated in the same way as for associated corporations.[103] For this case a transfer price is established which generally provides a profit for the internal management activity, but the rules are relatively prescriptive so that only a modest part of the overall profit is awarded to the country where the services are rendered.[104] The issue is becoming more important because of the centralization of internal management functions under restructures of the kind discussed above.

This presumed approach seems to be in some tension with the significant people functions approach, because in many cases the internal management services may be seen as significant people functions yet they are only rewarded with a relatively small part of the overall profit.[105] In fact it is thought that another important principle is at play here. The underlying assumption in the transfer pricing discussion of services above is that profits attributable to labour income are appropriately allocated to the place where the services are performed. This is also generally the approach in traditional source rules for services income. Increasingly the place where services are rendered is much less tied to other production processes than was the case previously. Moreover, individuals can provide services to the same geographical part of the

101. Using the cost of all labour inputs does not imply that uniform profitability per dollar of salary need be assumed. The firm will have accounting records that divide profits on transactions with independent parties in the market among the various product categories and individual products often at a highly disaggregated level. The same records will also necessarily have allocated costs, including employee salaries, across the categories and products. This information can be combined to work out the contribution of labour to the various elements of the firm's profits. There are various measurement problems involved but they are not anything new. Current practice recognizes that it is often necessary to aggregate in transfer pricing analysis (Guidelines, Paras. 1.42-1.44). Nonetheless there are important areas where full international agreement is lacking, most particularly the measurement and treatment of compensation in the form of equity in the corporate group (stock options, etc.); OECD, *Tax Policy Studies No. 11: The Taxation of Employee Stock Options* (2005), Chap. 4. Entrepreneurs and many managers in particular will be partly rewarded in this way and it is important if labour cost is being used in the allocation process that this amount be fully captured.

102. Commentary on Art. 7, Paras. 35-40.

103. Attribution Report, Paras. 251-256.

104. Corporate groups are effectively allowed to use the former PE rule of no profit for the internal management services if they wish (Guidelines, Para. 7.37).

105. The way only a modest profit is normally allocated is by calculating the profit allocated to the service provider on a cost-plus basis, with a relatively low cost-plus percentage. It may be in some circumstances that a greater share of the reward should be allocated, depending on relative risks of creation and use.

firm from a variety of locations as they move around the world for meetings and other activities related to their work. This is one instance where communication and transportation technology have a real impact.

There is an alternative source rule (as opposed to a transfer pricing rule) that would allocate income from technical services and the like to the place where the services are used, but this rule is widely resisted in treaty negotiations.[106] This rule partly reflects general difficulties tax systems have long had with the way in which services merge into property (especially intellectual property). Technology has given many more services some of the characteristics of property in that services can be used in a location other than where they were performed even if they are not regarded as having become property. It is considered that this source rule is implicitly being adopted for internal management services on the basis that it is the user (place of use) of the services which takes the risk with respect to the services. The provider of the services is generally treated similarly to a contract manufacturer, in this case appropriately, as the risk of loss (and opportunities for profit) are in an economic sense more likely located in the part (place) of the corporation that uses the services, not the part (place) that provides them. This is not to adopt a view that the export of services gives rise to tax jurisdiction in the country of use, as occurs in the treaty provisions that attract the opposition. The discussion here relates to use of the internal services by the firm in a country where it has FDI, that is, a subsidiary or a PE and not the simple export of services case.

This view of internal management services has wide application, as will become apparent in the discussion of property below. The idea provides a transfer pricing explanation for allocating profits in such cases between the locations of performance and use and reconciles the apparently all-or-nothing conflicting source rules for services (all at the place of performance or all at the place of use).

In summary of this part, the theory of the firm combined with the heterogeneity of firms suggests that profit allocation relating to labour is best done on the basis of total labour costs rather than under the significant people functions approach (trying to identify particular individuals who are regarded as contributing the major share of the firm profit). All the individuals contribute to the profit and their relative salaries are the most reliable measure of contribution. As elsewhere, in some cases profit allocation relating to labour can be done implicitly by market pricing of other (presumed) transactions. If the place of performance and use of services is different (as with certain internal management services), it is generally appropriate to regard the major part of the profit as allocated to the place of use of the services as the better reflection of the economic position. Transfer pricing rules for internal services provide this outcome and can be generalized, as further developed in relation to assets.

3.3.3. Assets

The approach that emerged in the finance area regards assets as giving rise to relatively uniform basic risk-free market returns and in the PE context allocates the assets, the basic return and the rest of the profit to where risk is managed in relation to the asset. By contrast, the theory of the firm often emphasizes asset specificity as one of the reasons for the formation of the firm and the capturing of profits on the assets which are not possible in normal market

106. Commentary on Art. 5, Para. 42.18, added in 2008 in relation to the services PE.

transactions.[107] The result is that many of a firm's major assets are specific to the firm and produce above risk-free rates of return. This view applies particularly but not only to the intangible assets of the firm. As noted above, the OECD has to some extent accepted the theory in this case and recently has reinforced it in relation to intangibles in the PE context.[108]

In this regard the transfer pricing issue for property has similarities to personnel and services. Property nevertheless presents more issues than personnel. As already noted for the merger of services into assets, there are questions whether profits are appropriately located where assets are created (if created by the firm, as is the case for most intangibles) or where used by the firm. In addition, as assets can also be the subject of separate legal ownership in a place different from the places of creation or use, there are three possible countries to which profits related to firm assets can potentially be located. Moreover, we can distinguish several types of assets to which different considerations may apply: assets used in the productive processes of the firm, which may be tangible or intangible and created by the firm or acquired by it; and assets in which the firm deals, which may be subdivided in a similar way. The discussion starts with assets created by the firm and used in the productive processes of the firm.

With respect to ownership of such assets, allocation of profit to ownership as distinct to the place of creation or use of assets raises the now familiar transfer pricing problem of freedom of contract. If ownership matters, then like contractual assignment of risk in the case of associated corporations, the location of profit will depend on a stroke of the pen. In fact we see a close analogue of the contract manufacturer in the area of intangibles for shifting profits, the contract researcher. If the firm wants to locate profits away from the place where the work creating an intangible occurs, the corporation in the group doing the research is treated as a contractor which does not take the risk of loss if the research fails. If it is wished to spread the profit around other parts of the group, whether including the researcher or not, the relevant corporations in the group will enter into a cost contribution arrangement under which they share the costs (risks) and benefits of the research. If it is desired to locate the profit where the work is performed, the researcher takes all the risk.

While contracts of all these types exist in the market, freedom of contract within the firm makes allocation of the profits arising from the research a matter of election for the firm. This is another case where freedom of contract needs to be constrained to produce a robust and meaningful allocation of profit within the firm. A significant part of transfer price structuring involves the location of ownership of intangibles within the corporate group. Even if intangibles are originally located where the research is done, they can be relocated by transfer of ownership within the group. There may be some upfront tax cost involved in such transfers. Still they figure significantly in current transfer pricing tax planning and are often associated with business restructures, which were discussed above. The firm seeks to centralize the management of its intellectual property interests (coincidentally in a tax-favourable location) and rolls the transfers into a larger restructuring project which gives cover for the tax planning. Ownership of intangibles is increasingly haven based. Accordingly freedom of con-

107. As in other areas of the theory of the firm, there are several interpretations of the reasons why firms are necessary to protect and maximize the value of assets – for example, Joskow, "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence", in Williamson and Winter, note 6, p. 117; Sautet, note 6, pp. 32-34, 79-81.
108. Attribution Report, Paras. 105-106.

tract in the ownership of assets area is a significant structural flaw in current transfer pricing rules.[109]

This discussion has concerned situations where assets used in production are created by the firm. In the case of acquisition of assets used in production, similar issues arise. Profits can potentially be allocated where the asset is acquired, owned or used. In this case the place of acquisition and ownership will often merge. Moreover, acquisition activity may be relatively trivial compared to creation situations, though much will depend on the circumstances. The place of use of such assets generally should be the major factor in allocation of profit; ownership should be generally irrelevant in its own right. For assets in which the firm deals, the same considerations apply to ownership. The allocation of profits arising from such assets, whether created or acquired, is postponed to the later section on sale.

If the place of ownership is (largely) eliminated, the remaining question is allocation of profit between the place of creation or acquisition and the place of use of assets. Because current rules distinguish between tangible and intangible assets, the following discussion does likewise. The focus is on PE situations, as the current rules for associated corporations accept that ownership matters, which is not a sustainable position for the reasons given above.

After initially leaning to freedom of contract for constructed transactions of PEs, so that the status of an asset used by a PE would be at the choice of the corporation, the OECD now takes the position that assets are generally owned by the PE where they are used (owned in the sense that the PE will have whatever interest in the asset that the corporation does). The effect is that if the asset is transferred to the PE from elsewhere in the corporation, there will effectively be a transfer of the interest to the PE. In other words, there will be a presumed sale transaction of the kind that has been discussed earlier (manufacture of asset at head office, sale of asset by PE, presumed sale of asset by head office to PE). Depending on relevant national law, gain may be recognized at the other part of the corporation that transfers the asset physically to the PE on the basis of the market value of the asset. Again depending on relevant national law, the PE will take the asset as owner and depreciate it or follow any other similar treatment that applies in the PE country.[110] If the asset is created by the corporation, any gain recognized in the transferring country is likely to be more significant than if the asset were acquired, but otherwise this approach can work equally well for created and acquired assets. It follows from this approach that if the asset is real estate in the PE country, it is treated as held by the PE.[111]

For intangibles, the issues are not so easily resolved. Initially it is important to distinguish production and marketing intangibles. The discussion here focuses on the former; the latter are left to the discussion of sales below on the preliminary assumption that they relate exclu-

109. The 1986 changes in the United States were driven by this problem. Rather than adopting the approach referred to in the following text, US law sought only in minor ways to constrain freedom of contract – by seeking to tax outbound transfers of intellectual property fully and allowing adjustments of royalty rates over time even if the original royalty rate were based on market prices when it was struck. Neither has proved effective to deal with the restructuring activity.

110. One of the benefits of this approach is that it is not necessary to rely on constructed transactions producing a different kind of interest in the asset for the PE from the interest held by the corporation. Constructed transactions would be particularly difficult in this area as the concept of ownership of tangible assets for tax purposes is a very nuanced one that would require very precise definition of the constructed transaction. If the PE takes the same interest as the corporation, the nature of the interest will be sufficiently defined for the application of national tax rules.

111. Attribution Report, Para. 104.

sively to the country of sale and so do not raise issues of allocation between the country of sale and another country. As noted above, such property is usually created by the firm rather than acquired. The position before the recent review of PE taxation was that a PE could only deduct its appropriate share of royalties paid on intangibles by the corporation to third parties, that is, no royalties on intellectual property created or acquired outright by the corporation were permitted. This was justified on the basis that:[112]

> In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g. payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights as well as the costs subsequently incurred with respect to those intangible rights without any mark-up for profit or royalty.

The property in effect is treated as an attribute of the corporation as a whole. The non-rival nature of intellectual property means that it is not possible to treat the property as owned where it is used in the same way as for tangible property, as it can be used in many places. Rather, all parts of the enterprise that make use of the intangible deduct a share of the costs of creation of the intangible and are effectively its owners. The presumed transaction is a cost contribution arrangement with all contributions valued at cost. It is considered that this is the appropriate outcome with one modification – the research location should be rewarded with some of the profit, as discussed above for internal management services.[113] The outcome is appropriate as the risk inheres in the intellectual property and is borne by those parts of the enterprise that use the property (that is, those parts for which it was created), but the place where the services of creating the intellectual occurred should have a part of the profit. This outcome is also consistent with the theory of the firm. The firm-specific assets are located where they are used in the firm's productive processes and services involved in their creation are rewarded.

The OECD position on this issue is more nuanced than in relation to tangible property, but can produce the result just indicated. The current Commentary receives particular criticism,[114] which is odd as the legal ownership argument is precisely the same argument that the OECD regards as critical in dealing with PEs and deploys in a variety of other contexts for PE attribution. The contrast with source rules noted above in relation to services is even more

112. Commentary on Art. 7, Para. 34. The "rule" about no deduction for internal royalties was stated in the 1950s, but the rationale quoted was only inserted in the Commentary in 1994.

113. If the research location also uses the intellectual property, effectively its contribution to that part of the intellectual property is valued at cost and it is not rewarded for that part of the services. The discussion in the text implicitly assumes a steady state firm with the use of the intellectual property by the various parts of the firm remaining constant over time. The analysis becomes more complicated in the real world where steady state does not apply. Current transfer pricing rules have to deal with this problem and have mechanisms for doing so which can be adapted to the approach in the text.

114. Attribution Report, Paras. 117-128.

striking here. It is generally accepted that income from intellectual property is sourced under traditional source rules where it is used, rather than where it is created, yet current transfer pricing rules for associated corporations (which allow freedom of contract) locate the profit where the property is owned. As a result intellectual property is at the centre of international arguments over division of taxing rights among countries.

The solution offered here is that in a broad sense the traditional source rule is the appropriate approach for transfer pricing; ownership is irrelevant but the place of creation of intellectual property should share in the profit as well. This approach can be extended to tangible property. It was noted above that the place of use of tangible property should be treated as its owner. Based on the discussion of intangible property, the place of acquisition or creation of the property should be rewarded for that activity if it were performed for another part of the corporation.

The measurement issues for property are very difficult if market prices have to be determined, particularly for firm-specific assets like intellectual property. One benefit of the approach suggested above is that the problem is largely avoided, as cost is generally used for property. The allocation of profit between the parts of the firm occurs indirectly through the pricing of products that ultimately are intended for sale to third parties, as discussed in the next part on sales. The main problem area is allocating profits between the place of creation and the place of use of property, but that again can depend on the circumstances, as noted for services above. The major point made here is that risk should not be treated as a separable issue and should be seen as residing in the property and mainly attached to the place where the property is used.

In summary, the major structural flaws of transfer pricing law in the assets area are the separation of ownership from creation or acquisition and use of assets, and the now familiar problem of freedom of contract as regards ownership. Risk is part of this story, as ownership in effect allocates the risk attaching to assets. If ownership by contract choice is eliminated from consideration as it should be, the issue is division of profits between the place of creation or acquisition and the place of use of assets. The view is expressed that the place of use should determine ownership/risk and that risk should not be able to be separated from the place of use. This is consistent with the theory of the firm in the emphasis on use of firm-specific assets as a main source of value in the production process. The place of creation of assets has a claim to a share of the profits, but not on the basis that that place takes the risk of the creation process. That risk is an attribute of the firm as a whole.

3.3.4. Sales

The end point of the firm is the sale of its products into the market. As noted above, under the theory of the firm an MNE exists to direct resources to make profits that are not available from leaving the allocation of resources to the market. It acquires those resources from the market and ultimately returns the products produced from directing those resources into the market through sales. The sale is as much a part of the direction of the firm's resources as the production process (as is what accompanies the sale, which will depend on the nature of the sale – for example, after-sales service, warranties and product liability in the case of common consumer products). Following from the two previous sections, part of the profit in the sense of allocating business income among countries should be allocated to the place or places where the firm's labour and assets participate in the sale process.

Because the sale is the end point of the firm, it needs to be identified carefully in the international context in a geographical sense. This takes us back to the boundaries of the firm discussed previously. It was noted there that the firm is identified geographically by what was called the dependency attachment. While that attachment includes employees and assets of the firm, it goes further to include non-employees and other assets which the firm directs without necessarily owning them in any legal sense, if the necessary dependency exists. The current PE definition falls short in not being fully based on dependency. Dependency does apply in the agency context and considerable tax planning occurs to avoid a legal agency for what is essentially agency in a commercial sense. In this way the firm is kept out of a country for international tax purposes and so the country is not allocated any profits of the firm. This tax planning is directed at the sale of the firm's products into the market and so is an important structural fault in the rules that affect sales. The fault was noted earlier but is repeated to emphasize its significance for sales. As with the previous discussion it is important to note that the discussion here does not concern the taxation of profits on exports in the country of destination. A country only has a claim to taxing rights if the firm is located (has FDI) there.

The tax planning is necessary because it is in fact difficult for firms not to establish a presence in a country if they have a significant market there for their products and want to move beyond export to FDI. Even though it was thought that e-commerce would make such presence less common in future, that outcome has not occurred significantly to date. Other variations on the earlier themes are used to move as much of the profit out of the country of sale as possible – freedom of contract among associated enterprises, shifting of risk by contract, movement of significant people to other more tax-favourable places and ownership of intellectual property in tax haven corporations. Together these strategies have been used in corporate restructures of the kinds described previously to remove profits primarily from the country of sale – in many cases also the country of manufacture.[115]

Hence, if the structural flaws in transfer pricing that have already been identified are fixed, then the jurisdiction of sale will have much of the profit restored to it that has been stripped out in recent years. The one remaining issue to consider is the class of asset that for many firms nowadays (particularly in business-to-consumer sales) is the most important – marketing intangibles like trademarks and goodwill. While these are subject to similar forms of tax planning to try to locate creation and ownership elsewhere, they are inherently connected to the sales market. The largest part of their creation in a particular market by definition almost must occur in the country of the market (with advertising there) and that is where they are used. To the extent that profits are attributable to such intangibles, the profits belong at the place of the market for the firm's sales, as they are an asset attached to that market.

The way in which firms have dealt with this issue has been implicit rather than explicit. The incompleteness of contracts within firms allows marketing tangibles to be simply left out of the analysis of profit allocation if they are not dealt with by contract and not recognized or properly valued for financial accounting purposes. In cases where trademarked goods are imported, the transfer price for the goods will often include the value of the trademark, which effectively allocates it to the place of manufacture, not sale. Yet while the trademark was attached at the point of manufacture, its value is not generated there so far as the sales market is concerned. In recent years the importance of marketing intangibles and the circumstances

115. See Vann, note 90, pp. 153-157.

of their creation and use have come to be recognized in transfer pricing, as well as the fact that they are inherently connected to the market of sale. While freedom of contract, risk and other problems of the kinds noted above are present in the OECD discussions, the direction of official thinking is similar as for assets, with the qualification that any difference between the places of creation and of use is not present to any degree.[116]

The recognition of marketing intangibles as created and used in the market of sale (that is, generally where the buyer is) in turn suggests that the boundary of the firm could be extended to include the market of sale where the firm is active in marketing and similar activities there and is not simply an exporter. The firm has assets there whose use is directed by the firm, and so the assets have a dependency attachment to the firm and constitute part of the firm. In the case of tangible assets it is recognized that a fixed place of business PE can exist where the assets are used in the firm's business, even if there are no firm personnel where the asset is located.[117] The same principle could be extended to intangible assets of a firm which are used in a jurisdiction, but this is not possible under current PE law, which requires a physical presence in the jurisdiction in the form of tangible assets or personnel. For now this possible limitation on the boundary of the firm is not greatly troubling, as it is in fact difficult for a firm to avoid a physical presence of the kinds discussed above in a market where it sells its products. Recognition of the importance of marketing intangibles and allocation of part of an appropriate part of the profit to them will represent a considerable advance in transfer pricing that will deal with the great majority of cases.[118]

The final point in relation to sales concerns the method used to achieve the allocation of profits to the sales jurisdiction. As the end point is reached with the sale by the firm into the market, there will be a true market price that can be used in the profit allocation process and so sales revenue is the obvious starting point for the allocation. The presumed transaction that naturally goes with the sale is the purchase of inputs by the part of the firm in the country of sale from the parts of the firm outside the country. Much of current transfer pricing tax planning for the sales jurisdiction involves trying to move the starting point of the allocation away from sales revenue. Although the point is not stressed in exactly this form in 3.2.3., it underlies the debate around freedom of contract and attribution of profits to dependent agency PEs. The presumed transactions permitted for allocation of profits in the sales jurisdiction should require sales revenue as the starting point.

In this part of the article it is suggested that many of the same flaws in transfer pricing rules identified previously are relevant to sales. Focus on one type of asset that is unique to sales – marketing intangibles – yields some further important conclusions about the current rules. First, marketing intangibles are often invisible in the analysis, which is possible because of the incompleteness of contracts within firms. Secondly, the existence of important firm-specific assets in the market of sale suggests that the definition of the firm could be expanded to include that market if the firm has some activities there apart from being an export destina-

116. The Attribution Report, Paras. 127-128 represents an advance from my perspective over the Guidelines, Paras. 6.36-6.39.
117. Commentary on Art. 5, Paras. 8-9, 42.1-42.10. The tendency to downplay the significance of assets to value is apparent here, however.
118. The USD 3.4 billion 2006 transfer pricing settlement between the IRS and GlaxoSmithKline indicates the magnitude of the issue, as the amount concerned profits from selling Zantac in the US market and significant reallocation to the place of sale (see Nutt, "Glaxo, IRS settle transfer pricing dispute", 112 *Tax Notes* (2006), p. 1020.

tion, though this will only be a pressing issue if it is possible for firms to make substantial sales in markets without any other physical presence there. As sales do involve an actual market price, that price should be the starting point of the allocation of profits to the sales jurisdiction.

4. Possible Solutions

This section first brings together the discussion above of the major structural flaws in transfer pricing and explores how those flaws may be remedied. It then considers if there are other rules that can support the specific rules in dealing with tax avoidance arising from transfer pricing or overcome flaws in transfer pricing rules which cannot be or are not remedied directly. In keeping with the rest of the article, the solutions are not provided in detail; rather, the direction and framework of possible changes are indicated. As it turns out we need not fear the end of the world – either the corporate tax or the current transfer pricing rules – nor continue to live in the current hard-boiled wonderland.

4.1. Fixing the transfer pricing rules

The current definition of the firm in transfer pricing rules – particularly the PE rule and ownership rule for associated corporations – falls short of the dependency attachment principle that is derived from the theory of the firm. Extending the definition to include dependency situations (like many distributors and franchisees), which could be done by requiring only a commercial rather than legal agency, would seem to be feasible as a practical test. Going further to include any country where the firm has sales (above a certain level and only when the firm has activities there beyond being an export destination) may create enforcement problems. These changes may not be necessary while firms continue to have a physical presence in countries where they have significant sales.

A major structural flaw in current rules is the freedom of contract that is permitted to associated corporations. Firms are often considered to be characterized by incompleteness of contracts and this freedom allows firms to fill in the details or not as they desire, and whether or not the details reflect the economic substance of what is occurring. Profit allocation can work through transactions but only if freedom of contract and the permitted transactions are constrained, or certain types of transactions are simply presumed which effectively allocate the residuum to the places where the firm is operating. Such a restriction on contractual freedom reduces the scope for tax planning under freedom of contract and seems a sensible starting point in using transaction prices as a method for allocating profits.

The next major structural problem identified in the rules was the heightened emphasis given to risk recently and the further views that risk can be freely assigned by contract between associated corporations within the firm, that only a small subset of firm personnel are responsible for risk (the significant people) and that risk is generally separable from assets. Limitation on freedom of contract can deal with the first issue. The others require more specific remedies. For personnel the assumption should be that their salaries reflect their relative contributions to the firm and that no specific group of personnel should be privileged. To the extent that different products of the firm have different profit levels, accounting records will be available to allocate profits and salaries of personnel appropriately, to the extent that this is not done through constrained or presumed transactions.

For assets the primary allocation of profit should be based on their place of use, with the place of creation of assets, if different, being given usually a lesser reward. Risk should not generally be treated as separable from the place of use of assets, especially firm-specific assets that are often regarded as one of the hallmarks of firms. This approach can be applied to both tangible and intangible assets, but is particularly important to the latter. For marketing intangibles this means that appropriate share of profits is allocated to the market of sale when the firm operates (has FDI) there. In a transactional setting for allocating profits among the parts of the firm, these views imply the presumption or constraint of a complete sale of the asset or services rather than some other form of provision from one part of the firm to another. These various constraints or presumptions seem to be workable – indeed they already exist in various areas.

Transactions may not allocate the full profits of the firm, or the construction of transactions may be thought artificial or difficult in particular cases. In this event it will be necessary to have recourse to some apportionment methodology. Such a method already exists in the form of profit splits, either of all the profits, or of the residual after allowing for partial allocation of profits by transactions. The discussion above, which has been couched in terms of personnel, assets and sales, will no doubt be read by some as simply another form of argument for formulary apportionment of the kind practised by the US states. These systems allocate overall profits on the basis of payroll, assets and sales. In fact it is not such an argument.

Formulary apportionment has become more problematic in practice over the years for a variety of reasons. Because the formula is arbitrary and is not based on any accurate assessment of the relative contributions to profit for firms generally, let alone specific firms, there is always a great temptation for states to change the formula when that seems to be in their favour. Moreover, it has not been possible to get any enduring agreement on the formula. Even if a formula based on the average firm is adopted, the heterogeneity of and evolution of firms means that it will not be accurate for any of them except by accident. In turn firms will feel less constrained in manipulating the formula on the basis that it is essentially unfair to individual firms. The use of sales in the formula potentially involves double counting. While the sales market should and will be allocated profits to tax under appropriate transfer pricing rules, this is because of the personnel and assets there involved in the sale (especially marketing intangibles). Using a fixed formula also means that measurement of the factors in a jurisdiction becomes critical and there are a host of measurement problems. In any event it is clear that there is not going to be any international agreement on simple formulary apportionment.

The profit split is a much more flexible apportionment methodology that tries to reflect the actual position of the firm. It also allows measurement and manipulation problems to be dealt with in part by choosing apportionment factors that are relatively robust and measurable. Moreover, if constrained or presumed transactions are maintained as part of the transfer pricing framework, firms can allocate all or much of the profit by that means. The resulting profit split then becomes a check on whether the allocation is appropriate in the circumstances.

The outcome in one sense is not far removed from the current transfer pricing rules, as it generally follows the contours of the rules by using transactions and focuses on similar issues. What is different and important are the constraints or presumptions that are introduced into the transactional framework. To some they may seem relatively minor changes, but for the transfer pricing specialist they will be recognized as major, even though articulated in a similar framework.

4.2. Are there other solutions for the growth of transfer pricing tax avoidance?

There is a range of other possible measures to deal with transfer pricing tax avoidance which are considered in this part, starting with the most specific and moving to the more general possibilities. One issue that they raise is which country should take the adjustment action. It was assumed in the previous part of this section that the action was being taken by the country from which profits are being shifted by transfer pricing. Based on the earlier discussion of the reasons for taxing corporations, there are two other countries that could deal with transfer pricing: the country of the headquarters of the corporate group or the country of the shareholder, even if they are not the country directly affected by the transfer pricing. If it is accepted that the country in which profits are generated under transfer pricing principles is the appropriate country to levy the corporate tax, it needs to be asked why the other countries should take action.

Many countries adopt controlled foreign corporation (CFC) rules to deal with deferral of tax by shifting income to corporations with headquarters in low-tax countries. The regimes are typically targeted at mobile passive income and transfer pricing. As the name of the regime suggests, it applies to situations of control of corporations in other (usually low-tax) countries. Typically, the most significant application of the regimes will be to corporate groups, rather than corporations controlled by individuals. The regimes operate in most cases by taxing the income in the "residence" country of the parent corporation of the corporate group (that is, its headquarters). Even if the shareholder is resident in the same country, it is not clear on the basis of the discussion in 2. why that country should make transfer pricing its concern, unless the transfer pricing is out of that country to another country. The application of CFC rules to transfer pricing is often limited to transfer pricing out of the country applying the CFC rules.

One problem with CFC rules is that they may have multiple operations if corporate groups consist of more than one tier of subsidiary, as they typically do. For example, if a listed US corporation has a subsidiary in Australia which in turn has a subsidiary in a tax haven deriving income targeted by CFC regimes, the CFC rules of both the United States and Australia may be engaged. In the case of transfer pricing, multiple applications will not be a problem if the CFC rules are limited in each case to transfer pricing out of that country. On the other hand, this limitation may reduce the efficacy of CFC rules. It may be clear when profits have been shifted to a tax haven by transfer pricing, that another country is not collecting its appropriate share of tax, but it may be less clear which country has suffered from the transfer pricing.

It has recently been suggested that countries with CFC regimes (typically OECD countries with significant numbers of MNEs based there) should coordinate their regimes so that the CFC regime of only one of them would apply in a given case in a uniform way.[119] Even though such overlap may not be an issue for transfer pricing if the CFC rules of each country are limited to transfer pricing out of that country, the idea could be extended to cover transfer pricing more generally. Each country with a CFC regime would become the enforcer of transfer pricing out of all countries in the coordinated regime, rewarded by the revenue from enforcing transfer pricing rules more generally. The justification for such an extension would be on a knock-for-knock basis, that is, each country would on average collect at least the same

119. Burnett, "Replacing CFC regimes with a collective attribution system", 38 *Tax Notes International* (2005), p. 1109.

amount of revenue if it limited its CFC regime to transfer pricing only out of that country. There is some voluntary coordination of CFC regimes at the moment, but nothing more concrete than that. More importantly for a variety of reasons, CFC regimes seem to be in decline in the sense that many countries are reducing their scope, including the removal of transfer pricing from their operation on the basis that the effect is to deal with transfer pricing differentially for resident MNEs and non-resident MNEs.

In the discussion of cause and effect in relation to revenue concerns about erosion of the international business tax base and problems in transfer pricing, there is often a *post hoc ergo propter hoc* assumption, that is, the rule being studied is defective in some way and because of that defect it is abused by taxpayers to lower revenue. The cure obviously is to fix the rule. So far in this article this has been the approach – to describe the problems that exist in transfer pricing rules in the context of the international tax system, why they have led to abuse and what the possible fixes are, including CFC fixes. The assumption and prescription are problematic, however.

If we lift our gaze from the individual trees for a moment to look at the forest, we should note that many tax systems have been plagued in recent years by corporate tax shelters.[120] Although the shelters often involve international tax issues in the plan to reduce tax, the use of such shelters applies across the whole spectrum of the system, domestic and international, and indeed may be thought mainly to apply to domestic income. It is true that corporate tax shelters often are devised after the event to eliminate large taxable gains that have already arisen or are reasonably certain and have one-off effects, whereas transfer pricing tax planning is applied in an ongoing way to reduce tax on future income that it is hoped but not certain will arise. Nonetheless, it seems plausible to assume that if MNEs are prepared to enter into one-off corporate tax shelters, they are also likely to plan in a systematic way to reduce tax on future income.

The implication is that while fixing the particular rules is one possible strategy to deal with transfer pricing as well as other abuses, other possible rule-based strategies include the use of business-purpose and economic-substance judicial tests and/or the adoption of a legislative general anti-avoidance rule.[121] Form over substance and similar rules could be applied to transfer pricing avoidance strategies where nothing of economic substance happens, such as risk shifting by contract within the corporate group. In many cases, however, there is economic substance. As noted above, corporate restructures often have commercial purposes as well as tax purposes. In that event the application of general anti-avoidance rules becomes more problematic.

As with CFC rules there are also issues of which country would apply its anti-avoidance rules. Generally the attitude of most countries is that its anti-avoidance rules only apply to avoidance of its own tax. Coordinated action of the kind discussed for CFC rules would be necessary if application of anti-avoidance rules by other countries were to be a possibility. This outcome seems even more unlikely than coordination on the CFC front.

120. For example, Bankman, "The New Market in Corporate Tax Shelters", 83 *Tax Notes* (1999), pp. 1775-1795.
121. In 2003 the OECD took the controversial position that tax treaties are subject to domestic anti-avoidance doctrines (Commentary on Art. 1, Paras. 7-26), which attracted considerable debate – for example, Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (IBFD, 2005), at pp. 78-92. Whether domestic anti-abuse rules can be used in treaty cases is an issue that will take some time to reach finalization in many countries.

Beyond substantive tax rules, it is also possible to address the incentives to enter into tax-motivated transactions through tax administration-related measures, such as increased auditing, higher penalties and greater information requirements (as to both record creation and reporting). In recent years many countries have taken action of this kind, directed at transfer pricing in particular. The most important of these measures probably are requirements of contemporary documentation of transfer pricing practices. Nonetheless it may be thought that these rules have increased compliance costs without having much impact on tax avoidance through transfer pricing, if we are to judge by claims of continuing tax avoidance with which the article started. Further there are issues of the kind already noted of which country requires which documentation, given that the countries are concerned with their own transfer pricing issues, not the problems of other countries, and of international coordination. In contrast to the CFC and anti-avoidance areas, international cooperation in this area is well advanced so that corporate groups can use common information and common formats of information to satisfy the documentation requirements of several countries.[122]

Continuing the metaphor of trees and forests, if we look beyond the tax forest to corporate behaviour more generally, there seems to be a fairly clear link between the recent problems in corporate governance and the growth in corporate tax shelters. If a firm is reporting fake profits for financial and corporate law purposes, it certainly does not want to pay tax on them. And if the managers of the firm are rewarded by reference to the (after -tax) profits of the firm, they certainly have an incentive to reduce the tax paid by the firm, which may encourage aggressive tax avoidance, including transfer pricing. Perhaps the remedy lies in corporate law either generally or in some tax-specific elements of corporate law (such as special corporate procedures or reporting in relation to corporate tax risk). There is some evidence of tax administrations taking this approach, but whether corporations are becoming more sensitized to the issue and more cautious as a result is unclear.

The issue once more is which country will apply the necessary corporate governance measures. In practice corporate governance strictures will be at their greatest at the level of the parent, usually listed, multinational corporation. In this case risky behaviour by firms from a corporate governance perspective would seem to be a concern even if it involves tax avoidance in another country. If corporate governance rules of countries take what is a selfless view from the tax perspective, then corporate governance rules may be an additional (and potentially more effective) international enforcement mechanism of transfer pricing rules.

Clearly it is important to keep these other mechanisms in mind when considering the ways in which transfer pricing can be counteracted. Generally, however, they would seem to provide additional rather than substitute protections against transfer pricing abuses. In terms of which country should take action to prevent abuses, these other areas suggest that it may be possible for countries to take action and so cooperate in transfer pricing enforcement even though they do not have a direct revenue interest at stake.

122. Guidelines, Chap. 4; Pacific Association of Tax Administrators (PATA – Australia, Canada, Japan and the United States) Transfer Pricing Documentation Package available at <http://www.irs.gov/businesses/international/article/0,,id=156266,00.html>; EU Code of Conduct on transfer pricing documentation available at <http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm>.

Appendix: Integration of Corporate and Shareholder Taxation

Part I – Relative tax at corporate and shareholder level under integration

For purposes of illustration of various points we will take two kinds of integration systems as representative: firstly, a dividend tax credit system under which corporate tax is attached to distributions from corporations and credited to shareholders (much like withholding from wages), and secondly a low flat-rate tax on dividends. Under the imputation system capital gains on shares are taxable in full, while under the low flat-rate system the same tax rate applies to capital gains on corporate shares. These capital gains arrangements are necessary for producing equivalent treatment under each system for retentions of corporate income, which are reflected in gains on sales of shares. The assumed corporate tax rate is 30%, the (maximum) individual tax rate is 40%, and in the case of the low flat-rate system the tax rate on dividends and capital gains is 15%. The first system has a resemblance to Australia and the second to the United States. Nonetheless most countries' integration systems can be aligned with these prototypes – for example, the first can be thought to represent broadly Canada and the United Kingdom, and the second broadly France and Germany.

Table 1

System	Imputation		Low flat rate	
	Distribution	Retention/sale	Distribution	Retention/sale
corporate income	100	100	100	100
corporate tax	30	30	30	30
corporate income after tax	70	70	70	70
shareholder income/gain	100 (70 distributed + 30 tax credit)	100 (price captures tax credit)	70	70
shareholder tax	10 (40 at 40%, less 30 credit)	10 (40 at 40%, but 30 tax credit available to buyer)	10.5 (70 at 15%)	10.5 (70 at 15%)
shareholder net	60	60	59.5	59.5

The main points of this example are twofold. The income derived through the company gets taxed in the end result at the shareholder's ordinary tax rate. In the case of imputation the correspondence is exact, while for the low flat rate it is close. The latter result is simply an artefact of the tax rates chosen but nonetheless is typical of rates found in systems that try to achieve rough-and-ready full integration for individual maximum-tax-rate shareholders. Further, most of the tax in each case is collected at the corporate level. Again this is a result of the relative corporate and individual tax rates, but again the rates are broadly representative of real-world rate structures in OECD countries.

Assuming that there are substantive reasons to levy the corporate tax in the country where the corporation is located and to integrate that corporate tax with taxation of the shareholder in the country of the shareholder, the calculations in Table 1 are still practicable but the result is that the bulk of the total tax goes to the country of the corporation, not the country of the shareholder. It is easiest in an administrative sense to achieve this result by the low tax rate method in Table 1 rather than imputation, as indeed the US system does; the low tax rate of 15% applies to dividends from foreign corporations as well as domestic corporations (and the low capital gains tax rate applies to gains on shares in foreign corporations).

Imputation is much more difficult to operate in this context, as it generally tries to tax distributed corporate income at the actual marginal tax rate of the shareholder, which requires refund of the corporate tax if the shareholder's tax rate is below the corporate rate. The country of the shareholder will not wish to refund foreign corporate tax. Mechanisms to deal with this problem are complicated but countries were experimenting until the European Court of Justice unfortunately and needlessly held that imputation was contrary to EU non-discrimination norms and killed the system off in Europe, where it had begun.[123] The ripples from Europe spread and only relatively few countries, like Australia, maintain the system nowadays. In its place have sprung up systems which are more approximate in their relief of double taxation, like the US system.

Part II – Integration where income is derived by permanent establishment of corporation

If the corporation derives the income from a PE in a third country, then the result in the shareholder country depends on a number of factors, of which the method of relief for double taxation in the country of the corporation is relatively minor. The following table illustrates these results. It assumes a corporate tax rate in the PE country of 25% and considers a foreign tax credit system in the country of the corporation and an exemption of branch income in that country. For the imputation system, the alternatives of giving tax credits or not in the country of the shareholder for the foreign corporate tax, at the corporate level only or at the corporate and shareholder levels, mean there are four permutations for that system.

Table 2

System	Imputation				Low flat rate	
	Imputation credits for foreign tax		No imputation credits for foreign tax			
relief of foreign tax	foreign tax credit	foreign exemption	foreign tax credit	foreign exemption	foreign tax credit	foreign exemption
PE income	100	100	100	100	100	100
PE tax	25	25	25	25	25	25
PE net	75	75	75	75	75	75
head office tax	5 (30 less 25 credit)	0	5	0	5	0
head office net	70	75	70	75	70	75
shareholder dividend income	100 (gross-up foreign and domestic tax)	100 (gross-up foreign tax)	75 (gross-up domestic tax)	75 (no gross-up)	70	75
shareholder tax	10 (40 less 30)	15 (40 less 25)	25 (30 less 5)	30	10.5 (70 at 15%)	11.25 (75 at 15%)
shareholder net	60	60	45	45	59.5	63.75

123. Graetz and Warren. "Income Tax Discrimination and the Political and Economic Integration of Europe", 115 *Yale Law Journal* (2006), p. 1186; Graetz and Warren, "Dividend Taxation in Europe: When the ECJ makes Tax Policy", 44 *Common Market Law Review* (2007), p. 1577.

Under an imputation system the result depends entirely on whether the imputation system in the shareholder's country grants any relief for foreign tax and is independent of the method of relief of international double taxation in the country of the corporation. If the shareholder country grants relief for foreign tax in the same way as for domestic corporate tax, then the result is the same as in the domestic case. If the shareholder country does not grant imputation relief for foreign tax, then the outcome in the shareholder country is the equivalent of giving the shareholder a deduction for the foreign tax – the shareholder is taxed on the net income after foreign tax (the head office net in the table).

For the low-rate system, the method of relief in the country of the corporation has some impact but the impact is relatively minor if the difference between the corporate tax rates in the country of the PE and the country of the corporation is not significant. If the country uses a foreign tax credit, the ultimate outcome for the shareholder depends on the corporate tax rate in the country of the corporation. If the country of the corporation uses the foreign income exemption, the result for the shareholder depends on the corporate tax rate in the PE country. If the corporate tax rates of the countries are similar, the variations in outcome are small, whichever country levies the tax.