



Working Paper 13

Is the International Tax System Fit for Purpose, Especially for Developing Countries?

Sol Picciotto

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International Centre for Tax and Development,
Institute of Development Studies,
Brighton BN1 9RE, UK
Tel: +44 (0) 1273 915637 Fax: +44 (0) 1273 621202
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Sol Picciotto

Summary

Taxes are a basis of national states, but they have been internationally coordinated since the emergence of taxes on income and profits, which were central to the legitimacy of taxation and the increased power of states in the 20th century. This paper traces the historical development of this international system, especially in relation to its interaction with the growth of transnational corporations (TNCs), and analyses attempts to adapt the system to the increasingly dominant role of TNCs in the world economy. It explains and discusses the key principles and concepts (permanent establishment, arm's length, controlled foreign corporations, transfer pricing), and shows that they have become increasingly inadequate especially following recent renewed economic globalisation. Contributing to current debates on reform of the system, this paper puts forward proposals for an evolutionary shift towards a unitary approach for taxing TNCs.

Keywords: international tax; transnational corporations; unitary taxation.

Sol Picciotto taught at the universities of Dar es Salaam (1964-68), Warwick (1968-1992), and Lancaster (1992-2007), where he is now emeritus professor. He is the author of *International Business Taxation* (1992) and *Regulating Global Corporate Capitalism* (2011), several co-authored books, and numerous articles on international economic and business law and regulation, as well as state theory. He is a Senior Adviser to the Tax Justice Network, and a member of the Advisory Group of the ICTD, for which he is coordinating a research programme on unitary taxation with special reference to developing countries.

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Abbreviations

ALP	Arm's Length Principle
APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting
BRICS	Brazil, Russia, India, China and South Africa
CaCbCR	Combined and Country by Country Report
CCCTB	Common Consolidated Corporate Tax Base
CFA	Committee on Fiscal Affairs
CFC	Controlled Foreign Corporation
CPM	Comparable Profit Method
CUP	Comparable Uncontrolled Price
DTT	Double Tax Treaty
FDI	Foreign Direct Investment
GAO	US Government Accountability Office
GDP	Gross Domestic Product
IAS	International Accounting Standards
ICTD	International Centre for Tax and Development
IFA	International Fiscal Association
IMF	International Monetary Fund
IPR	Intellectual Property Right
IRS	Internal Revenue Service
MAP	Mutual Agreement Procedure
OECD	Organisation for Economic Cooperation and Development
PE	Permanent Establishment
TIEA	Tax Information Exchange Agreement
TNC	Transnational Corporation
TNMM	Transactional Net Margin Method
UN	United Nations
UT	Unitary Taxation

Introduction

Is there an international tax system and, if so, why do we need it?

Some may question the topic of this paper. After all, surely taxes are national? They provide the foundation for national sovereignty, and the characteristics of the tax system reflect and shape the form of each nation state, according to fiscal sociology pioneered by Goldscheid and Schumpeter (Musgrave 1992). According to this perspective, the emergence of the modern fiscal state occurred in developed capitalist countries in the last quarter of the 19th century (Daunton 2001). Yet this consolidation of national states took place in a period of debate about the international scope of taxes, and awareness of the need for international tax coordination. This interaction between forms of taxation as the foundation of national state power and concern about their international scope and coordination has continued to be central.

The concept of tax justice underpinning the fiscal state rests on the broad acceptance as legitimate of both fairness in raising taxes and the effectiveness and accountability of expenditure (Daunton 2001, 2002). In liberal capitalist states, this depends centrally on income taxes. The notion that all citizens should contribute equally, and in proportion to their income, became the mainstay of the legitimacy of taxation in developed capitalist countries, sustaining state expenditure of an ever-growing proportion of Gross Domestic Product (GDP), and financing the welfare-warfare state that dominated the 20th century.

The shift to increasing reliance on income taxes took place in the first period of high liberal capitalism, 1880-1930, which inevitably raised the question of how to tax international income – to which states gave varying answers. Britain's income tax applied to all residents on their worldwide income, and for companies the courts took the view that residence was where the board of directors met, as they provided the finance. Conscious that many of the shareholders were foreigners living outside the UK, they recognised that the issue involved 'the international law of the world', but confidently replied to concerns that this might deter such investors that if they chose to place their money in London 'they must bear the cost of it' (Calcutta Jute 1876). Other capital-exporting countries, such as the USA and the Netherlands, introduced a unilateral foreign tax credit. Despite strong lobbying by British-based firms, the UK was reluctant to do so without international agreement. The issue was taken up through the League of Nations – leading to the formulation in 1928 of the first model tax treaties, which laid the foundations for the present international tax system. The treaty network which provides the skeleton of that system was constructed in the middle decades of the 20th century, the high point of the Keynesian state, and in the period of post-colonial nationalism of the 1950s and 1960s.

Colonial and dependent territories, however, generally took the form of what can be called tribute states, relying substantially either on levies on natural resource extraction, or on land, hut or head taxes. Capitation taxes had the dual role of coercing indigenous populations into the money economy of international capitalism, and creating new concepts of private and public wealth, policed by the state institutions of governance. Thus, the post-colonial states generally inherited a system in which, due to their tax basis, the exercise of political power rested on the definition and regulation of the boundaries of licit wealth, and the power of its appropriation (Roitman 2005). This has blurred the lines between state and elite revenues (Moore 2011), fostering both endemic corruption and the emergence of military-commercial alliances in many states (Roitman 2005), and moulding the characteristic governance problems of so-called weak and failed states. Establishing a more effective and legitimate basis for such states to generate their own resources is now regarded as central to resolving their governance problems.

Thus, it can be seen that the fiscal powers that underpin the sovereignty of the national state depend on the international framework for their coordination. Indeed, as I hope to show here, the strengthening of this coordination is essential to the reassertion of effective governance in the current era of renewed economic globalisation.

For both developed and developing countries, the road to improved governance depends on re-establishing the efficacy and legitimacy of general taxes, especially on income. This has generally extended to the income of both natural and legal persons, i.e. companies. Arguments have often been made, from an economic perspective, to exclude corporate profits from income taxation, usually on the grounds that it is a cost that is just passed on to consumers. This idea is based on the view that companies do not really exist, they are no more than a bundle of contracts between shareholders, other lenders and the company's officers and employees, as well as its suppliers and customers. But firms are real organisations, and are protected by the state as separate legal persons, because of the economic advantages of combining activity (especially labour) under centralised direction (Coase 1988: 39-40). To encourage this, states grant companies special privileges, especially limited liability. These rights should also carry responsibilities, particularly the payment of taxes on the profits earned by the company, to help pay for the collective services and infrastructure which help to generate those profits. More pragmatically, corporate income tax revenue accounts for an average of 8-10 per cent of the tax take in developed countries, and generally double that percentage in developing countries. Ending corporate taxation would mean either enormous cuts in public expenditure or large increases in taxes on individuals. It would also open the door to all kinds of avoidance, as people could form companies through which to carry on their trade or profession. This would shift the burden of income taxes to employees.

If this international tax system helped establish the modern fiscal state, its continued vitality is central to sustaining that form of state. This seems to be a point of agreement in the rhetoric of both its defenders and critics. Those who campaign vehemently against the erosion of national tax capacity, especially through international evasion and avoidance, argue for the need to maintain beneficial social spending in areas such as education and health (Murphy 2011). On the other side of the coin, those who no less strongly attack international tax coordination as a state cartel, and justify tax competition from tax havens, make no secret of their preference for a reversion to a minimalist, nightwatchman state (Mitchell 2007).

Certainly, there is considerable ferment today around international tax. There is much concern particularly about the secrecy system, centred on tax havens, which facilitates not only extensive tax evasion and avoidance, but also the major problems of laundering proceeds of crime, including corruption, and capital flight. Although distinct, these matters are interrelated, so that a remedy for the running sores of tax evasion and avoidance would make a significant contribution to a cure for the other ills.

The ways in which taxation is internationally coordinated also clearly strongly influence the international allocation of capital investment. The goal for a tax system, of establishing a neutral environment for investment decisions, is obviously very difficult to attain internationally, especially when there is strong competition between states to attract foreign investment.

All these considerations should, I think, convince any doubters of the importance of understanding the international tax system – especially as it applies to corporations, which is my topic here.

1 The institutional framework for international tax coordination

The formal legal structure, or skeleton, for international tax coordination is provided by the bilateral treaties for the avoidance of international double taxation and prevention of fiscal evasion. These are usually referred to as double tax treaties (DTTs).²

The first model DTTs were drawn up at a League of Nations conference in 1928, which set up a Fiscal Committee. This Committee continued to meet during the Second World War in the western hemisphere, and issued a new model treaty in Mexico in 1943, influenced by Latin American capital-importing countries. This tended to favour taxation at source (that is, where the income is generated), as opposed to residence (the home country of the investor). A subsequent model issued in London in 1946 shifted towards residence taxation. The League of Nations' work was taken up by the United Nations (UN) under a Financial and Fiscal Commission; it quickly became deadlocked by east-west and north-south splits, and ceased to meet after 1954. In 1956 a Fiscal Committee was set up under the Organisation for European Economic Cooperation³ (which administered the Marshall Plan), and allowing the inclusion of countries from other parts of the world. The Committee on Fiscal Affairs (CFA) is now part of the OECD's broader tax work; it consists of member state representatives, and is serviced by a very large number of staff.⁴

In 1967 the UN set up an Ad Hoc Group of Experts on International Cooperation in Tax Matters. This was prompted by Prof. Stanley Surrey (then working for the US Treasury), concerned that developing countries (especially in Latin America) had been unwilling to sign up to OECD-style treaties, although some former European colonies had inherited treaties extended to them by their mother countries. The work of this Expert Group focused on adapting the OECD model DTT to the needs of developing countries, to produce a UN model. It was slightly upgraded to a Committee of Experts in 2004, but still has minimal resources (only 1.5 professional staff) – especially compared to the OECD, which in practice dominates the system. The OECD continues to try to marginalise the UN, by opposing any upgrading of or additional resources for the UN Committee, and confining its work to the model treaty, which it insists should be based on the OECD model with only minor modifications. The OECD has also admitted Observer states to the work of its Fiscal Committee, and established a Global Forum in 2003. This was initially described as a Global Forum on Taxation, and then as the Global Forum on Transparency and Exchange of Information for Tax Purposes, which includes tax haven states. It has a Global Relations Programme, largely funded by voluntary contributions, which conducts extensive training and outreach activities.

This institutional structure is now clearly outdated and dysfunctional, as many have pointed out. With the increased economic importance of the emerging economies (Brazil, Russia, India, China and South Africa (the BRICS)), the G20 has recently become the forum where a political impetus is given to technical work on fiscal and financial regulation. This still

² The main model tax treaties, starting with the first ones of 1928, have been helpfully made available by Prof. Michael McIntyre, at <<http://faculty.law.wayne.edu/tad/treaties-historical.html>>. Additional very useful historical documentation has been provided by Prof. Richard Vann at <<http://setis.library.usyd.edu.au/oztexts/parsons.html>>. For a more detailed discussion of the historical development of the international tax system see Picciotto (1992, chs. 1-3).

³ Renamed the Organisation for Economic Cooperation and Development (OECD) in 1961.

⁴ The numbers are not publicly available; however, they have grown rapidly from the 1990s, during the leadership of Jeffrey Owens. At the beginning there were a handful of people responsible for the work of the Fiscal Committee. This then expanded to take on ever-increasing tasks, resulting in the establishment of the Centre for Tax Policy and Administration; now there are around 100 staff, generally seconded from or former officials of national tax authorities (Owens 2012).

excludes most states, especially the vast majority of developing countries. Furthermore, the technical work on tax has invariably been referred to the OECD Fiscal Committee, perhaps inevitably as it is the only body with adequate resources. In late 2012, for example, the public disquiet about tax avoidance by transnational corporations (TNCs) led Osborne, Schauble and Moscovici (the UK, German and French finance ministers), to ask for an urgent progress report from the OECD Fiscal Committee's project on Base Erosion and Profit Shifting (BEPS), produced for the G20 meeting held in Russia in February 2013 (OECD 2013a). More on this below.

This asymmetrical relationship between the OECD and the rest of the world on an issue as central to governance as taxation reeks of neo-imperialism. Calls to establish an international tax organisation to provide a more inclusive, and hence legitimate and effective, framework go back some way – at least to Richard Vann's proposal in 1991 (Vann 1991), Vito Tanzi's in 1999 (Tanzi 1999), and made with some political support by the Zedillo report to the UN Financing for Development Conference in 2001 (Zedillo 2001). The minimalist response to these calls, however, was the creation of the International Tax Dialogue in 2002, by the OECD, IMF and World Bank, and the main OECD countries have continued to block any upgrading of the UN Committee or expansion of its resources. While there are legitimate concerns about the deadening effects of the UN's byzantine bureaucratic politics, the OECD's domination of international tax is clearly unsatisfactory.

Beyond these institutional questions, there is the deeper dilemma of what may be termed the culture of international tax. In common with many areas of global governance, the central issue is the gulf between technicism and politics (Picciotto 2011: 22-24). If tax treaties are the skeleton of the international tax system, and flesh is put on these bones by additional authoritative documents, such as the Commentaries to the model treaties, its sinews are the experts who construct, elaborate and operate the system. They form a specialist community with its own knowledge, language and culture, formed and strengthened through the activities of organisations such as the International Fiscal Association (IFA), and through contacts in professional practice. These technical specialists began to emerge in the early days of formulation of the treaty system, participating in the work of the League of Nations, and then advising corporations. A notable example was Mitchell B. Carroll, an American partly educated in Europe, who worked for the US government, became the US representative on the Fiscal Committee, then went into private practice, helped to found the IFA, and was its long-serving first president.

It was certainly a significant achievement for Carroll and his colleagues to lay the foundations of international tax coordination, largely through this type of expert work, in the interwar period of economic turmoil and political conflict. One can also perhaps understand that the same low-profile technicist methods would continue in the post-war period of the Cold War and decolonisation. It has become increasingly apparent in recent years, however, that international tax raises such important issues of economic, social and political concern that it cannot be left only to experts. The technical nature of their work weakens the political accountability of those working for government, while the involvement of private practitioners gives business interests disproportionate influence.

The importance for developing countries of maximising their own resources, rather than continuing the debilitating reliance on external aid, has brought tax questions to the fore. In developed countries, also, the increased resistance of individual taxpayers to their growing tax burden began to generate debate about tax fairness, and this was much heightened with the fiscal crises resulting from the financial crash of 2007-8. This new context has led to widespread media coverage of tax issues, especially concerning tax evasion and avoidance by both rich individuals and large corporations. Civil society organisations have also begun to examine these issues more closely, and this has perhaps begun to close the gap between political concern and technical knowledge. Much remains to be done, however, if we are to

improve both the quality of public debate and the accountability of technical work in this important field.

Here, however, we will next plunge into a consideration of the substance of the international tax system, beginning with an account of its historical development. This should provide a basis for a discussion of its current state and travails.

2 The tax rules for international business

2.1 Origins of the tax treaty rules

From the beginning, the design of the rules for international tax cooperation was closely bound up with consideration of how they would affect international investment flows. When the first model tax treaties were formulated in 1928, most businesses and corporations were national, and international economic flows mainly consisted of trade and portfolio investment. Portfolio investment involves lending, by banks and by investors in bonds or shares, to business ventures abroad. This is very different from foreign direct investment (FDI), in which the investor controls the foreign business – this generally takes place through companies based in one country that set up or take over businesses in other countries, and hence are referred to as transnational corporations (TNCs).

Aimed at portfolio investment, the rules in the model tax treaty envisaged an investor in a 'home' state lending to a separate business enterprise in a 'host' or recipient state. From this perspective, it seemed fair that the host state should tax the profits of the actual business, while payments to a foreign investor (of interest or dividends) should be taxed by the home state, as part of the income of the investor resident in that state. This would ensure that all businesses in the host state are subject to the same taxes whether they are funded by local or foreign investment (later called capital import equity), while investors in the home state should pay the same taxes whether they place their money at home or abroad (capital export equity). Equally, it meant that both businesses and investors paid taxes in the countries where they had the most ties, so contributing to the collective services from which they benefited.

However, some FDI had taken place since the 1870s, leading to the emergence of the first TNCs. Tax authorities were aware that local branches or subsidiaries (affiliates) of foreign companies were rather different, because of the control exercised by the foreign owner. The 1928 model treaty allowed a host state to tax the profits of the local branch of a foreign company, but only if it constituted a Permanent Establishment (PE). However, a branch is not a separate legal person, and might not have separate accounts to those of the company as a whole. A subsidiary is a separate legal person, but any accounts it might be required to produce would be strongly influenced by its relationship to its parent, with which it would be likely to have significant two-way flows of finance, goods and services.

To deal with this, countries had enacted laws giving their tax authorities powers to ensure that the tax base of a branch or affiliate of a foreign firm reflected a fair proportion of the profits made by the firm as a whole. In the UK, for example, from 1915 the Inland Revenue had the power to tax a non-resident doing business in the UK through an agent, branch, or subsidiary on a share of the total profits based on the proportion of turnover in the UK.⁵ Similarly, German courts developed the concept of organic unity (*Organschaft*) to allow taxation of TNC affiliates on a proportion of the TNC's global profits (Picciotto 1992: 177-83).

⁵ Finance (No. 2) Act 1915, s.31 (3) & (4).

For practical reasons, it might be best to start from the accounts of the affiliate, but tax authorities all agreed that they needed legal powers to adjust these to ensure that the profits shown and hence tax payable were proportionate to the affiliate's contribution to the group as a whole.

There was therefore a need to accommodate the special case of TNCs to the provisions of the model tax treaties drawn up in 1928. The various methods used to deal with the special case of TNCs were examined by a study for the League of Nations Fiscal Committee in 1932-33, coordinated by Mitchell B. Carroll (already mentioned above).⁶ Carroll found that in the case of a branch or subsidiary of a TNC, most national tax authorities tried as far as possible to assess the income of the local entity on the basis of its own accounts. However, they generally also insisted on checking whether such accounts were a true reflection of the entity's activities. This verification usually relied on comparing the accounts with those of similar but independent local firms, as well as examining the accounts of the parent or related business to ascertain the breakdown of income and costs with the affiliate.

If these methods proved inadequate, they fell back on what the report described as 'empirical methods'. This entailed assuming that the local affiliate made the same percentage profit as the enterprise as a whole, or as others in a similar line of business, and assessing its taxable profit by applying this percentage either to its turnover, or to some other factor such as capital employed. The UK report to Carroll's inquiry estimated that in some 55 per cent of cases an assessment could be done on the basis of the affiliate's own accounts, although with careful checks on the pricing of internal transfers, and often with adjustments negotiated with the taxpayer. In a further 20 per cent of cases, a percentage of turnover would be used, and in the final 25 per cent a percentage of another factor (e.g. assets for banks, train-mileage for railways). The UK report stressed that the 'fact that the revenue authorities have the alternative of basing profits on a percentage of turnover prevents the taxpayer taking up an unreasonable attitude' (League of Nations 1932: 191).

Carroll also reported that some systems used an alternative method, which he described as fractional apportionment. In particular the report from Spain stated that in 1920 it had abandoned assessment on the basis of the accounts of the local entity, since many branches of foreign companies showed little or no profit. It argued strongly that the only way to ensure that no enterprise would be taxed at more than 100 per cent of its total profits was to start from the accounts of the firm as a whole. Under the Spanish system, any branch or affiliate forming a unity with a foreign company was assessed on the basis of a proportion of the unitary firm's total profits. The appropriate allocation percentage was fixed for each firm by a committee of experts, having regard to the accounts of the affiliate (if they existed), and with a right of appeal. The Spanish report argued that this method also entailed the least interference with the enterprise, since it did not require the checking of hundreds of internal prices, which would result in the substitution of often arbitrary figures, and taxation on the basis of largely imaginary accounts.

Profit apportionment was also used in some other systems: for example, the French tax on revenue from securities (interest on bonds and dividends on shares) was applied to such payments by foreign companies with affiliates in France, based on the proportion of assets in France. The fractional approach was also used in federal systems, in particular by Swiss cantons and a number of states in the USA, and in a few international treaties, such as those of Austria with Hungary and Czechoslovakia.

⁶ The full study consisted of five volumes, the first three containing reports from 27 states (League of Nations 1932, 1933a, 1933b); the fourth was Carroll's own report (Carroll 1933), and the fifth by a US accounting professor Ralph C. Jones, *Allocation accounting for the taxable income of industrial enterprises* (Jones 1933).

2.2 International apportionment and the Arm's Length Principle (ALP)

The Carroll report (Carroll 1933) recommended that the international system should be based on treating affiliates as separate entities from the parent, but their accounts could be adjusted as appropriate. Carroll considered that the aim should be to ensure that there had been no diversion of profits, so he recommended that such adjustment should be based on the 'independent enterprise' standard. Accounts should be based on what became known as the Arm's Length Principle (ALP): attributing to the entity 'the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions'.⁷ This was adopted as the basis for treaties based on the League of Nations model, and with some rewording remains the principle laid down in model treaties today (OECD 2010a, Article 9).

The report recognised that various methods would need to be used to adjust accounts to ensure a fair apportionment, especially because within an integrated business it is often hard to allocate items of income and expenditure to a specific source. General overhead expenses, such as the costs of the centre of management, and the financing of capital items benefiting the enterprise as a whole, were commonly allocated by tax authorities using some kind of formula. Carroll considered that this was different from a general formula apportionment of profits, and compatible with the ALP. In the case of separately incorporated affiliates of a TNC, the starting point should be their own accounts; if these diverge from the ALP, an appropriate adjustment could be made to the profits and taxed accordingly.

Allowance was also made for states to continue to use fractional apportionment if they had customarily done so, although only for Permanent Establishments (PEs). This provision is still included in article 7 of the UN model DTT (subject to the proviso that such an apportionment must comply with the ALP), but it was dropped from the OECD Model at the last revision in 2010, which made significant changes to article 7. However, this was not accepted by all OECD states, and has not yet been widely implemented by renegotiating actual tax treaties. The current anxiety about low effective tax rates of many TNCs, especially those in the digital economy, has revived concern about the appropriateness of the definition of PE in article 5, as well as the rules for attribution of profits to it in article 7. Since the PE concept is based on physical presence, it does not cover virtual presence through the internet, allowing digital economy companies to make large profits from selling services and products in a country while paying no taxes there.⁸ This was highlighted in

⁷ Article III of the Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation, adopted by the League of Nations Fiscal Committee: see Report to the Council on the Fifth Session of the Committee Document C.252.M.124.1935.II.A, available from <<http://setis.library.usyd.edu.au/pubotbin/toccer-new?id=brulegi.sgm&images=acdp/gifs&data=/usr/ot&tag=law&part=9&division=div1>>; the 1935 convention was added as a Protocol to the League of Nations model treaties in both the Mexico and London versions.

⁸ The OECD Fiscal Committee issued its first proposals on taxation of e-commerce in 2000; despite the views of some states (notably Portugal and Spain) that the physical presence requirement was inappropriate in the digital age (OECD 2000, para. 6), it recommended staying with the classic concept of a PE. This entailed rejecting the view that a website could be a PE, even if it is in the local language and aimed exclusively at local consumers; on the other hand, a server could in some circumstances be considered a PE, because it has a physical presence. This perverse logic was followed to the bitter end in extensive detailed work in a Technical Advisory Group including industry representatives (OECD 2005). The results were embodied in a section on Electronic Commerce in the revised Commentary to the Model Convention of 2010 (OECD 2010a paras. 42.1-10), but reservations were expressed on these by several OECD states (Chile, Greece, Mexico, New Zealand and Turkey), and many non-OECD states (Argentina, Brazil, Hong Kong, India, Indonesia, Latvia, Malaysia, the People's Republic of China, Romania, Serbia, South Africa and Thailand). In parallel, the OECD revised article 7 on attribution of profits to a PE, to treat a PE similarly to an affiliate (OECD 2006, OECD 2008); this 'authorised OECD approach' was implemented in the 2010 version of the model treaty (OECD 2010a), but rejected by developing countries and the UN Tax Committee. The inappropriateness of this approach very quickly became apparent with the growing press reports that internet giants such as Google and Amazon were effectively able to avoid taxation on sales; for example, Google's sales of advertising in many countries are booked through an affiliate formed in Ireland, but considered under Irish law as resident in Bermuda, as its management is located there (termed the 'double Irish': Sandell 2012). This has led some countries to reconsider whether to adopt this approach: for example, in May 2012 the Australian government referred this question to its Board of Taxation. But the PE principle can be tenacious: an attempt by the Indian tax authorities to tax Google and Yahoo on profits from sales of advertising was rejected by a Tax Appeals Tribunal, despite the reservation expressed by India to para. 42.2 of the Commentary to the

particular by an experts' report for the French Ministry of Finance, which called for a reconsideration of the PE concept, and of other tax treaty principles, as part of the BEPS project (Colin and Collin 2013: 121). The first report from the BEPS project echoed the same point, and agreed that revisions of the model treaty are needed (OECD 2013a: 52), but the BEPS Action Plan issued in August envisaged a more modest provision to prevent the artificial avoidance of PE status (OECD 2013b: 19).

In 1933 it was understood that the ALP did not establish a clear or precise measure, but at best a general principle. Indeed, the German report accepted that fractional apportionment was superior in principle, and would in practice be used in the many cases where separate assessment was not feasible (League of Nations 1932: 122). However, the consensus was that a unitary approach would be difficult if not impossible to adopt for political reasons,⁹ since it should be based on international agreement on: (i) tax accounting principles for assessment, and (ii) a common allocation formula. The ALP was obviously much easier to operate in a network of bilateral treaties. However, its adoption merely converted the problem from a decision on the principles of general apportionment by formula to negotiation of specific ad hoc apportionments, by adjustment of transfer prices to ensure a fair profit split. The German report stressed that this would in practice require close cooperation between tax authorities, from which more general principles could perhaps emerge. I think it can be said that after eighty years of experience we have finally reached this point, as will be argued further below.

Carroll reported not only that some firms manipulated internal transfer prices to reduce their tax bill, but also that others considered that, despite their meticulous efforts to allocate profits fairly, tax authorities of different countries took different views, which could result in assessment on more than 100 per cent of the total profits. However, the report did not recommend giving the taxpayer any remedy for the latter. The model treaties provided only for discussions to resolve disputes between the states, with the possibility of an advisory opinion by a technical body of the League of Nations. The post-war model DTTs did give the taxpayer the right to present a claim to their national tax authority, but such a claim should be resolved by consultation between the authorities concerned, with no guarantee that conflicting adjustments must be resolved. This mutual agreement procedure (MAP) has been a major target of complaint by TNCs due to the time it takes and its arbitrary nature. In recent years tax treaties have begun to include provisions for arbitration as a fallback to resolve such conflicts,¹⁰ and a multilateral system for such arbitration has been in place in the EU since 1990. Regrettably, however, these procedures are highly opaque – the outcomes are rarely published, so they remain known only to the participants and the well-paid advisors, particularly from the major accounting firms. This lack of transparency is detrimental to the system, as it does not allow the development of a body of practice that is widely known and could guide others.

OECD Convention that a 'website may constitute a permanent establishment in certain circumstances' (Right Florist 2013). Developing countries which have retained a wider scope for source taxation in their treaties and national laws are likely to want to exercise this in relation to e-commerce, but may nevertheless feel constrained in doing so by tax treaties. This was evident for example in the Guidelines for Taxation of E-Commerce issued by the Inland Revenue Board of Malaysia on 1 January 2013 (Malaysia 2013).

⁹ This is entirely understandable in view of the political weakness of the League of Nations: the US did not join that body due to a negative vote in the Senate; Russia and Germany were not admitted; and others such as Japan left. In that context international coordination under its auspices of issues such as tax, with the participation of non-member states and indeed in this case with US leadership, was clearly only possible without the involvement of politicians. Since then the technical experts have constructed a system which is now producing outcomes which are equally clearly politically unacceptable.

¹⁰ An arbitration provision is included in the 2010 OECD model, and a similar one is an option in the UN model of 2011. It is noteworthy that the MAP procedure applies (under article 9(2) of the model treaty) to deal with pricing between related enterprises (indeed these are the majority of MAP cases), even though these are not strictly issues of double taxation. The term sometimes used is 'economic', as opposed to 'legal', double taxation, since it concerns the same economic entity although different legal persons; paradoxically, the economic concept of a unitary firm is used to identify when there is double taxation, although the standard applied is the separate-entity Arm's Length Principle.

Thus, the approach adopted attempted to reconcile the specific case of TNCs to the general principles for treatment of international investment in tax treaties, being based on the ALP but subject to adjustments reallocating profits as necessary, including formula apportionment of specific items of general expenditure. From the 1930s, however, with the imposition of currency controls international lending dried up, and from the 1950s foreign direct investment by TNCs became the dominant form of international capital flows.

2.3 The tax treaty system and international avoidance

Although model DTTs were formulated early on, it took longer to negotiate actual treaties. This occurred in the second half of the 20th century mainly through the OECD. OECD members were both exporters and importers of capital, so found it easier to agree on principles for allocating tax jurisdiction. Nevertheless, it took over twenty years from the establishment of its Fiscal Affairs Committee in 1955 for the OECD countries to negotiate a network of DTTs among themselves, as well as some with other countries.¹¹

In the meantime, TNCs became adept at exploiting the many loopholes in the interaction of national tax laws in order to minimise their tax exposure. From their perspective, many of the devices to which they resorted were necessary and reasonable, to counter the inadequacies of international coordination. Two main techniques were devised. One, dealt with in the Carroll report, was profit-shifting by the adjustment of internal transfer prices, which came to be known as transfer pricing (Carroll 1933). The second, which became much more important, was the creation of intermediary entities in convenient jurisdictions or tax havens.¹² Wealthy individuals and families had already pioneered this device for tax evasion (illegal tax-dodging) early in the 20th century. The further development and systematisation by TNCs of the facilities and techniques of the tax haven system had much more far-reaching and serious consequences. Like dangerous drugs, the facilities offered by the offshore system became addictive both to TNCs and many other users, while the suppliers of these facilities came to think there was no other way they could earn a living.

The basic principles of tax avoidance can be summarised quite simply, although many of the techniques became extremely complex. Essentially, it consists of channelling payment flows through entities (a company, partnership, trust or other legal person) formed in jurisdictions where such receipts would be subject to low or no taxes. This can be done by using these intermediary entities to carry out activities (e.g. financial transactions, transportation, providing advice or other services), or to act as holding companies owning assets (e.g. intellectual property rights (IPRs), bonds, shares). These entities usually only exist on paper, perhaps with a nameplate on an office building, but diverting payments to them by well-designed routes can greatly reduce taxes on the corporate group of which they form a part.

It should be stressed that these methods do not usually involve deliberate and therefore unlawful tax evasion, but entail finding ways through the often murky grey areas of tax law for tax avoidance. A central bone of contention is the claim of the home state to tax the worldwide profits of 'their' TNCs, subject to a credit for foreign taxes paid, including those profits from their foreign operations which are not actually remitted to the parent. In the US in particular there have been long debates about whether and the extent to which such tax

¹¹ Some OECD countries (e.g. the Netherlands and the UK) extended their tax treaties to their colonies and dependencies, and they continued these after independence.

¹² Whether a country can be used as a haven depends both on its laws and their interaction with those of other countries. Hence, any country might be a haven: for example, Canada's Newfoundland was used as one in the 1920s and 1930s. Over time, some countries have refined their laws, usually at the behest and with the help of advisers specialising in avoidance, and these are recognised as the main havens. Some specialise in particular activities (e.g. hedge fund formation, captive insurance, brass-plate companies); what they have in common is a high level of secrecy, especially in relation to enforcement of other countries' taxes (see Picciotto 1992: 132; Tax Justice Network 2007).

deferral is legitimate dating back to the 1950s (Picciotto 1992, 109-116). These are still alive today (Fleming, Peroni and Shay 2009; US Congress 2013).

An argument in favour of deferral is that these profits are subject to tax at source, as the business profits of the affiliate in the host country. However, the tax liabilities of such affiliates can be greatly reduced by deductions as costs of payments to related affiliates, as interest on loans, royalties for intellectual property rights, or charges for services. This minimises the host country's taxation of the affiliate's profits, while withholding taxes on the payments can be reduced or eliminated if they are routed through a conduit company in a country with which the host has a tax treaty. The profits can then be passed through to another affiliate in a country which either has no or low taxes, or exempts foreign-source profits. Such techniques in effect provide TNCs with a cash flow of retained earnings which have been subject to low or no taxation, and which can be used for further expansion of their business (Picciotto 1992: 114-5).

This is the reason for the offshore accumulation of untaxed 'stateless income' (Kleinbard 2011a), estimated for the US alone at over \$1.7 trillion. In May 2013 it was reported that Apple, which was estimated to have a \$145 billion cash pile, planned to borrow \$17 billion to partly fund a special dividend. As an editorial in the *Financial Times* commented (2 May 2013), 'Tax makes companies do strange things': this was just a more tax-efficient way to satisfy shareholders than repatriating profits which would be taxed; the interest on the loan would be tax-deductible.

The rapid growth of TNCs since the 1950s, much of it funded through such retained earnings, led to the systematisation of these techniques of avoidance. Indeed, that growth was partly due to the ability of TNCs to reduce their cost of capital by using such avoidance techniques to reduce their effective tax rates overall. The use of tax havens was also linked to the growth of the offshore finance system, which offered facilities, above all secrecy, which could be used for both avoidance and evasion, as well as money-laundering. TNCs became the main users of the haven system, lending it some respectability. If this could be removed it would be much easier to deal with these disreputable uses.

Concerns about tax avoidance by TNCs resurfaced in the 1960s, especially in the United States – the home of many of them. To combat the use of tax havens, the US in 1962 enacted measures to include in the profits of a US parent company the income of its affiliates formed in low-tax countries, if they fall within the definition of a controlled foreign corporation (CFC). Other OECD states gradually adopted similar rules in the 1970s and 1980s, harmonised and coordinated through the OECD Fiscal Committee. This was especially to meet objections from Switzerland that they conflicted with tax treaty principles that would require states introducing CFC rules to reach new agreements with their relevant treaty partners. To deal with this, it was agreed that such anti-avoidance measures should comply with the OECD consensus.

Essentially, CFC rules attempt to strengthen taxation by the home country of a TNC of its foreign profits if they have been retained abroad, but only if they could be considered to have been lightly taxed. In effect, they served to legitimise deferral of home country taxation on foreign income that did not come within CFC definitions (see Box 1). With increased globalisation tax systems have become increasingly territorial, as home states of TNCs have retreated from trying to tax profits earned elsewhere. In 2012 the UK revised its CFC regime, removing the presumption that an activity that could have been carried out in the UK must have been located abroad for tax avoidance reasons. The US is also now debating such a shift towards a more territorial system (US Congress 2013; Huang, Marr and Friedman 2013). CFC regimes have also become increasingly complex – indeed impenetrable except to the dedicated specialist.

To combat the second main problem, in 1968, after several years of consultations, the US introduced detailed transfer pricing regulations elaborating how such prices should be determined. Unfortunately, this dual policy response was contradictory. The CFC approach effectively allowed jurisdictions to treat separate entities as if they were part of the parent. The 1968 Transfer Pricing Regulations took a diametrically opposite approach, strengthening the 'separate entity' principle and cementing the ALP into place. In particular, the US regulations specified that where possible the prices of specific transactions should be based on those for similar transactions between unrelated firms, or 'comparable uncontrolled prices' (CUP). Only as a fallback, where these were not available, did they allow other methods, including apportioning the aggregate profit (see Box 2, profit-split method).

Box 1: Controlled foreign corporations (CFCs)

The US rules first introduced in 1962 are known as Subpart F (after the relevant part of the Internal Revenue Code). Germany introduced measures in a decree of 1965 (after a 1964 report on tax havens), and a Foreign Tax Law (*Aussensteuergesetz*) from 1972. Others followed during the 1970s and 1980s.

Although they differ in detail, such measures generally treat the income of a foreign affiliate as part of the income of its parent, even if not remitted (e.g. as dividends), and therefore directly taxable by the home state (parent's state of residence), provided it meets the definition of a CFC. Generally, this entails three tests, all of which have become more difficult to apply with increased globalisation:

- **Control:** it is owned and/or controlled mainly by one or more companies resident in the home state; the control threshold can be circumvented, and has become harder to apply as TNCs have become more decentralised and regionalised;
- **Passive Income:** the income it earns does not derive from an active business in the place where the CFC is located; but it is hard to define the location of many service functions, especially finance and management of IPRs, both of which have become increasingly important; heavy lobbying by the financial services industry has ensured that most banking, finance and insurance income is generally considered non-passive, which explains why financial firms are the biggest users of tax havens;
- **Low-tax:** the CFC is resident in a low-tax jurisdiction, usually designated by issuing a list; as preferential tax regimes have proliferated, it has become more difficult to distinguish outright havens.

Other tests may also be applied, e.g. a tax reduction motive test.

2.4 Problems with the ALP

Hence, anti-avoidance techniques, coordinated mainly by the OECD, have tackled the problem with separate solutions rather than a holistic approach. In particular, transfer pricing has been dealt with only by continued elaborations of the ALP. This has further entrenched the separate enterprise approach, which became increasingly unworkable as TNCs became ever more globally integrated, and the international tax system became more complex. As it became more developed and refined, the ALP has increasingly been shown in practice

to be impossible to apply effectively or consistently, and demanding a very high level of resources.¹³

The US transfer pricing regulations of 1968 did not treat the ALP as a general principle for ensuring broad fairness in allocating costs and profits within a TNC, which is how it had been conceived in the 1930s, but instead attempted to define rules for pricing specific transactions. Recognising that these had international implications, the issue was taken up through the OECD,¹⁴ and then also the UN Group of Experts. This was also spurred by growing concerns about the power of TNCs,¹⁵ including some high-profile publicised cases involving transfer pricing, notably the Swiss pharmaceutical firm Hoffman-LaRoche.¹⁶ The OECD eventually produced a report in 1979, *Transfer Pricing and Multinational Enterprises* (OECD 1979), which defined a consensus around the ALP, generally following the approach in the US regulations. This was subsequently revised and became the *Transfer Pricing Guidelines* (OECD 2010b).

Significantly, the OECD report did not propose any revisions to the model treaty, nor even to the commentary on its provisions, but merely set out guidelines to be taken into account by states.¹⁷ Tax administrations work within national laws, which generally enact a broad power to adjust the accounts of taxpayers owned or controlled by foreign entities. Such powers are formulated in various ways, and with different degrees of specificity, sometimes elaborated in regulations (e.g. in Germany) and sometimes only through guidelines for tax officials. The Guidelines themselves are not usually explicitly enacted, although they may be referred to as an authoritative guide.¹⁸ Since they have been written and successively revised only by government officials, with no democratic scrutiny, albeit after extensive consultation with business representatives, whatever legal force they may have raises issues of legitimacy.

For various reasons, the OECD technocrats have increasingly fiercely defended what they describe as the international consensus, based on the ALP. Yet this apparent enthusiasm for the ALP has contrasted sharply with the lack of agreement on clear rules to apply it. The OECD Transfer Pricing Guidelines, as successively revised, only put forward a variety of methods, which are each extensively discussed. All of these purport to constitute implementations of the ALP, although some of them are in fact methods of apportioning profits. This is disguised by the Orwellian term 'transactional profit methods'. The Guidelines are now both complex and extensive, covering some 370 pages.¹⁹ They have been familiarly referred to as the 'Bible' (Sheppard 2012), and as this scriptural analogy suggests, they do

¹³ For reasons of space I will not provide a detailed analysis here, but only an outline of the main issues which have arisen and attempts to deal with them.

¹⁴ In fact, the OECD set up a working group to examine the issue as early as 1965, at the request of the US, so the international discussions ran in parallel with the development of the US regulations.

¹⁵ Leading the UN to commission a Report from a Group of Eminent Experts, and then to set up the UN Centre on TNCs, while the OECD produced its general Guidelines for Multinational Enterprises in 1976.

¹⁶ Publicised in the report by the UK Monopolies Commission (1973) *Chlordiazepoxide and Diazepam*. This showed that the firm's UK affiliate was paying £922 per kilo to its Swiss parent for the active ingredient of its new wonder-drug Valium, whereas the same ingredients could be obtained from small companies in Italy (where Roche's patents were at that time not protected) for £20 per kilo.

¹⁷ The original 1979 Report was renamed Guidelines when a revised version was issued in 1995; the most recent revised edition was in 2010 (OECD 2010b). In 2012 proposals were released for revisions of sections of the Guidelines on Safe Harbours, and Intangibles.

¹⁸ In the UK they were at first only informal guidance notes, but s. 164 of the Taxation (International and Other Provisions) Act (TIOPA) 2010 now says that the legislative provisions (in Part 4 of that Act) are to be interpreted to ensure consistency with the OECD Guidelines, insofar as the UK's double taxation arrangements incorporate the OECD model. The UK statute itself simply enacts the ALP (TIOPA 2010 s. 147.1.d and 147.5), with more detailed provisions defining related enterprises, and governing specific aspects such as finance and oil. Despite the apparent narrowness of the statutory rule, which focuses on transaction pricing and specifies the arm's length rule, British officials have at various times said that in practice consideration of what seems a fair split of the overall profit plays a part, and such a broad interpretation was approved early by the courts (see Picciotto 1992: 195-6). The reference to the OECD Guidelines, which are discursive and offer a wide range of methods, has the effect of broadening the otherwise narrow literal wording of s.147.

¹⁹ Available from <<http://www.oecd.org/ctp/>>, unfortunately only on payment or for subscribers.

indeed combine authoritative pronouncements with a variety of formulations susceptible to different interpretations. Furthermore, the ritual public affirmation of adherence to the OECD consensus and the ALP contrasts sharply with the generally fierce disagreement and conflict over its actual application in practice. Recently, for example, the US Competent Authority, in a meeting for practitioners, complained of his Indian counterpart's preference for policy over rules, and for profit-split rather than the more transactional methods, so that they have suspended negotiation of bilateral Advance Price Agreements (APAs) (Parillo and Trivedi 2013).

The Guidelines originally stressed that the ALP should as far as possible be applied to the pricing of specific transactions, and also wherever possible on the basis of a comparison between the TNC's internal (controlled) price and comparable prices charged between independent enterprises (comparable uncontrolled prices). But this rested on the fundamental flaw of the ALP: in economic reality TNCs exist because of their competitive advantages, foremost of which is their control of unique technology or know-how. Hence, as studies have repeatedly shown, it is not only extremely complex and time-consuming to try to identify comparables, but in the large majority of cases true comparables do not exist. For example, no other cellphone is truly comparable to an Apple iPhone, and a Parker pen is superior to an ordinary ballpoint. The Guidelines therefore offered two alternatives: the resale price minus a profit margin, or the cost price plus a mark-up (see Box 2 below). Although these are described as transactional pricing methods, in reality they aim to identify the appropriate profit level of the affiliate. However, they do so in comparison with other firms in the same line of business, so again they tend to overlook the competitive advantages of TNCs, and are inappropriate for TNCs with internationally integrated activities.

Box 2: Accepted methods for transfer price adjustment in the OECD Guidelines

The OECD Guidelines now provide five broad methods for adjusting accounts to conform to the ALP, and state that the most appropriate method should be used in each case, depending on factors such as the nature of the transaction and the availability of information (OECD 2010b para. 2.2). They distinguish between 'traditional transaction methods' (CUP, resale and cost-plus); and 'transactional profit methods' (transactional net margin method (TNMM) and profit-split). The methods are not prioritised but the Guidelines state that the traditional methods provide the most direct means of establishing the ALP, and that profits-based methods must be applied in a way that is compatible with the ALP. Briefly, the five methods are:

- **Comparable uncontrolled price (CUP):** the price charged between unrelated firms in transactions which are similar in all respects which could affect open market pricing, or which can be determined by reasonably accurate adjustments to take account of any such differences;
- **Resale price:** the price at which a product bought from a related party was sold to an unrelated party minus a gross profit margin to cover costs and an appropriate profit;
- **Cost-plus:** the costs incurred in the production of goods or services by a supplier to a related party, plus an appropriate mark-up, based preferably on that charged by the same supplier in comparable transactions with unrelated parties;
- **Transactional net margin method (TNMM):** although this is called a transactional method, it looks at profitability. It establishes the net profit realised from an appropriate base (e.g. costs, sales, assets) in a transaction (or series of transactions that can

appropriately be aggregated), ideally by comparison with similar transactions by the same person with unrelated parties, or if not possible the net margin earned in comparable transactions by independent enterprises, based on a functional analysis to determine comparability;

- **Profit-split:** the total combined profits earned from a transaction or transactions are apportioned according to one or more 'allocation keys'. These can be based on assets or capital employed, costs, headcount, or sales. This method in effect apportions the combined profit according to a formula. This method has been approved for use, for example, in relation to some kinds of insurance and banking business, such as 24-hour global trading of financial instruments, where a trading book is passed on to offices in different time zones (e.g. New York, London, Singapore).

Meanwhile, however, the application of these regulations by the US itself was challenged as ineffective. Indeed, even as the ALP became enshrined in the OECD Guidelines, criticism of this approach had mounted in the USA, fuelled by several studies showing its limitations, including one for the Congress by the Government Accountability Office (GAO) in 1981.²⁰ In 1988 the US Treasury announced a new approach (US Treasury and IRS 1988), which would severely restrict transactional pricing methods to cases where an 'exact comparable' could be found, and put forward a new method to calculate an 'arm's length return'. This was to be done by attributing to the affiliate a profit based on analysing its functions and applying an industry average rate (the comparable profit method (CPM)).

This entailed analysing the functions carried out by affiliates, to which would be attributed a market rate of return on the capital invested, leaving the remaining residual profits for the parent company. A major motivation for this was the concern that US TNCs had been shifting profits by setting up manufacturing plants abroad, often in low-tax countries such as Ireland, where they could show high profits due to the unique technology embodied in their products. The US Internal Revenue Service (IRS) preferred to treat such affiliates as contract manufacturers, which would deny them any profits attributable to intellectual property rights such as patents, transferred to them from the parent company.²¹

This new US view led to sharp conflicts within the OECD for several years, with big business lobbies joining other tax administrations in attacking the US line. The disputes were patched up with the issuing of the 1995 Guidelines, which reformulated the new US approach, to try to assimilate it to the ALP under the rubric of transactional profit methods. These are the TNMM and profit-split method (see Box 2). The Guidelines now stress that these are the only such methods compatible with the ALP, and this affirmation was linked to a strong rejection of any use of global formulary apportionment, although this is defined narrowly as apportionment by a formula fixed in advance. At the same time, the Guidelines moved away from expressing an explicit preference for transactional pricing methods, and now say that the aim is to find 'the most appropriate method for each case' (OECD 2010b: 59).

As a result the Guidelines became highly contradictory, even incoherent. Although the new methods are described as transactional, they can be applied to aggregate transactions. So

²⁰ The GAO Report concluded: 'Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on inter-corporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers. ...We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under s.482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations' (US GAO 1981: 52-3).

²¹ CFC rules could not be applied, since such affiliates have 'active' income; but applying transfer pricing rules, even after the 1986 revisions, proved difficult as the courts resisted the 'contract manufacturer' concept: see Bausch and Lomb (1991).

they are, in effect, profit apportionment methods, although the question of which transactions can be aggregated raises significant legal issues (Wittendorff 2013). In fact, only the CUP focuses on pricing of comparable products; all the other methods attribute a level of profit considered appropriate. The cost-plus and resale price methods, accepted since the 1930s, use as the criterion the profit margins of firms manufacturing or selling comparable products. The TNMM can be applied to a wider range of affiliates than just manufacturing or retailing, as it begins by identifying the function performed. It also requires less product comparability; it authorises attribution of net profit by applying an appropriate rate of profit to a suitable base, e.g. costs, assets or sales. This is regarded as being suitable for an affiliate that does not make a unique contribution, i.e. it performs a specific and rather generic function, such as contract manufacturing. In practice the TNMM is a method for apportioning profits, by applying an analysis of economic factors, and hence is a step towards formulary apportionment.

The profit-split method goes further, and allows the apportioning of the combined profits according to an appropriate measure of the contribution made by each. The Guidelines say that it is appropriate where the related entities are closely integrated, or both make unique contributions. They accept that this method 'tends to rely less on information about independent enterprises', but claim that the 'overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises' (OECD 2010b, paras. 2.114-5). This sophistry does nothing to conceal that this method accepts that the competitive advantages and synergies of a TNC generally generate additional profits that the fragmented analysis of specific affiliates based on the other methods could simply overlook. Thus, profit-split allows allocation either by a percentage based on an evaluation of the contributions made by each affiliate, or by applying one of the other methods to each of them, and then apportioning the residual. The split can be based on one or more 'allocation keys', such as assets or capital employed, costs, headcount, or sales.

As several commentators have pointed out, the profit-split method is essentially a unitary approach with formulaic apportionment, albeit not using a formula fixed in advance, but one chosen ad hoc. It has been used for some twenty years in APAs, especially to apportion the profits from 24-hour global trading of financial instruments, where a trading book is passed on to offices in different time zones (e.g. New York, London, Singapore).²² Hence, it has been suggested that it provides a basis for at least a partial transition towards unitary taxation, by using formulary apportionment to divide the residual (Avi-Yonah, Clausing and Durst 2009; Avi-Yonah and Benshalom 2010). These ideas have taken on a much greater salience as the political pressure generated by media reports and activist campaigns about TNC tax avoidance galvanised the OECD's BEPS project into a serious investigation of a new approach in 2013 (see further section 3 below).

The many statements in the OECD Guidelines rejecting unitary taxation can be traced to the hard-fought compromises in the 1990s over acceptance of the profit apportionment methods, as well as another campaign by big business lobbies against its use by US states, especially California (discussed further below).

The 1995 Guidelines also attempted to deal with the difficulties posed by intangibles, which go to the heart of the increasing problems of applying the ALP. As already pointed out, these are rooted in the inability of the ALP to deal with the basic characteristics that give TNCs their competitive advantage, especially their control of know-how, in the broadest sense. This has become increasingly important with the transition to the knowledge economy, in which

²² See US Treasury Notice 94-40 (1994 IRB LEXIS 213), which states that the main apportionment factor should be the traders' remuneration.

TNCs are at the forefront. In their 1995 version (still current in the 2010 edition) the Guidelines approached this very narrowly, in terms of transfers of intangible property.

Due to inadequacies in the treatment of intangibles, a complete rewrite has now been undertaken, culminating in a draft issued in June 2012.²³ This now attempts to deal with Intangibles more broadly; but it is still hampered by the focus on transactions, which is inevitable under the ALP. The limitations of this approach were shown in a news report by Reuters in October 2012 that Starbucks had shown no taxable profits in the UK for 10 years, although it had regularly trumpeted to its shareholders the profitability of its UK operations. Commentators suggested that this was probably due to intra-firm pricing, especially the payment of royalties of 6 per cent to the parent company for use of the brand name and related IPRs, which is at the top end of permissible rates based on comparables (Bergin 2012). Another news investigation focused on Google, reporting that the company had cut its overall tax rate almost in half, saving \$2 billion in taxes entirely legally, by using a dual-resident Irish-Bermuda affiliate to channel \$9.8 billion, 80 per cent of its 2011 pre-tax profits (Drucker 2010, 2012). This was also probably due to the foresight of Google's legal advisers, in transferring ownership of rights in software to its Irish-Bermuda affiliate early on, before they began to generate such enormous profits. This type of planning makes it hard to use arm's length transfer pricing rules to challenge the valuation of such rights, which must be done in relation to the time of transfer, as well as the cost-sharing arrangements for continuing R&D work.

The continuing problems with intangibles actually reflect the fundamental flaw in the ALP, since a firm's knowledge or know-how is very much a result of synergy, and it is very hard to value the different contributions to that whole, or attribute profits to particular parts. This is so even when such knowledge can take the form of intellectual property, since this concept creates a misleading notion of the nature of innovation or creativity as individualised, episodic and discrete, instead of collective, continuous and cumulative. In the pharmaceutical industry, for example, profits are commonly thought to be attributable to the specific primary research which results in patentable drugs. In practice, research is a continuous process, amassing knowledge in a general field and often resulting in a line of products. Furthermore, firms spend as much or more on development and testing, as well as marketing, and these activities are likely to take place in different locations to the basic research.

In one notable case which became public because it had to be litigated, the pharmaceutical company GlaxoSmithKline was assessed for US\$5.2 billion in back taxes and interest by the US Internal Revenue Service (IRS) in 2004 related to profits from its anti-ulcer drug Zantac. Glaxo claimed it should be paid a refund of US\$1 billion, so there was a difference of over \$6 billion. The drug had resulted from research done in the UK, but the IRS argued that a significant proportion of the high revenue it generated in the US was attributable to Glaxo's US marketing intangibles. The dispute was finally settled with a payment by Glaxo of US\$3.4 billion (Sullivan 2004).²⁵ To take another example, the enormous profitability of Google is often taken to have resulted from the basic algorithm driving its search engine, originally devised by its founders, Sergey Brin and Larry Page. However, much of the power of that search engine derives from its continuous development and refinement; this involves work in many countries, including mining the data from its users all over the world, also contributing to Google's development of other products, such as Maps and Translate.

²³ See <<http://www.oecd.org/ctp/transferpricing/transferpricingaspectsofintangibles.htm>>.

²⁵ Ironically, Glaxo made the opposite argument when the Canadian authorities challenged the pricing of the Zantac licences to Glaxo Canada, on the grounds that they could be acquired for less under compulsory licences from generic producers; Glaxo argued that such prices were not comparable to what it offered in the comprehensive licence package, which included the brand name.

2.5 Attempts to improve transfer pricing administration

Various means have been used to try to deal with the vast administrative problems of applying the ALP in practice. These are broadly of two kinds: (i) the time and special expertise needed to carry out the checks on transaction prices; and (ii) the difficulty of achieving consistency due to the complex and often subjective nature of the judgments involved. One means of dealing with these is to adopt 'safe harbour' or 'bright line' rules. These can greatly economise on the resources needed by tax administrations and simplify compliance by taxpayers, but they can be easily avoided and may make international coordination more difficult.²⁶ Hence, the 1995 Guidelines discouraged their use; but the revisions proposed in 2012 now look on them much more positively, at least in relation to smaller taxpayers. The OECD viewed this as part of a bigger effort for simplification of transfer pricing administration, including documentation requirements (Andrus 2012).

Another method, more appropriate for large TNCs, is the adoption of Advance Pricing Agreements (APAs). An APA gives the TNC prior approval of its pricing scheme, but requires submission of detailed documentation and negotiation with the tax authorities, often of several countries. The time and expense involved means that they are mainly useful for large firms – although they are strongly promoted by the large accountancy firms, for whom they provide good business.

The effectiveness of APAs is also limited because they are ad hoc and secretive. Effective administration of a complex body of rules such as those on transfer pricing could be helped by publishing rulings such as APAs, to provide guidance to other similarly situated taxpayers. Regrettably, however, APAs are generally regarded as highly confidential, and are not published. As a result, decisions often involving hundreds of millions of dollars are taken in secret, and even the issues involved are known only to the company involved and its advisers (for whom this is of course very important information). One example of the kind of anomaly this can create was shown when the details of an APA negotiated by the pharmaceutical company SmithKline were discovered by its then rival Glaxo, but only after the two firms had merged; this information helped to fuel extensive litigation by Glaxo involving billions of dollars, as discussed in the previous section. The same is the case for inter-state settlements through the mutual agreement procedure. Even if they have been referred for resolution by arbitration, the decisions cannot be published unless the parties agree, which rarely occurs. Indeed, the OECD rejected responses to its consultation on these procedures that argued that such arbitral decisions on transfer pricing adjustments should normally be published.²⁷ Yet both these decisions and APAs involve important international regulatory judgments, akin to decisions taken by the dispute resolution procedures of the World Trade Organisation, which are published.

2.6 Problems for developing countries

The OECD position – that the ALP expresses an international consensus as the only way to combat transfer pricing – has been deployed to close down debate elsewhere, especially in the UN Tax Committee. In recent years many developing countries have introduced anti-avoidance rules, and there has been in particular a viral spread of transfer pricing regulations (Ernst and Young 2012). However, the vast majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach.

²⁶ As mentioned below (section 3.6), the Brazilian rules go further, and apply the cost-plus and retail methods with fixed profit margins, a method which has been criticised by the OECD.

²⁷ This point was made in submissions by myself and Prof. Michael McIntyre.

Application of the ALP is particularly difficult for comparability analysis – which is not just a matter of access to suitable databases, as some seem to think. There is always scope for disagreement between tax authorities and the taxpayer, not only over what constitutes a truly comparable product, but other factors which affect price, such as volume and transportation costs. Even a small adjustment of the applicable transfer price can often mean a very great difference to the resulting profits, for example in relation to the per barrel price of oil if millions of barrels are involved. Thus, the ALP, far from offering a clear and easily administrable basis for taxation, is a recipe for disagreement. Its wide degree of interpretive latitude means that case resolution often depends on negotiation, and its scope for discretionary judgement leaves openings for arbitrariness or corruption.

The OECD has attempted to support the propagation of its approach through capacity building. However, it does not seem a good use of resources to train specialists to administer a system that is dysfunctional. Training specialists to audit transfer pricing by searching for comparables under the ALP seems wasteful of scarce resources, and indeed could be counter-productive. What is the likely result if revenue authorities do enhance their scrutiny of transfer pricing, by searching for appropriate comparables? They may achieve some positive results, especially if there has been egregious mispricing. Inevitably, however, companies subject to such audits will themselves employ a growing legion of specialists and advisors, often by recruiting the best of the officials expensively trained by the government and the capacity-building aid. Private practitioners will enthusiastically throw themselves into this new field: indeed, transfer pricing has grown apace as a major fee-earner for international tax specialists. The result is to create a system which becomes enormously expensive and time-consuming for both tax administrations and taxpayers.

This can be seen from the Indian experience. India enacted specific transfer pricing regulations in 2001, thus setting off what one commentator has called the ‘great Indian transfer pricing circus’ (Vijayaraghavan 2012). Transfer pricing quickly developed into a boom area of professional practice, controversy and litigation. By fiscal year 2007/2008, tax authorities were reported to have made transfer pricing adjustments of close to \$9 billion. A decade after the regulations were passed, 3,000 transfer pricing cases were pending before the Income Tax Appeals Tribunal, which had to establish four special benches to deal specifically with them (Supekar and Dhadphale 2012). It is hardly surprising that this led to calls for a radical rethink (Vijayaraghavan 2012). The Indian authorities have attempted to improve the situation, for example by introducing an APA programme. However, they have run into conflicts with both business representatives and the US tax authorities, who have complained that their interpretation and application of international tax rules are ‘advancing a policy agenda’. The US competent authority publicly announced that bilateral APAs with India were not possible, apparently because of India’s preference for abandoning other transfer pricing methods and going ‘right for some sort of profit-split’ (Parillo and Trivedi 2013).

Others among the BRICS countries, as well as developing countries more generally, also report that they find it hard or impossible to find adequate comparables, and prefer methods that are easier to administer. Although they affirm their adherence to the OECD Guidelines, they often also emphasise the need for a holistic approach. In practice, the methods they prefer are very different from each other, and from those of OECD countries.²⁸ Thus, Brazil relies on the resale or cost-plus methods, but using specified fixed margins. This has led to criticisms in the OECD Committee from others who regard it as a significant departure from the OECD Guidelines. In contrast China, which also finds it hard or impossible to find comparables, prefers profit-split methods, but takes account of distinctive factors, notably location-specific advantages that it considers justify allocation of higher profits to Chinese

²⁸ The UN Manual includes helpful outlines of the difficulties faced and approaches adopted by Brazil, China, India and South Africa (UN 2012, ch. 10).

members of TNC groups. India also employs this criterion for adjustments. However, this approach also is likely to produce results that diverge from those acceptable to OECD countries.²⁹ So even as the OECD approach is extended to other countries, it is likely to create increasing problems due to divergent approaches, while most countries will lack the capacity to apply it effectively.

2.7 Advantages and limits of the ALP

It is easy to understand why the ALP was first adopted in the early 1930s. At a time when international capital flows were mainly in the form of loans, it provided a means of accommodating TNCs as a special case within the international system. But, once established, it has become hard to dislodge. Indeed it has become even more deeply embedded as it has become increasingly elaborated. Practitioners are comfortable with the system they know, both as tax administrators and as tax advisers earning large fees.

For a national tax administration, it may seem natural to start from the accounts of the entities within its jurisdiction, even if they form part of a larger TNC. The adjustments to the accounts that this inevitably entails can be done according to the specific circumstances of the company, using any of the wide range of methods now approved as acceptable under the ALP according to the OECD. The OECD Guidelines recognise that 'transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer' (OECD 2010b: para. 1.13).

Despite the high costs of separate accounting, most TNCs seem to prefer it. The main reason undoubtedly is that it allows them freedom to organise their internal structure, and generally to deal with national tax administrations one-on-one, unless the company itself requests resolution of a conflict. No single authority necessarily sees the complete tax accounts of the TNC as a whole.³⁰ Hence they have to rely on bilateral exchange of information that is authorised under tax treaties, but secrecy jurisdictions such as tax havens do not generally provide such information.³¹ TNCs are generally unwilling to reveal even to their shareholders how much tax they pay in each country where they do business, as shown by their reluctance to accept country-by-country reporting (Murphy 2012; PwC 2012). The separate entity approach does have some disadvantages for business: in particular separate accounting does not automatically allow the offsetting of losses in one country against profits in another. But for most TNCs these seem to be outweighed by the ability to exploit the

²⁹ The OECD Guidelines (OECD 2010b, paras. 9.148-153) do discuss the issue of location savings in the context of the restructuring of a TNC's operations to relocate activities to a lower-cost country, in terms of how such savings should be allocated among the parties. China and India appear to have broadened out this concept considerably and, not surprisingly, stress their own locational advantage as a factor that justifies a higher allocation of profit. The CFA has now issued a draft revision of chapter VI of the Guidelines on Intangibles, which includes a broader concept of location savings (OECD 2013c).

³⁰ The UN Practical Manual on Transfer Pricing for Developing Countries, revised in 2012, advises that among the documentation which a tax administration should request for a transfer pricing audit should be the 'Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years' (UN 2012: para. 8.6.9.12). Interestingly, comments on the draft sent to the UN Tax Committee by the US Council for International Business objected to this provision, although it accepted that such consolidated accounts are readily available for publicly quoted companies. The objections were not accepted by the Committee, but the US expert member suggested that the matter could be raised again.

³¹ The information exchange provision in the traditional tax treaties was until recently very limited: notably, the requested state had no obligation to obtain information which it did already have for its own tax purposes. Successive revisions of the tax treaty models since 2000 have greatly extended this, although it takes time to implement the model provisions in actual tax treaties. Tax havens are not usually party to such treaties, but since 2007 the OECD efforts against evasion and avoidance have resulted in negotiation of an increasingly large number of bilateral treaties for the exchange of tax information (tax information exchange agreements (TIEAs)). However, these provide only for information on the basis of a specific and targeted request, and their limitations mean that they are not much used. In any case, few developing countries have the resources either to negotiate or to utilise such treaties.

opportunities for international tax avoidance, especially through the tax haven and offshore secrecy system.³²

Box 3: Transfer price adjustments

The aim of transfer price adjustments under the ALP is said to be to ensure that transfer pricing reflects market forces, by making adjustments to establish 'the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances' (OECD 2010b para. 1.3). When national tax authorities in country A assess the accounts submitted by the relevant local affiliates of the firm, they may require adjustments in the pricing of transactions with its affiliates in country B. The firm may frequently be able to adjust these related company accounts accordingly, if the accounts have not yet been submitted to the tax authorities in country B. If this is not possible, the firm must request a corresponding adjustment from the country B authorities. If this is refused, the firm may ask for the conflict to be referred for negotiations between tax authorities under the mutual agreement procedure (MAP) in tax treaties. Today, these conflicts may involve hundreds of millions of dollars, and taxpayers complain of long delays, and arbitrary settlements. As a partial remedy, arbitration has been introduced as a fallback under some DTTs, and is available among EU states under a multilateral treaty. Nevertheless, both tax authorities and TNCs prefer to sort out these disputes under a shroud of confidentiality, and have strongly resisted pressure for publication of either the private MAP settlements or the arbitral decisions.

Hence, although TNCs are facing increasing problems in dealing with the heightened scrutiny of their transfer prices by tax administrations, many of them strongly resist changes that might threaten the techniques for tax avoidance using tax havens, on which a significant number of them have become dependent.

3 Taking a new approach

3.1 Current proposals and prospects

As the previous section has shown, the current system is very poorly adapted to taxation of TNCs. Indeed, it acts as a strong incentive for firms to create complex legal structures for profit-shifting, and there is considerable evidence that TNCs make extensive use of the opportunities it provides for reduction of their effective tax rates (Devereux 2006; OECD 2013a). This is a very serious problem, and not only because of the direct revenue losses. Systematic tax avoidance by the richest and most powerful companies in the world undermines the general legitimacy of taxation, as the OECD's report in February 2013 on Base Erosion and Profit Shifting acknowledges (OECD 2013a). It gives the TNCs that exploit these avoidance opportunities a very significant competitive advantage over national firms, resulting in inefficient allocation of investment and major distortions to economic activity. At the same time, it distorts the decisions of these firms themselves, resulting in some benefits to some countries but overall economic welfare losses (Keuschnigg and Devereux 2013). The techniques and facilities of the tax haven and offshore secrecy system, which indeed those firms were largely responsible for creating, are now used not only for tax avoidance,

³² It is noteworthy that most TNCs are supporting the EU proposals for a Common Consolidated Corporate Tax Base (CCCTB), which would apply a formulary apportionment, but only within the participating states: it would not, as currently formulated, require a combined report with worldwide consolidated accounts (see further below).

but also tax evasion, as well as money-laundering, yet they give this system a degree of respectability. This system has now become a major obstacle to tax fairness, and a facilitator of corruption and crime. TNCs are now the dominant element in the world economy. Their tax liabilities run into billions of dollars, and have major implications both for their competitiveness and for national tax revenue. It no longer seems acceptable that the determination and allocation of these taxes between states should be done on the basis of methods that are clearly impossible to administer effectively, consistently or fairly.

At the centre of the dysfunctionality is the ALP, which precludes a holistic approach to taxation of the TNC's total profits, and hence positively encourages profit-shifting. As the previous sections have explained, this began as a device to adjust the special case of FDI to the principles devised for international portfolio investment, which predominated when the rules were first formulated. Nevertheless, at that time, tax authorities understood that they should use back-up methods looking at the combined profits of related entities to ensure a reasonable and fair division of the total profits. As TNCs became dominant in the second half of the 20th century, the rules became both highly complex and also increasingly contradictory. The separate entity principle has been increasingly emphasised, especially in the OECD Transfer Pricing Guidelines, even as those Guidelines accepted profit-split methods. Some anti-avoidance rules do entail looking through the corporate veil of 'sham' entities, notably the rules on CFCs and limitation-of-benefit provisions; but their effectiveness has been blunted, due to continuing deference to the separate entity concept.

The issue now facing us is whether a way can be found out of this impasse. Applying further patches to existing rules now seems futile. What clearly seems necessary is to reorientate international tax rules and place them on a more realistic foundation that can treat TNCs as single firms, instead of being based on the unrealistic fiction that they are a loose collection of separate and independent entities in each country. A number of proposals with this perspective have indeed been put forward. The most comprehensive is Unitary Taxation (UT) with formula apportionment. This is widely accepted as a superior approach in principle, although not without its difficulties. The main objection usually made is that, whatever its technical merits, it would be difficult or impossible to reach political agreement on such a system.³³ Interestingly, this is the same argument made eighty years ago in the Carroll report for the League of Nations (Carroll 1933).³⁴

Perhaps we may hope that international political and economic cooperation has improved since then. Certainly, there has been extensive trade and financial liberalisation leading to a new phase of economic globalisation. We have learned, not least from the 2007-8 financial crash and ensuing economic crisis, that liberalisation and globalisation should be complemented by stronger international coordination of economic regulation, which should include taxation. At this moment, with the popular pressure that has generated the impetus given by the G20 leaders to the OECD's BEPS project, we have the best opportunity for years to undertake a 'holistic' and 'comprehensive' reform (OECD 2013a: 50) of the international tax system.

Proposals have been made for various states to take unilateral measures, moving away from the separate entity principle dominating the current system. Thus, Ed Kleinbard has argued that the US should apply assessment of TNCs on their worldwide profits, with a credit for foreign taxes paid (Kleinbard 2011b, 2013). A similar approach, which essentially involves extending CFC rules to all foreign affiliates of US corporations, has also been advocated by

³³ See, for example, the comments of Pascal St-Amans, head of the OECD Tax Centre, in his evidence to the UK House of Lords Committee on Economic Affairs on 11 June 2013, question 107; available at <<http://www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/inquiries/parliament-2010/taxing-corporations-in-a-global-economy-is-a-new-approach-needed/>>.

³⁴ At that time, as discussed above, the German report for Carroll's study expressed the hope that over time the experience of cooperation between tax authorities would provide the basis for agreement on a more holistic approach.

Reuven Avi-Yonah.³⁵ However, this approach essentially favours residence countries, and aims to enable these home countries of TNCs to reassert tax rights over the worldwide earnings of 'their' TNCs, at least to the extent that they have been taxed at lower rates elsewhere. Michael C. Durst, who concurs with this approach, also makes a complementary proposal that would help developing countries, to disallow or limit deductions from the business profits of operating companies.³⁶ Michael Devereux and Rita de la Feria are developing a proposal for taxation of TNCs based on their income from sales defined by destination, although it is not clear whether this entails assessing related entities on a unitary basis, and, if not, whether it would deal with the problem of profit-shifting.³⁷ Jarass and Obermair have made a proposal with some similarities to this in Germany, for taxation of earnings before interest and taxes (Jarass and Obermair 2008). The report for the French Ministry of Finance on the Digital Economy recommended unilateral introduction of a specific tax on the digital sector, but as a means of pressuring the OECD towards a more coordinated approach (Colin and Collin 2013: 121-8).

Such measures may well be desirable in the short term, although it remains to be seen whether governments' need for revenue and desire to placate public opinion will lead to their actual enactment, in the face of the pressure and threat of disinvestment that will inevitably come from corporate lobbies. In my view we also need to look beyond these, and set our sights on how to achieve more fundamental reforms, moving towards a UT approach. While this would involve looking at TNCs through a different optic than the ALP, in my view an evolutionary and pragmatic shift towards a unitary approach is both necessary and possible. There is long experience of unitary taxation with formula apportionment in federal systems, especially in the USA, and a fully worked-out proposal has been developed for the EU. There are also many elements of such an approach within the present system, which can be built upon. What is needed is a road map for such a transition. This will be sketched out in what follows.

3.2 Elements of a unitary approach

Unitary Taxation (UT) is not a panacea, but it would go a long way towards placing international corporate taxation on a sounder foundation. It would replace or greatly simplify most of the main complex and problematic areas of international taxation: not only transfer pricing regulations, but also rules on corporate residence and source of income, as well as anti-abuse provisions such as CFCs and limitation of benefits clauses. Compared with those thorny problems, the difficulties to be resolved in making UT workable are relatively minor. It does not involve wholesale replacement of one system by another; a gradual shift to UT is both necessary and possible. As a number of specialists have pointed out,³⁸ some elements already exist that can be built upon. The need is for a road map and a strategy for transition.

A workable UT system should have three components: combined reporting, profit apportionment, and a resolution procedure. Each can be introduced to some extent immediately, and could be refined gradually by building on existing provisions.

Combined reporting

First, any company with a business presence in more than one country should be required to submit a Combined and Country by Country Report (CaCbCR) to each tax authority. This

³⁵ Presentation at the joint meeting of the Oxford University Centre for Business Taxation and the IFA, 27 June 2013 <<http://www.sbs.ox.ac.uk/centres/tax/conferences/Pages/CBTandIFASummerConference2013.aspx>>.

³⁶ Keynote speech, Research Conference of the Internal Revenue Service and the Tax Policy Center, Washington DC, 20 June 2013, <<http://www.irs.gov/PUP/taxstats/productsandpubs/13resconprogram.pdf>>.

³⁷ Evidence of Rita de la Feria to UK House of Lords Committee on Economic Affairs, 11 June 2013, question 123.

³⁸ In particular, Avi-Yonah, Clausing and Durst (2009).

should include: (i) consolidated worldwide accounts for the firm as a whole, taking out all internal transfers; (ii) details of all the entities forming the corporate group and their relationships, as well as of transactions between them; and (iii) data on its physical assets and employees (by physical location), sales (by destination), and actual taxes paid, in each country.

No change is needed to international rules for this. Indeed, states are already recommended to obtain such data by both the UN's *Practical Manual on Transfer Pricing* (UN 2012), and the OECD's *Draft Handbook on Transfer Pricing Risk Assessment* of 2013 (OECD 2013d: para. 98). At present, however, few states have such a requirement, so tax officials starting from separate affiliate tax returns find it hard to see the big picture, and this is especially difficult for those in poorer countries.

Formalisation of this requirement should be facilitated by drawing up an agreed template for such a CaCbCR. A good starting point for the standards for the consolidated accounts could be those in the proposed Common Consolidated Corporate Tax Base (CCCTB), as they resulted from several years of work by technical specialists from many countries. However, they would need to be compared to the US federal tax accounting standards (also used for state formula apportionment), and those of other states – especially developing countries. International financial accounting standards (IAS) are not themselves suitable for this as they have been drawn up for the purposes of financial accounting, and have in any case come under considerable criticism, for example, in their emphasis on mark-to-market for asset valuation. However, tax authorities do generally consider financial accounting rules are an acceptable basis for tax accounts, subject to the modifications required for tax purposes. Hence, the existence of IAS should be helpful in some respects for the development of an international tax reporting standard.

The Combined Report should apply to all entities belonging to a unitary group, building on the criteria for ownership and control developed for the EU's CCCTB. It should exclude unrelated activities even if under common ownership and control to prevent profit-stripping, learning from the unitary business concept applied in the USA.

Profit apportionment

Secondly, states can use the CaCbCR to decide on an appropriate apportionment of the profit. This also can build on existing practice, in particular the profit-split method, which apportions the aggregate profits of related entities according to suitable allocation keys. This approach should be extended, because at present it envisages aggregation at the level of transacting entities, whereas TNCs use more complex cross-linkages among affiliates. There is already some experience in applying formulaic apportionment both of fixed and shared costs and of profits. Indeed, it has been applied for some twenty years in the finance sector, in APAs with banks in relation to the profits of global trading through offices in different time zones over 24 hours.³⁹ If firms such as Apple, Amazon, Google and Starbucks would really like to pay a fair level of taxes wherever they do business, they too could enter into APAs and agree an appropriate apportionment.

The experience of using profit-split and APAs could be combined with proper research to determine the most appropriate apportionment formulae. The most balanced approach seems to be a three-factor formula, using physical assets, employees, and sales. The assets factor should be limited to physical assets (as in the CCCTB), excluding intangibles, which (as discussed above) are elusive to define and value and can easily be relocated. Some argue that there is no need to include assets, since they are of decreasing importance in the

³⁹ See US Treasury Notice 94-40 (1994 IRB LEXIS 213), which states that the main apportionment factor should be the traders' remuneration.

'weightless economy'. Nevertheless, in my view a general formula designed to apply as far as possible to all sectors should include an assets factor, provided it is indeed limited to physical assets. As regards employees, US states use employee payroll costs not headcount, but this would be inappropriate internationally due to the greater wage differences. The proposed CCCTB would use a 50:50 weighting of payroll and headcount, which seems appropriate. Sales should be quantified according to the location of the customer. Sellers can and do identify the location of their customers for delivery purposes, and for sales of services and digital products at least through their billing address. Although customers may use accounts based in havens for such purchases, they would have no reason to do so in order to reduce the tax liability of the sellers.

Some argue that states would aim to weight the factor which produces the most revenue for them, so would never agree on a formula. In fact, states need also to consider the effects on investment, and in the US the trend has been towards the sales factor. A balance between production and consumption factors seems best. This could be locked in by adopting a two-stage apportionment: an initial allocation to each country by production factors, then apportionment of the residual by sales.⁴⁰ Special formulae may be needed for specific sectors. However, it should be remembered that tax on business profits is only one instrument. For extractive industries in particular it must be supplemented by rent taxation, using royalties and/or a rent resource tax.

It should be stressed that this approach does not seek to *attribute* profit, since it assumes that the profits of an integrated firm result from its overall synergies, and economies of scale and scope. It *allocates* profits according to the measurable physical presence of the firm in each country. Some argue that firms could still reorganise themselves to minimise their taxes. However, if the factors in the allocation formula are based on real physical contact with a country, such reorganisations would involve actual relocation of such factors. If they choose to divest to truly independent third parties some operations, e.g. retail sales, they would lose the profits of synergy and scale. It is hard to imagine a company such as Apple being willing to transfer a significant slice of its profits to a truly independent wholesaler in a low-tax country. Jurisdiction to tax should be based not on the physical presence concept of permanent establishment, but a broad business presence test, to include, for example, sales via a website.

States would remain free to choose their own marginal tax rates. Hence countries could compete to attract genuine investment rather than the formation of paper entities aimed at subverting the taxes of other countries. Harmonisation of the tax base definition would greatly reduce the existing damaging forms of competition to attract investments by offering special exemptions. UT would therefore eliminate harmful tax competition, while allowing countries to make genuine choices between attracting investment in production and generating revenue from corporate taxation. Such a system would of course not be perfect, but aligning tax rules more closely to the economic reality of integrated firms operating in liberalised world markets would make it simpler and more effective.

Resolving conflicts

The third important element is a procedure for resolution of disagreements and conflict between states. This also is already provided for in the MAP in tax treaties, but it should be improved and extended to include negotiation of APAs. This could increasingly be done on a multilateral basis, which is favoured by some TNCs. Developing countries should strengthen or develop APA negotiation programmes, and investment in expertise for these would be much more cost-effective than for transfer pricing adjustments based on comparables.

⁴⁰ As suggested by Avi-Yonah, Clausing and Durst (2009), who suggest that the first step allocation could be based on operating expenses.

These procedures could also be considerably improved. In particular, the MAP is at present very secretive, and decisions often involving hundreds of millions or even billions of dollars are not published. The secrecy of both MAP processes and APAs greatly increases the power of frequent actors in these processes, i.e. the international tax and accounting firms, to the great detriment of the system as a whole. Publication of both would be a great step towards a system that could both provide and, more importantly, be seen to deliver a fair international allocation of tax.

4 Conclusions

I hope that the analysis in this paper has shown that international taxation is a process of coordination, which is necessary to ensure the effectiveness of national taxation. Hence, far from being a surrender of sovereignty, it is essential to maintaining and restoring the powers of national states. As the patterns of economic globalisation have changed, so should the forms of international coordination. This is the challenge we now face. Some might also wish to see even more ambitious projects for global taxes, which might be used for international redistribution to assist development. Those, however, are topics for another occasion.

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International Centre for Tax and Development
at the Institute of Development Studies
Brighton BN1 9RE, UK
T: +44 (0)1273 606261
F: +44 (0)1273 621202
E: info@ictd.ac
www.ictd.ac