

Problems in international division of the business income tax base

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Dear Colleagues,

The attached draft is in its final stage so far as the text is concerned but there is considerable more referencing to be done. The draft in part will be a response to OECD documents due to be released before the end of the year and so there is more referencing in particular to be done for OECD materials.

The argument in a broad sense is twofold. First, neither the country of the shareholder nor the country of headquarters of a multinational corporate group collect much tax on the international business income of the group for a variety of structural and policy reasons (Section II of the article). The collection of corporate tax occurs in the countries to which the profits of the group are allocated under transfer pricing rules. Secondly, current transfer pricing rules have a number of structural flaws which permit the movement of profits to tax havens (Section III of the article). Section IV brings the previous sections together in proposing solutions. I suggest that you read Sections IIC and III.

Regards,

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I Introduction

In the US alarm bells are regularly sounded concerning the loss of corporate tax revenue from international tax avoidance. A common culprit blamed for the loss is transfer pricing.¹ The OECD recently decided to investigate if there is a fire.² This article seeks to assess why current transfer pricing rules are the source of tax avoidance and to explore some possible remedies.

To do this the article first places transfer pricing rules in the overall context of the international division of the income tax base in the common situation where a widely held corporate group operating in several countries derives business income. The purpose is to show why transfer pricing is the dominant international issue as compared to corporation and shareholder or residence and source taxation. The article then identifies that it is structural issues in transfer pricing rules which are the main drivers of tax planning, not difficulties of finding appropriate prices. Identifying the causes of tax planning in turn suggests possible solutions. The theory, or rather theories, of the firm stemming from the work of Coase provide the backdrop to the analysis.

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

The rules with which the article deals are generally a mixture of national tax rules applicable to international situations and bilateral tax treaty provisions. Over the 80 years

¹ Two recent examples are Desai, Foley and Hines, "The demand for tax haven operations" 90 *Journal of Public Economics* 513 (2006) and Altshuler and Gruber, "Governments and multinational corporations in the race to the bottom" 110 *Tax Notes* 979 (2006). Specifically the former focuses on transfer pricing and deferral while the latter targets the use of hybrids in international taxation but in the broader sense they are all about transfer pricing related tax avoidance as appears hereafter. There is a long history of work on the possible revenue impacts of transfer pricing.

² The OECD has been revising its transfer pricing rules since 1992. Just as the exercise was approaching its conclusion, the OECD became concerned with business restructures under which, in one view, relatively minor organizational changes in the business lead to large shifts of profits from high tax to low tax jurisdictions. The original announcement at the 2nd Annual Centre for Tax Policy and Administration Roundtable: Business Restructuring held on January 26-27, 2005 was fairly mild and limited, "There was general agreement that it would be useful to do further work in clarifying and perhaps re-examining the role of the dependent agent definition." See summary of proceedings from which this quote is taken at http://www.oecd.org/document/20/0,2340,en_2649_201185_34535252_1_1_1_1,00.html. By 2006, there was greater urgency, "[T]here has been massive restructuring, typically involving risk stripping and intangibles stripping, over the past decade. Governments ... need a theoretical framework to differentiate legitimate restructuring from tax rearrangement, and they need to know how to treat the legitimate version." Comments of Caroline Silberztein, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration, OECD as reported by Sheppard, "OECD makes nice to Americans, Part 2" 111 *Tax Notes* 1200 (2006).

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

II Context of division of the international business tax base

There are three main sets of rules which allocate taxing rights among countries over international business income derived through corporations: rules about corporate-shareholder taxation, rules about residence and source taxation and transfer pricing rules.⁴ The first two sets of rules effectively cede primary taxing rights to the third set of rules and the discussion here indicates how and why. As well as explaining the importance of transfer pricing, this context will be relevant to the later discussion of solutions to current problems.⁵

A Corporate shareholder taxation

Most corporate shareholder tax systems nowadays attempt some degree of integration of the taxes at the corporate and shareholder levels, including the US since 2003.⁶ The problem of integration would not arise if the only tax on income derived through corporations were at the individual shareholder level. It is generally accepted that conduit (look-through) taxation of income of widely held corporations is not practically possible and that generally income of necessity is taxed on a realization basis. As a result a levy of income tax at the corporate level is necessary, otherwise there would be potentially

³ Many of the general statements about various countries' tax systems are sourced from Ault & Arnold, *Comparative Income Taxation: A Structural Analysis* (The Hague, Kluwer, 2004) 2nd ed especially Parts 3 and 4, and Vann, "Trends in company/shareholder taxation: single or double taxation" General Report in International Fiscal Association *cahiers de droit fiscal international* vol LXXXVIIIa 21-70 (2003) (hereafter "Trends").

⁴ Nowadays usually a fourth set of tax rules is involved arising from the fact that a great deal of individual investment in listed corporations is intermediated by one or more collective investment vehicles (CIVs – mutual funds, pension funds, etc). As CIVs are not generally taxed in their own right they are ignored in this discussion, though they add considerable complexity to international taxation of corporate income in practice.

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

⁶ Internal Revenue Code §1(h)(11) (capping the maximum tax rate on dividends at 15%). The recent research and some account of the recent events in the US can be found respectively in Graetz and Warren, *Integration of the US corporate and individual income taxes: The Treasury Department and American Law Institute reports* (Arlington, VA, Tax Analysts, 1998), Vann, Trends, note 3.

infinite deferral of income tax by retention in the corporation of the income realized at the corporate level.⁷

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

The deferral justification for the corporate tax only requires levy of the corporate tax on any retention of profits. Moreover it suggests that corporate tax should be levied by a country with respect to the proportion of the corporation's retained income attributable to shareholders in the country. Levy of corporate tax only on retentions and in the country of the shareholder are not the international norms (assuming that corporation and income are located elsewhere). Taking the point about not taxing in the country of the shareholder first, there are obvious practical reasons for this result. It is difficult to enforce the tax against the corporation if it has no links with the jurisdiction and to detect the proportion of shareholders in the country, especially if the concern is to find the ultimate individual owner of the shares and there are interposed entities. Relatedly and more fundamentally such a tax would contradict the underlying assumption of the system already noted that it is not feasible to tax corporate income on a look through basis. Although the tax would be on the corporation, the amount of tax levied in the country could only be determined by looking through the corporation and in effect attributing retained income to shareholders.

Similarly corporate taxes focused on retentions (systems which give tax deductions for the payment of dividends or apply reduced rates of corporate tax on distributed income) are rare historically and apparently extinct. A number of reasons explain the levy of corporate tax on all corporate income, not just retained income. Most obviously it is a convenient administrative device to ensure effective collection of tax on distributions as well as retentions. Further, if the shareholder is in one country, and the corporation and

⁷ Realization at the shareholder level is generally taken to mean taxation of dividends and of realized gains on corporate shares. The income realized by the corporation is, if retained in the corporation, only realized when the shareholder disposes of the shares. If for any reason there is no effective capital gains tax at this point, for example, shares held until death in the US under Internal Revenue Code ("IRC") §1014, deferral becomes exemption. It will be noted that this is a different concept of realization to that which applies at the corporate level so that it is possible to have income realized at the corporate level but not at the shareholder level. One of the appeals of a system under which income realized at the corporate level is attributed and taxed to shareholders whether or not distributed is that it aligns the concepts of realization at the corporate and shareholder levels. As noted in the text, for widely held corporations such a system is not regarded as feasible.

its income in another country, a dividend deduction or similar system would mean that the tax take of each country and its timing would be affected by the amount of profits distributed. The corporation could shift tax between the countries at will. Germany in the past used a split rate of corporate tax with a significantly lower tax rate on distributed earnings and simply ended up giving a lower corporate tax rate to US owned corporations compared to German owned corporations.⁸ Apart from the potential for manipulation, it is not evident what policy would be served by making revenue division between the countries depend on the level of corporate distributions.⁹

In summary of this section, corporate tax is necessary because of the problem of deferral of tax on retained earnings at the shareholder level under a realization based income tax. In the international context the corporate tax is necessarily applied to all corporate income and not just retentions if the corporate tax is levied by a country other than that of the shareholder. Otherwise the distribution of tax revenue between countries would be at the whim of the corporation and the result would not serve any other purpose. In practical terms, this tax cannot be levied in the country of the shareholder¹⁰ if the corporation and income are located elsewhere.

B Residence and source taxation

To this point the article has referred to the shareholder, corporation or income being in a particular country. The terms used in international taxation for such locations are residence and source but the focus above was corporate shareholder taxation and so far as possible residence and source issues were suppressed.

In a general sense a taxpayer's residence is the country with which the taxpayer has the closest connection and income's source is the country with which the income has the closest connection. The current international norm is that the residence country taxes the worldwide income of the taxpayer and the source country taxes only the income of the taxpayer sourced in that country for which the residence country provides relief to

⁸ [History of German system]

⁹ The result could be offset by the levy of a dividend withholding tax on the shareholder in the country of the corporation equal to the corporate tax rate but from that country's perspective such a complication hardly seems worthwhile compared to taxing the corporation on all its income. Such a proposal was made in the US in 1984 but did not proceed, [Treasury I proposal]. It is possible to separate the methods of taxation of corporation and shareholder from the division of the resulting revenue between countries by using treasury to treasury transfers of tax revenue. While such approaches have been used in the past, they have not been particularly successful and have not survived. They are not sufficiently practical or politically acceptable to be discussed further.

¹⁰ It has long been recognized that it is possible to levy an accruals income tax on portfolio shareholders in listed corporations by taxing dividends received plus or minus the annual change in value of the shares. The difficulty is that an accruals system is not practical for other assets such as closely held businesses and real estate because of valuation and other issues with the result that there would be discrimination in the taxing method among different classes of assets. Nonetheless several countries do levy accruals taxes on shareholders in foreign corporations in cases where it is likely that the income of the corporation is essentially passive fixed income, the income is retained in the corporation, and no corporate tax is paid by the corporation, for example, a corporation based in a tax haven investing in fixed interest securities, see Ault and Arnold, note ? at 386-389. Because this is a departure from the normal realization rule, countries are careful to apply the tax to very limited cases which are not intended to include investment in multinational corporations operating active businesses.

prevent international double taxation. The justification for worldwide residence taxation is that the residence country being the country to which the taxpayer is most closely connected is the one that properly takes account of the personal circumstances of the taxpayer and provides redistribution to or away from the taxpayer under its tax and transfer system. Hence personal tax benefits of various kinds are confined to residents and the progressive income tax rate schedule is applied to residents. To make sensible decisions about distribution it is necessary to take the full circumstances of the taxpayer into account which includes their full (worldwide) income.

There is much less agreement or indeed discussion on what the justifications for source taxation are and therefore what source means. Source taxation is often just taken as a given in which case discussion revolves around solution to the double taxation problem arising when two countries tax the same income (the residence and source countries). One view would explain source taxation on the basis of economic rents, though exactly what rent means in this context is usually not elaborated. The oil well provides the standard example – few query the taxing rights of the country where the well is situated. Another view explains source on the basis of benefit taxation – the amount a taxpayer pays for the benefits received in a jurisdiction.¹¹ It is widely accepted that income from use of a taxpayer's asset in a jurisdiction is sourced there: real estate rentals, mineral royalties, chattel rentals, royalties on intangibles, interest on money lent. For sales and personal services income there is less agreement on the source rules, a matter returned to below.

Because source taxation does not reflect the full circumstances of the taxpayer, it is generally accepted that issues of progressive taxation (or not) are irrelevant and that tax should be levied at flat rates. For similar reasons, the tax levels should be lower than the highest individual tax rates of progressive tax systems in residence countries as the higher rates are there for redistributive purposes. Mainly for administrative reasons, taxes on passive income at source are levied by final withholding on a gross basis, except generally for income from real estate.

The theoretical literature on residence and source taxation addresses two main issues – whether residence only taxation is the appropriate policy and what is the appropriate method of relief in the country of residence for source taxation. The former literature essentially assumes that corporations do not exist while the latter literature assumes that the owners of the corporation are resident in the same country as the corporation. The argument for residence only taxation is that source taxation is shifted to immobile factors and/or residents of the source country and so does not achieve its purpose of taxing the non-resident.¹² While it is easy to show that such shifting occurs in particular situations especially involving gross basis source taxation, it is by no means clear that the same

¹¹ The literature is conveniently collected in Arnold, “Threshold requirements for taxing profits under tax treaties” in Arnold, Sasseville and Zolt eds, *The Taxation of Business Profits Under Tax Treaties* (Toronto, Canadian Tax Foundation, 2003) at ? note 4, and see Pinto, “The Need to Reconceptualize the Permanent Establishment Threshold” 60 *Bulletin for International Taxation* 206 (2006).

¹² The literature is briefly summarized in Kaplow, “Taxation” section 5.5 to be published in Polinsky and Shavell eds, *Handbook of Law and Economics* (North Holland, Elsevier due 2007) available at http://www.law.harvard.edu/programs/olin_center/papers/542_Kaplow.php.

result applies to corporations under the current arrangements.¹³ If the result does apply, then levying the corporate tax in any country other than the residence of the shareholder will not achieve its purpose of preventing deferral at the shareholder level as the incidence of the tax will not be on the shareholder. As already discussed levying the corporate tax in the country of the shareholder is not feasible if the corporation and its income are located elsewhere. It is assumed in what follows that the incidence of the corporate tax is generally on the shareholder. The current international system that has survived for over 80 years on a coordinated international basis and longer on an uncoordinated basis is based on the corporate tax being levied at a place other than the shareholder's country and operates on an assumption of no shifting of the tax.¹⁴

The arguments over the method of relief of double taxation revolve around whether the preferred policy is capital export neutrality, capital import neutrality and national neutrality/welfare.¹⁵ The double tax relief systems associated with these concepts are the foreign tax credit, exemption of foreign income from tax and deduction of the foreign tax respectively. We can avoid discussion of this issue by noting that it elides the residence of the corporation and its shareholders and so is inapplicable in the context of the increasingly common case where a corporation's shareholders are not necessarily resident at the location of the corporation. Moreover, even if the corporation and shareholder are in the same country, the ultimate result at the shareholder level is what is important and

¹³ The problem is most evident for interest on loans from financial institutions. If the country of the borrower levies a flat rate gross withholding tax on the interest even at a low rate, the tax will exceed the bank's gross profit on the loan, that is, its spread between its borrowing and lending interest rates. International lending agreements therefore typically contain a clause that grosses up the interest rate by any interest withholding tax at source and shifts the tax to the borrower. For corporate tax on business income, it may be that the tax holidays often provided by developing countries (and the issue of tax competition between countries more generally) may be a signal of shifting, that is, countries give up or lower their tax rates when they think shifting of the incidence is occurring. Similarly widespread tax planning by non-residents to avoid source tax may be a signal that shifting is not occurring. Conversely if such tax planning is by residents of the source country dealing with the non-resident as commonly occurs in international lending transactions, this is an indicator that shifting has occurred. On this basis we might conclude that shifting is a problem for many developing countries who therefore cut source tax rates significantly or create special tax incentives, for certain types of income taxed on a gross basis and perhaps for corporate tax rates that are high by international standards. Conversely, the studies about loss of revenue referred to in note 1 may indicate that shifting does not generally occur in large developed countries. In the end result, however, we do not know to what degree shifting occurs. Even if tax is shifted, the nominal taxpayer will often be benefited if the tax can be avoided, which explains why some corporations seek to avoid sales taxes.

¹⁴ The problem of shifting of source tax was a concern from the very beginnings of the coordination of the international system and figured prominently in the report of the four economists which effectively inaugurated international tax cooperation, see Economic and Financial Commission (Bruins, Einaudi, Seligman and Stamp), *Report on Double Taxation* submitted to the Financial Committee Economic and Financial Commission (League of Nations Document EFS73F, 19 April 5th 1923) at 7-16 (available electronically at <http://setis.library.usyd.edu.au/oztexts/parsons.html> item 3 1st document). More recently, Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies" 54 *Tax Law Review* 261 (2001) has taken issue with the residence only argument.

¹⁵ The original discussion is usually attributed to Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge, Harvard Law School, 1969); following Musgrave's lead US authors usually come down in favor of capital export neutrality, compare Desai and Hines, "Evaluating International Tax Reform" Harvard NOM Working Paper No. 03-48 (2003) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=425943 [get more recent version].

will often vary from that at the corporate level. The result at the residence of the shareholder, wherever it may be, has as much to do with the method of corporate shareholder taxation as the international double tax relief in the country of the corporation. Appendix Part II provides more details of this result. To put it another way, the traditional residence source analysis only makes sense in the case of individual taxpayers.

In summary this section argues that residence and source taxation is under theorized in the sense either that corporations have not been fitted into the framework which essentially concerns individuals, or that it is assumed the corporation and shareholder are in the same jurisdiction while the method and extent of corporate-shareholder integration are ignored. The framework does not provide any significant information about which country should tax income at the corporate level, if it is accepted that the country of the shareholder cannot perform this task.

C Transfer pricing

The corporation is relatively invisible in discussions of corporate shareholder taxation and residence and source. It is effectively assumed to be a pure conduit for income and the focus is on the taxation of the ultimate shareholder, with taxation on the corporation cast in a secondary supporting role. Yet the major part of tax revenue from international business income is collected at the corporate level with little regard to the country of residence of the shareholder. The purpose of this part is to explain why that is so and exactly how it is achieved.

Theory of the firm

The suggestion here is that the corporation is seen in international taxation as the origin of value and as more than a mere conduit of income. The international tax treatment of corporations is linked, though not coherently, to the views of the firm broadly associated with Coase. In these views firms form to make greater profits by directing the allocation of productive resources instead of leaving resource allocation decisions to the market. The explanations in this Coasean tradition of why the firm is able to make profits not available from market transactions vary and include:

- transaction costs (Coase himself);
- exploitation of assets which because of their special characteristics cannot be fully exploited in the market; and
- the role of the entrepreneur.

Firms differ from the market in directing resources rather than leaving allocation to the market and involve hierarchies of personnel through which this direction occurs and in being characterized by incomplete contracts.¹⁶ Under these theories, the firm acquires

¹⁶ Coase's original statement of his position, "The theory of the firm" (1937) 4 *Economica* 386 (republished often including in Coase, *The Firm, the Markets and the Law* (Chicago, University of Chicago Press, 1988)) went according to him at least virtually ignored for 40 years largely because it did not fit into the dominant approach to microeconomics of the day, see Coase, "The Nature of the Firm: Influence" in Williamson and Winter eds, *The Nature of the Firm* (New York, Oxford University Press, 1991) at 61. More recently his position has been elaborated by a variety of scholars, notably Williamson who in addition

inputs from the market up to the point that it cannot produce the input internally and make a profit on it compared to the market price, but the firm expects to make profits on its use of inputs acquired from the market (as otherwise it would leave the next step to the market). In terms of outputs, the firm sells to the market only at the point that it cannot make any additional profit on internalizing the sale into the market.

Although it is not the purpose of the theories to explain where profits are generated in a geographical sense, it is but a short step to see the profits as located where the firm operates, that is, where its resources are located and directed.¹⁷ This does not mean that firms should be taxed entirely separately from their shareholders. Although such separate systems of corporate taxation have existed in most countries at some point in time, there is now general agreement that it is the ultimate tax burden on the individual shareholder that matters. But the idea of the firm generating profits beyond market returns by the direction of resources has provided the justification for taxing the corporation on all its profits in countries other than the residence of the shareholder and has indicated which countries are the appropriate ones to collect the tax (the countries where the resources are directed).

We can trace such a view to the very origin of the transfer pricing rules, even before Coase published his theory. The author of the rules, Carroll, explained his view of them as follows,¹⁸

[I]n the usual case where an enterprise has its principal establishment in one country and secondary establishment in others ... the real centre of management is probably at the principal establishment. The control and management, financial and technical, are centred there. At the meetings of the directors the decisions are taken which make or break the enterprise. There the risks are centred. The profit or loss results from all the activities of the enterprise taken together, but how can the part attributable to the establishment in each country be most readily

to his own major works edited a series of essays on the variants on the theory to mark the 50th anniversary of original publication of Coase's work, *ibid.* A recent survey of the literature which expounds an entrepreneurial view of the firm is Sautet, *An Entrepreneurial Theory of the Firm* (London, Routledge, 2000). For the purposes of this article, the interest is in what unites the modern variants on Coase rather than what divides them. In this view they are able to stand together in the sense that they identify a number of features which are characteristic of firms. No attempt is made here to rank or critique the theories; rather existing transfer pricing rules and their development are examined to see whether they fit with the theories and what the implications of the theories are for international division of the business income tax base. There are other views which also explain important features of the firm (particularly as it is represented in the modern corporation) but do not require as Coasean theories do that firms exist because of the profits that can be earned from the direction of resources. They include the view of the corporation as a nexus of contracts and the work on agency problems in corporations.

¹⁷ There is some work which links the theories directly to transfer pricing, Holmstrom and Tirole, "Transfer Pricing and Organizational Form" 7(2) *Journal of Law, Economics & Organization* 201 (1991), Sautet, note ? at .

¹⁸ Carroll, *Taxation of Foreign and National Enterprises Volume IV Methods of Allocating Taxable Income* (League of Nations, Geneva, 1933) at para 677, available at <http://setis.library.usyd.edu.au/oztexts/parsons.html> at item 5. An understanding of the firm in the Coasean sense is evident in this passage. The details of the conclusion reached by Carroll were not accepted at the time and are still a live issue in international taxation as explained below.

measured? If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit or loss after allocating to each outlying secondary establishment compensation for the services it has rendered to the enterprise in accordance with what would be paid to an independent enterprise rendering such services.

Thus it is plausible to see the distribution of taxing rights over corporate profits in terms of Coasean theories of the firm.

Residence of corporations

The way in which this distribution of rights to levy corporate tax among countries in international taxation occurs is complex. Rather than allocating taxing rights over a corporation's profits to countries directly, the corporation was fitted into the residence and source framework even though at a policy level as noted above all that matters is the residence of the individual.

This apparent assimilation of individuals and corporations in international tax rules might be explained on the basis that most or all of a widely held corporation's shareholders are resident in the same country as the corporation but that is less and less true for listed corporations and the discussion that follows focuses on this development by assuming that the corporation is centered in a different country from at least a significant number of its shareholders. If shareholder residence were the focus, one would expect the corporate residence rule to reflect that idea, such as a majority of shareholder's resident in the country. Residence rules of this kind are in fact very rare which may be explained by the practical considerations mentioned above for taxing the corporation in the country of residence of the shareholder, with the difference that the problem of detecting the proportion of shareholders, including tracing through interposed entities, would arise in the residence rule rather in calculating income subject to corporate tax. Indeed such a rule, for reasons noted above, is equally contrary to the assumption that it is not possible to apply a look through or conduit approach to taxation of shareholders in widely held corporations.

At the level of the widely held corporation, corporate residence rules effectively rather adopt the location of the corporate headquarters.¹⁹ This test may reflect a relatively

¹⁹ This is more evident in civil law countries where tests more or less directly refer to the headquarters. In countries influenced by the UK the test is central management and control, which is generally taken to mean where the board of directors takes its decisions but this usually equates to the corporate headquarters. Many countries include a place of incorporation test as well as a headquarters type test but generally listed corporations will ensure that they coincide to avoid dual residence problems. The US is the best-known contrary example of a country using only a place of incorporation test for corporate residence. For a description of the rules see Ault and Arnold, note ? at 349-350. Even for the US in practice for listed corporations the place of incorporation coincides with corporate headquarters. As was seen recently in the case of corporate inversions, Congress is likely to intervene if attempts are made to separate the place of incorporation of widely held corporations from US located corporate headquarters, IRC §7874. The extract

unthinking anthropomorphic view of the corporation as a person²⁰ and on its own would suggest that the country of the corporate headquarters taxes the corporation on its worldwide profits.

Transfer pricing rules

In fact very few countries,²¹ not including the US, really tax multinational corporations on their worldwide profits by reference to the notional residence of the parent corporation based on its headquarters, even though most countries nominally tax corporations on a worldwide basis, including the US. The nominal residence rule for corporations performs other purposes. To understand the actual operation of the system it is necessary to introduce the transfer pricing rules. As well as a corporate residence rule based on the location of headquarters, the transfer pricing rules are also built on another central concept, the permanent establishment or PE,²² which is constituted by a corporation having in a country a fixed place of business or dependent agent that carries on (part of) the corporation's business.

The transfer pricing rules then provide as follows:

- (1) A corporation may not be taxed in a country other than its residence unless it has a PE there.
- (2) The profits which a corporation makes at its residence in relation to its dealings with associated corporations resident in other countries are determined on the basis of the

quoted above note ? from Carroll who was from the US clearly adopts a headquarters view of residence. The tie breaker in tax treaties for dual resident corporations is the "place of effective management," see OECD, *Model Tax Convention on Income and on Capital Condensed Version* (OECD, Paris, 2005) article 4(3) at 26.

²⁰ The classic UK case on residence of corporations developing the central management and control test as a judge made rule, *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455, may fall into this category, "In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. An individual may be of foreign nationality, and yet reside in the United Kingdom. So may a company. Otherwise it might have its chief seat of management and its centre of trading in England under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad and distributing its dividends abroad." Under Coasean theories of the firm, it is possible to construct a (fairly weak) justification for worldwide taxation by the country of the headquarters of a corporation. The justification would see the direction of the firm's resources driven by the corporate headquarters as supporting corporate tax on those profits by the country of the headquarters even though the activities directed may have occurred in other countries. Such a view is suggested by the passage from Carroll quoted above, note ? but the point that the headquarters may warrant a special allocation of profits can be dealt with in other ways as noted below in the text.

²¹ Sweden and New Zealand seem to be the only countries that seek to tax active business income of a multinational corporation (including subsidiaries) on a current basis if the parent corporation is based there, Vann, Trends note ? at 61.

²² This term is not very "English" in any version of the language. That is because it is a (bad) translation derived from German via French, see Avery Jones et al, "Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States" 60 *Bulletin for International Taxation* 220 at 234-235 (2006). The PE terminology is standard in international tax language (which courts have recognized as a specialist language) and is used here. A more meaningful English rendering might be "branch or agency" but that phrase is both cumbersome and inaccurate for reasons that will appear.

profits it would make if it were an independent corporation dealing on normal market terms with the associated corporations.

(3) The profits which a corporation makes at a PE (and which may be taxed in the PE country) are the profits which the PE would make if it were an independent corporation dealing on normal market terms with the rest of corporation of which it is a part.²³

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

In recognition of the two critical aspects of the rules they are often referred to collectively as the “separate enterprise arm’s length” principle or variants thereon. “Separate enterprise” recognizes that the firm is effectively divided up on geographical lines and “arm’s length” the use of market prices between the parts to allocate profits. The separate enterprise part of the principle means that the international tax system is premised on

²³ The typical tax treaty provisions state as follows:

Article 7 Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

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

Article 9 Associated enterprises

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

See OECD, note ? at 28-30.

taxing each corporation separately, and accordingly recognizing each corporation's separate residence by applying the normal residence rules for corporations.

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

Relief of international double taxation for corporations

The final rules that it is necessary to notice in understanding the actual operation of the transfer pricing rules are those for relief of international double taxation. Because corporations are regarded as resident at the place of the headquarters, the headquarters country under the normal operation of residence and source concepts would tax the worldwide income of the corporation and be obliged to give relief for tax levied at source. In fact in most cases, there is no tax levied in the country of the headquarters on income that is treated by the transfer pricing rules as taxable in another country. The route by which this result is reached varies from country to country. Most directly some countries use a comprehensive exemption system for corporations so that profits of PEs, dividends from foreign subsidiaries and capital gains on shares in foreign subsidiaries are exempt from tax in the country of the headquarters (in the case of foreign PEs) or residence of the parent (in the case of foreign subsidiaries).²⁴

To the extent that a country uses a foreign tax credit for corporations (such as the US), the lack of tax in the country of the corporation's residence arises in the case of PEs generally because of the rough equivalence of corporate tax rates around the world combined with considerable foreign tax credit tax planning. For foreign subsidiaries, tax in the country of the parent is generally only triggered when the subsidiary pays dividends or the parent sells shares in the subsidiary. Moreover, in the case of dividends, the foreign tax credit is extended to the corporate tax paid by the subsidiary not just source taxes on the dividends. Foreign tax credit planning is thus available for dividends in the same way as for PEs. More importantly both payment of dividends and sale of shares are in the control of the parent and so it is possible to postpone tax in the country of the parent, which is generally referred to as deferral.²⁵

As already noticed, deferral is really an issue with respect to tax on the ultimate shareholder. Deferral is only a problem in the country of the parent corporation's

²⁴ Some countries use exemption fairly generally for foreign income while others use it only for corporations. Even in the countries which use the system generally there are special rules for corporations which mean that there is different treatment in most countries compared to individuals.

²⁵ Deferral is an endemic issue in the income tax but the use of the term in this specific sense has a long history.

headquarters if the shareholder is resident in the same country. Otherwise application of the foreign tax credit in this country does not make much sense as the residence rule for the corporation is essentially operating through the transfer pricing rules to locate income in the country, not to tax worldwide income. If it is thought that the activities of the headquarters deserve special recognition, because, for example, the headquarters is responsible for the strategic direction of the firm, that can be more clearly achieved by allocating more of the firm's profit to the headquarters under the transfer pricing rules rather than residual taxing rights under the foreign tax credit mechanism.²⁶ There is a noticeable trend around the world to exemption systems for relieving international double taxation of corporations, including in the US though only for the calendar year 2005 for dividends from subsidiaries.²⁷

The outcome of the way in which international double tax relief systems work for corporations is that the application of the same residence and source regime to corporations as to individuals is only apparent, not real. The residence of the corporation is used along with the PE and transfer pricing rules to connect income (profits) to a country, not generally to tax on a worldwide basis. In the sense that source is the connection between income and a country, the residence rule for corporations, the PE rule and the transfer pricing rules together are sourcing rules.

Transfer pricing and source taxation

It follows from the conclusions of the previous sections and here that the corporate tax on listed corporations is essentially a source tax. The pitching of the corporate tax rate around the world is consistent with this characterization. A standard policy prescription in a purely domestic context is that the corporate tax rate should be equal to the top marginal tax rates for individuals to eliminate deferral of shareholder tax entirely for closely and widely held corporations. Nonetheless over long periods of time and in most countries, the corporate tax rate has typically been significantly lower than the top individual marginal tax rate. This is consistent with the view of the corporate tax as a source based tax. It will be recalled that source tax rates are generally flat rate and lower than top progressive tax rates.²⁸ The US is currently an exception with alignment of the federal corporate and top marginal rates at 35% but over the longer term the US has also fitted the standard pattern.

²⁶ At least one country, Switzerland, has long expressly incorporated a return to management at the headquarters in its tax system. The quote from Carroll, note ?, adopts a similar view.

²⁷ IRC §199. The push for a general exemption system for corporations in the US remains strong but the debate is generally framed in the traditional terms of capital export neutrality, capital import neutrality and national welfare. It is not the purpose of this article to argue for the exemption system as such but rather to explain why corporate tax is not collected to any degree in either the country of the shareholder or the country of corporate headquarters if the income is allocated by the transfer pricing rules to another country. The implication, however, is that the current debate over exemption is misdirected to the extent that it ignores the residence of the shareholder and the method of integrating corporate and shareholder income taxes, see Vann, Trends note ? at 53-63.

²⁸ In many countries the corporate rate is nowadays also similar to the flat rate charged in national law on passive income taxed on a source basis.

Whether this be the explanation for the corporate tax rate or not, to the extent that the residence of the shareholder and/or the headquarters of widely held corporations are different from the country to which income is attached by the combination of the corporate residence, PE and transfer pricing rules, it is the last country that will collect the bulk of the tax on the income generated by the corporation. That tax will be generated by the corporate tax levied on the income allocated to the country under the transfer pricing rules.

It should be noted that the international system tackled the problem of how to divide taxing rights between countries when transactions occurred across borders such as manufacture of tangible goods in one country and sale in the other as an essentially stand-alone exercise. Combined with the fact that the residence rule for corporations is essentially a sourcing rule as just described, not surprisingly the current international tax system exhibits both complexity in its handling of residence and source issues²⁹ and does not reconcile the principles underlying traditional flat rate final source taxes described earlier and the transfer pricing rules. Transfer pricing rules differ in a number of respects from simple sourcing rules of the kind described. Traditional source rules see all income from a particular productive resource as located in one country; by contrast, transfer pricing rules involve allocating profits from a particular productive process between countries. The source taxes are often levied on a gross final basis while the transfer pricing and associated rules effectively require taxation on a net basis.³⁰ The transfer pricing rules were for many years seen as effectively anti-avoidance rules while the traditional source rules were seen as systemic. Tax treaties either significantly reduce or suppress entirely the traditional source taxes except in the case of real estate but require the application of the separate enterprise arm's length principle to allocate business income.³¹ These differences will be dealt with at various points in the next sections, but no final solution is offered though some possible directions are indicated.

The recognition of corporate residence as a sourcing device also throws light on another common criticism that the separate enterprise part of the transfer pricing rules fails to recognize the economic unity of the corporate group. If corporate residence is viewed as a true residence rule as the formal nature of the rule for corporate residence rule suggests, then it is artificial to break up the residence of members of the group based on whether there are separate corporations or not. We do not divide up the residence of an individual based on where the individual's income earning activities occur – that is the function of

²⁹ Vann, "Reflections on Business Profits and the Arm's-Length Principle" in Arnold, Sasseville and Zolt eds, *The Taxation of Business Profits Under Tax Treaties* (Toronto, Canadian Tax Foundation, 2003) 133 at 142-146.

³⁰ Tax treaties generally permit gross basis taxes for dividends, interest, royalties and rent but effectively require net basis taxation for business income, see OECD, note ? articles 6, 7(3), 10-12, 24(3), (4) at 28-33, 39-40.

³¹ It is common to tie a number of these features to a distinction between active and passive income, for example, Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" 74 *Texas Law Review* 1301 (1996), that is, source taxation of passive income (apart from real estate) is very limited and taxed at final flat tax rates; business and services income is active and is taxed at source without limit once a basic threshold is passed but the tax is levied on a net basis. While true and reflective of the history of international taxation in a broad sense, the distinction does not explain all the differences noted in the text.

source principles. If we recognize the corporate residence rule as at bottom a sourcing rule like the PE rule, this form of the criticism is not compelling.

What is a problem rather is the lack of robustness of the corporate residence rule within the group. We have noted that at the level of listed corporations residence will generally coincide with the headquarters, despite the variety of expression of corporate residence rules. Within the group, all forms of corporate residence rule are the subject of tax planning, because the place of incorporation, headquarters or board meetings of subsidiary corporations can be easily manipulated, especially if the corporation in question carries out few activities. Hence the creation within the corporate group of corporations resident in tax havens is easily organized. In itself this corporate residence manipulation is only really a concern for highly mobile income like interest.³² If the transfer pricing rules for allocating business income were robust, little income could be allocated away from countries where business is actually done. But the transfer pricing rules are not robust for the structural reasons explored in the next section.

Summary

This section has introduced the transfer pricing rules in international taxation and linked them to Coasean theories of the firm. Contrary to the appearance of their being at least in part a residence rule based on the headquarters of widely held corporations, the principle in fact provides sourcing rules which allocate business income between countries. The effect, when combined with mechanisms for relief of international double taxation, is that most corporate tax is collected in the country to which income is allocated under the transfer pricing rules. Relatively little tax is collected by the country of (nominal) residence of the corporation or the country of the ultimate individual shareholder if the rules allocate the income elsewhere. Hence the effectiveness of the transfer pricing rules is central to the effectiveness of the corporate tax in relation to multinational corporations.

To the extent that the residence of the ultimate shareholder is not in the same country as the headquarters of the corporation, we have also seen that some current international tax rules have a questionable basis. The headquarters country of the corporation has little policy claim to tax more than the income allocated to it under appropriate transfer pricing rules.

III Operation of the transfer pricing rules

This section seeks to isolate the structural weaknesses of current transfer pricing principles that make them ripe for tax planning. Over recent years the detail of the rules

³² The source of interest is simply a question of which financial institution where is chosen for making deposits. Tax systems respond to this problem within corporate groups by controlled foreign corporation (CFC) regimes that tax passive income derived by corporate groups at the place of the headquarters (residence) of the parent company, see Ault and Arnold, note ? at 377-386. Like many other rules discussed above, there is an implicit assumption that the ultimate individual shareholders will be resident in the same country. If they are not, the taxing claim of the country of the headquarters of the corporation is not obvious. In some countries, the CFC rules are also extended to transfer pricing situations. I return to these rules in the discussion of potential solutions to transfer pricing tax avoidance.

has expanded as a result of OECD work and parallel elaboration in national legislation and practice.³³ The details themselves provide many tax planning opportunities but that is not the focus here. If it is possible to get the framework right, the details can be left to the courts or other action at the national level to ensure that the details match the framework.

The discussion starts with the definition of the firm to which the rules are applied. It then discusses the significance of market prices between independent enterprises as the standard of allocation, particularly its implications for value that may be created above market prices in the firm and for using legal transactions (contracts) as the basis of the rules. Finally, the functional analysis at the heart of modern transfer pricing practice is examined. This methodology requires that profits be allocated among countries on the basis of the “functions performed in the light of the assets used and risks assumed” (commonly referred to as FAR for functions, assets, risks). Rather than being a unifying and robust methodology as intended, it has been at the centre of much of the tax avoidance activity. The treatments of the following areas are considered in relation to the functional analysis: risk, personnel, assets and sales. In each of them the methodology has been manipulated in practice to allow diversion of profits to low tax jurisdictions.

A The firm

Because we are discussing the international division of the business income tax base, we need to divide the firm up in a geographical sense and relate the firm to specific countries. As noted above such a geographical connection is not the general concern in theories of the firm. Nonetheless the Coasean theories posit a distinction between the firm and the market based on the direction of resources rather than market allocation of resources and this essential feature can be used geographically – if we find resources in a country that are being directed in this sense, then the firm is present in the country.

The current international rules in part seem to adopt this approach and in part not to. It was noted above that the rules use the residence of the corporation and the PE to describe the necessary connection with the country. At this point it is necessary to expand slightly on these concepts. The definition of the PE includes not only fixed places of business, that is, facilities in a country occupied in a legal sense by the corporation itself,³⁴ but also dependent agents who enter into sales contracts with third parties on behalf of the corporation. Dependent agents cover employees and non-employees, including other corporations. The dependency test turns on whether the agent is legally and economically independent of the principal or not. The idea is one of a dependency attachment to the

³³ The current OECD rules are contained in *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, OECD, 2001) which deal with associated corporations. The position on PEs is currently being developed in a four part discussion draft which is referred to in part later in the article; the final version of the first three parts is due for publication before the end of 2006. For the US the rules are contained in the regulations under §482. Together this material amounts to many hundreds of pages. More generally see Ault and Arnold, note ? at 420-425.

³⁴ The notion of permanence implied by PE terminology has two aspects. The location must be relatively static (not moving equipment for example) and last for generally 12 months. For agents the permanence idea means that the agent must act for the principal “habitually.”

principal and corresponds to the direction of resources idea in Coasean theories.³⁵ In the case of separate corporations, the required relationship is that the corporations be “associated enterprises” which in turn is expressed in terms of control. Although control could be viewed as another way of stating the dependency attachment idea, in fact it is generally taken as an ownership test (that is, parent and subsidiary and similar relationships).³⁶

There are two fault lines in these rules. So far as the PE is concerned, the dependency attachment test is subordinate to the agency test so that if agency is avoided (and agency here is the legal concept, not the commercial concept of the term), it does not matter if there is dependency. In the case of the associated enterprises, the dependency idea in the PE rule has been replaced with an ownership test. While ownership will usually imply a dependency attachment, dependency is possible without ownership. It is obvious in the case of employees that “ownership” by the firm is not required for the employee to constitute part of the firm. The direction of the supply of the employee’s labor is sufficient. Coase came to regret that employees loomed so large in his original exposition of direction of resources being the hallmark of the firm as attention was diverted from other relationships in which the necessary direction was present.³⁷

The combination of these fault lines means that some dependency situations will fall outside the definition of the firm in the international tax rules. Some possible examples are certain kinds of franchise and distribution arrangements. If the franchisee or distributor is a separate corporation, it will not be viewed as part of the firm constituted by the franchisor or producer if it is not owned by the franchisor or producer of the products being distributed and is not an agent. As franchisees and distributors typically sell in their own right and not as agent, the test essentially comes down to ownership. The significance of this structural problem in the rules will become evident as we proceed particularly regarding the significance of transactions and sales. It is not often highlighted as one of the problems in transfer pricing rules which may mean that a Coasean policy basis is implicitly rejected for defining the firm. If so, it is not clear what the underlying

³⁵ The distinction can be seen clearly in two extremes. If a firm uses a large stockbroker with many clients to sell some of the firm’s portfolio shareholdings in listed corporations, then assuming that the broker is acting legally as agent which is the case in some countries at least, the broker would not constitute a dependent agency PE as the broker is independent. Both the broking and the sale transaction are normal market transactions. By contrast if a firm which manufactures unique goods sells them through agents in various countries and the agents only act for that firm and under strict guidelines, the agents will be dependent agents as they are a part of the firm not much different from employees. The agency contract will not be a normal market transaction in the sense that the firm expects to make at least some of its profit out of its direction of the selling activity of the agent, in addition to its manufacturing profit. The term “integration” can be used to describe the idea as it conveys that the person or asset is part of the firm. Because the term “integration” has been used above as is also common to describe systems that try to overcome double taxation of corporation and shareholder, the terms “dependency” and “dependency attachment” are used here to describe when a person or asset is considered to be part of the firm.

³⁶ The ideas in this part of the article are considerably expanded in Vann, “Tax Treaties: The Secret Agent’s Secrets” [2006] *British Tax Review* 345 (hereafter “Secret Agent”).

³⁷ Coase in Williamson and Winter note ? at 64-65.

policy basis of the rules is.³⁸ While it is possible to posit some cases where dependency is present but ownership and agency are not, it is more problematic to provide a direct test of dependency that is sufficiently detailed but not subject to manipulation.

In summary this part of the article has suggested that a dependency attachment should be the organizing principle in defining the firm for international tax purposes. Current rules adopt dependency but add requirements of ownership or agency which have the effect of bringing the rules up short of the principle.³⁹

B Market price benchmarks: transactions, dealings and legal entities

To paraphrase from earlier discussion, the benchmark for allocating a firm's profits across the countries where the firm operates is the profit that would arise if the part of the firm in each country dealt with each other part of the firm in other countries as if they were independent corporations transacting in the market in the normal way. As already noticed, the benchmark appears to contradict the Coasean theory of the firm which posits that a firm organizes because it is able to make profits which are not available in market transactions – the reasons for the additional profit varying to some degree in different versions of the theory. The firm does contract with the market for inputs and outputs but the profit that arises after taking account of these contracts is attributed to the internal activities of the firm. It is these internal activities of the firm to which the market price benchmarks are being applied in allocating profits across countries for corporate tax purposes.

The application of the market price benchmark may be an implicit denial that firms exist for the reasons expressed by Coasean theories. Certainly that denial has been expressed in other contexts and may underlie theories that do not require there to be any additional profits for firms to form. This style of argument has been deployed in recent times in relation to international taxation of dependent agency PEs to suggest that even if such a PE exists, there is no profit to tax to the principal in addition to the separate taxation of the agent on its profit.

³⁸ The PE concept is frequently criticized as a threshold test for source taxation, see the work of Arnold and Pinto referred to in note ?. The criticism is not, however, formulated in the terms set out here as the PE concept is seen as all or any of mechanical, outdated, or administration based and hence a barrier to source taxation, rather than as a principled, if flawed, concept for sourcing business profits.

³⁹ Further, the PE rules have exceptions which were originally intended to be de minimis as indicated by their description of “preparatory or auxiliary.” While the exceptions do not cover firms whose very business is the activity in question, it is not clear if there is an overall preparatory or auxiliary limit on the exceptions, and nowadays the listed activities include significant value adding elements – purchasing, warehousing, delivery, advertising, collection of information and research, but not after sale service. In the case of purchasing activities, no profit is attributable to the activity even if there is otherwise a PE. These exceptions hark back to a different world when international trade consisted mainly of raw materials and finished goods which more or less sold themselves. They are the subject of considerable manipulation and indicate the problem of using proxies instead of direct rules. If it is desired to have a de minimis rule so that firms are not subject to the considerable compliance costs entailed in filing a tax return in a country, the rule would best be expressed directly through some kind of threshold such as the level of turnover or of purchases (the former is common in value added taxes).

The argument runs as follows. Assume that a dependent agent in a country is selling goods manufactured abroad by a foreign principal. The agent is a separate legal person from the principal and enters into an agency contract with the principal. The price in that contract will reflect the market value of the agent's services, or, if the agent is an associated corporation of the principal in an ownership sense (such as a subsidiary), the agency contract can be adjusted to the market price under the transfer pricing rule that applies to associated corporations. To the extent that the agent constitutes a part of the principal's firm under the dependent agency PE rule and the principal is to be taxed in the PE country, the revenue of the principal attributable to that country will be the market value of the agent's services because that is the activity of the principal that is carried on there and hence is the amount of revenue that the principal should have attributed to the PE. This amount is given by the actual contract price with the agent or the adjusted price of that contract if the agent is an associated enterprise. The expense of the principal at the PE will be the fee paid to the agent under the contract (or the adjusted fee if the agent is an associated corporation). Revenue of the PE thus equals its expense and nothing is taxable to the dependent agency PE, which is sometimes described as the nil sum view.⁴⁰

Although it would seem quixotic for the officials entrusted with devising the international tax system to spend 80 years creating rules that it now turns out leave nothing to tax in a country, this argument is widely accepted in the international tax profession and is the source of a significant amount of tax planning. It has not been the subject of an adequate official reply.⁴¹ My response is twofold: first, that the international system has from the beginning accepted that there is an additional profit to allocate above the market prices of the actual external (non-dependent) inputs of the firm, and secondly, that the profit may be allocated in whole or in part in many cases by positing appropriate transactions within the firm and using market prices for those transactions effectively to allocate the profit generated by the existence of the firm. The most explicit recognition of this response is the OECD sanctioned transfer pricing method called the "residual profit split."⁴² Under this method the total profit is allocated in part by market prices of (presumed) transactions among the parts of the firm and as to the remainder by some appropriate apportionment "keys" representing the contributions of various parts of the firm in addition to the transactions. In my view it is clear that the international system accepts the Coasean theory of the firm despite the apparent oddity of the market price benchmark.

⁴⁰ For the detailed history of the relevant rules and my response to the nil sum view, see Vann, "Secret Agent" note ?. The nil sum argument at the moment is mainly deployed in relation to subsidiaries. It has not been generally used in relation to employees who constitute an agency PE or to fixed place of business PEs though it could equally be used there with the result that there would not be any taxable profit in any PE.

⁴¹ The current official response appears in OECD, [Revised] *Discussion Draft on the Attribution of Profits to Permanent Establishments: Part I General Considerations* (2004) available at <http://www.oecd.org/dataoecd/22/51/33637685.pdf> at 60-65 which is criticized in Vann, Secret Agent, note ? at 376-380.

⁴² In this article I use profit or income to refer to the firm's overall profit. In the usage 'residual profit split' the term residual refers to the profit remaining after allocation of some of the profit by the market prices of transactions.

The apparent oddity is to be explained by the assumptions that were made by most countries during the many years over which the transfer pricing principles were developed and refined. Returning to the situation of the agent above, the assumption was that the dependent agency PE would have allocated to it as revenue the selling price of the principal's goods rather than the value of the agent's services. The principal through its dependent agency PE is selling its goods and the revenue of the PE is derived from the sales not from the agency activities. In other words there is a presumed sale by the parts of the principal outside the PE country to the PE in the country at the (manufacturing) market price and then a sale by the PE to the ultimate buyer at the (selling) market price. It is the market price of that presumed contract which is relevant under transfer pricing rules, not the market price of the agency contract.

Under this approach the overall profit of the firm is effectively split between the country of manufacture and the country of sale with the manufacturing profit taxable in the former and the sales profit taxable in the latter. In this simple case the full profit is allocated between the manufacturing and selling country and there is no need to go any further. It will be noted that this is the same allocation between countries as would apply if the transactions were structured with manufacture by a foreign parent, sale by the parent to a local subsidiary and sale by the local subsidiary. The rules in other words were structured on the basis of presumed ways of dealing among the parts of the firm which by a convenient short cut allocated the Coasean profits in what were the common cases in past years.⁴³

In the case of PEs the contracts generally have to be presumed because the PE is simply one geographical part of the same legal entity. This is true for both fixed place of business and dependent agency PEs although in the case of the latter there tends to be confusion of the agent in its own right with the PE (and hence of actual contracts with presumed contracts). Although the PE is constituted by the dependent agent's activities, it is those activities viewed as part of the firm of the principal, which they are because of their dependency attachment to that firm, that constitutes the PE. This confusion in part underlies the arguments that no profits are attributable to dependent agency PEs considered above.

In the case of associated corporations, however, there can be actual contracts in the legal sense between the parts of the same firm (parent and subsidiary in the simple example here). The issue then is whether those actual contracts trump the presumed contracts that would be used in a PE situation. Little attention was given to this issue in the original framing of the rules for associated corporations as at the time the problems of allocating profits between countries seemed mainly to arise through PEs.⁴⁴ It was no doubt assumed that actual and presumed contracts would line up. In fact corporations quickly exploited the possibilities of varying the actual contractual arrangements from the presumed ones. It was easy to read the way in which the transfer pricing rules were formulated as

⁴³ It was at this critical point that country practice departed from the views of Carroll, quoted above n ?. Carroll rejected such presumed sales and viewed a PE as providing services to the head office.

⁴⁴ Corporate laws in some jurisdictions did not permit corporations to own shares in other corporations which may partly explain this position.

permitting this freedom of contract which is the hallmark of the market and the rules have been interpreted as based on freedom of contract within fairly broad limits.⁴⁵

Thus it is possible to vary the contracts in the parent and subsidiary situation so that the parent legally sells the goods in the country of the subsidiary and the subsidiary simply provides assistance in making the sales without rising to the level of an agent in the legal sense. The only contract to price for taxation purposes in the country of the subsidiary is the sales assistance contract between the parent the subsidiary. The parent ensures that it does not have a PE and so is not taxable in the country of the subsidiary while the subsidiary performs an apparently minor role which is appropriately rewarded with a market contract price. In reality little has changed but the nil sum view is effectively achieved by different contracts.⁴⁶ The choice of switching the pattern of the contracts means that the allocation of the total profits is essentially within the power of the corporation.

The theory of the firm indicates that the source of the problem is the assumption of the market freedom of contract. The way in which the subsidiary is acting in these cases is at the direction of the parent and the subsidiary's activities are dependent on those of the parent. Another way of expressing the point which is common in the literature is that firms are characterized by incomplete contracts (though arguments range back and forth about whether incomplete contracts are characteristic of firms or a much more general market transaction). On the incomplete contract version, the only actual contract between parent and subsidiary here is incomplete in that it is really a contract for much more than minor selling services.

There are other dimensions to what is essentially the same problem. The contracts between associated corporations may be obviously incomplete but nevertheless are priced on the basis of a different complete market transaction. This occurs in the case of licensing of intangibles. Contracts between associated corporations may be written as non-exclusive licenses so that powers of enforcement remain with the licensor (depending on intellectual property rules in different jurisdictions) but are treated by the corporations for transfer pricing purposes as if they were exclusive licenses as that is the equivalent market transaction. While it is possible in some cases to find comparable market transactions, even though they do not represent the actual incomplete contract, in other cases there will not be a comparable market transaction because separate firms

⁴⁵ It was only in 1995 that principles were formulated for the disregard of transactions between associated corporations but despite their very broad expression, the principles were stated to be exceptions to be utilized rarely. The exceptions are "where the economic substance of a transaction differs from its form [and] where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises, behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price." Transfer Pricing Guidelines, note ? at para 1.37.

⁴⁶ For more details, see Vann, Reflections, note ? at 154-157.

would not have entered into the transaction in question as the nature of the contract depends critically on the dependency attachment of the parties to the same firm.⁴⁷

Whether expressed as a lack of freedom of contract or as incomplete contracts, in the end the clear object of the transfer pricing rules was not to produce different allocations of profit in what are essentially the same circumstances. Either associated corporations have to be limited in the type of contractual arrangements that are acceptable for transfer pricing purposes or the actual contracts have to be replaced by presumed contracts. The attraction of the former approach is that it is using actual contracts which feel familiar to taxpayers and tax officials. Even so in the associated corporations case it will not always be possible to find equivalent market transactions. Current transfer pricing detailed rules specify circumstances where only certain kinds of contracts are acceptable. The view which is being stated here is thus not new but it must be much more widely applied. The current freedom of contract is one of the most significant structural weaknesses in transfer pricing.

Returning to the PE situation, that fact that contracts have to be constructed as no real relevant contracts generally exist (with an exception noted below),⁴⁸ does not necessarily preclude notional freedom of contract. The early development of the rules contained a number of rules of thumb which limited any notional contractual freedom. In the recent and on-going reconsideration of PE transfer pricing rules, it appeared for a time that the OECD was going to extend the same freedom of contract to constructed contracts. More recently as the OECD has begun to finalize its views on the application of transfer pricing rules to PEs it is creating or preserving more and more presumptions in the PE rules which effectively amount to restrictions on the freedom of contract. In later parts of this section of the article a number of these presumptions will be noted as they are the best current indication of how restriction on freedom of contract might be implemented. To the extent that these presumptions appear sensible, they should be extended to associated corporations.

That the same or very similar standards should apply to PEs and subsidiaries is necessary as the choice of a PE or subsidiary is effectively within the election of the corporation. In recent times the electivity has become even greater because of hybrid entities. Originally these were generally exotic entities that different countries treated in different ways for tax purposes. One country treated the entity as a corporation taxable in its own right and the other country treated it as a part (and usually PE) of the entity or entities which owned the hybrid. When the US introduced the check-the-box rules for the classification of entities as corporations or PEs, it was no longer necessary in cases involving the US to use an exotic entity to achieve this outcome.⁴⁹ What two corporations for the purposes of another country under its corporate, contract and tax law will for US purposes be two

⁴⁷ As explained later, contracts involving intellectual should in any event be constrained and not permit licensing transactions at all.

⁴⁸ Within the corporation there are usually only the various activities of its different parts, which the OECD refers to as “dealings” to distinguish them from the legal contracts between associated corporations, which the OECD refers to as “transactions.”

⁴⁹ Regulations §301.7701-2

separate corporations in corporate and contract law but one corporation with a PE for the purposes of tax law if the corporations so choose. Thus it is possible to have actual legal contracts (because the corporations are separate legal persons for corporations and contracts law purposes), but a single corporation with a PE for tax purposes. If freedom of contract were permitted for PEs it would be possible by this means to remove one of the difficulties of manipulating PE taxation – ambiguities about what the contractual arrangements are.⁵⁰

In summary this part of the article has argued that while the market price benchmark may be thought to contradict Coasean theories of the firm, in fact those theories do underlie current rules. However, the freedom of contract permitted under current transfer pricing rules for associated corporations means that the allocation of the profit, which can be appropriately allocated under certain market priced contractual arrangements, may be subverted by different contractual choices. This is a significant structural flaw in current transfer pricing law which is also inconsistent with the theory of the firm. It is necessary to constrain freedom of contract in transfer pricing rules in order to allow the market price to allocate profit appropriately and even then such prices may not fully exhaust the profit in which case other methods of allocation will be necessary. With PEs, contracts generally have to be constructed and current and developing rules in the area are moving in the direction of much less freedom of contract. The kinds of presumptions existing and emerging in the PE area may provide the way forward.

C Functional analysis and risk

Tax avoidance problems in the transfer pricing area are not new. As noted above the functional analysis and the accompanying FAR jargon (“functions performed in the light of assets used and risks assumed”) that came into use in the 1980s was intended to prevent, not create, tax avoidance opportunities, but the emphasis on risk had precisely the opposite effect.⁵¹ There are two stages in the development though historically there is considerable overlap. The first stage flowed from the failure to tackle freedom of contract between associated enterprises. As risk can be assigned by contract more or less at will, it was possible for associated corporations to move risk around a corporate group as they wished and with the risk went a substantial proportion of the profit. Some simple examples are contract manufacturing and captive insurance.

⁵⁰ Altshuler and Gruber, note 1 have recently identified the check-the-box rules as one significant cause of loss of corporate tax revenue in the US. As the brief discussion here indicates, the problems are essentially ones of transfer pricing. The problems mainly show up in the parts of transfer pricing involved in financing of firms. These issues will not be dealt with in the article. [Tax calculation details for PEs and of corporations of which they are part will still differ from parents and subsidiaries but not in ways that affect the point made here– include brief technical discussion in full version].

⁵¹ In the US 1986 tax reform, some important changes were made with respect to intangibles and a study of the whole area was mandated. There followed a 1988 US Discussion Paper on transfer pricing which introduced the functional analysis and the economist into the transfer pricing area. After this shift in transfer pricing analysis found its way into US draft regulations, the OECD got involved as many countries considered that the new US approach was not consistent with the then orthodoxy (as concerned methodologies rather than theory). The final 1995 “compromise” in the Transfer Price Guidelines represented a victory for the US approach with the FAR jargon appearing prominently in the Guidelines.

The main difference between an ordinary manufacturer and a contract manufacturer is that the latter takes no inventory risk. It manufactures to the order of another corporation which carries the risk of being able to sell the manufactured items. Such arrangements are now commonplace between independent parties. If a member of a multinational corporate group is carrying on manufacturing activities in a country, at the stroke of a pen it can be either a full risk manufacturer or a contract manufacturer vis à vis other members of the group as the group desires, even though with respect to the market generally the group is a full risk manufacturer. Product liability and related issues have produced a whole industry of captive insurance which pulls such major risks out of countries where they arise generally to tax havens. The corporation which otherwise would carry such risk enters into an insurance contract with an associated corporation which thereafter carries the risk. Tobacco firms in Australia have diverted 10% of sales revenue through this route⁵² and given the current litigation and insurance situation in the tobacco industry, this figure can probably be upped considerably.⁵³

These kinds of tax planning had been around well before the 1980s development of the functional analysis but the highlighting of risk in that analysis certainly gave encouragement to them and they are now standard transfer pricing tax planning fare. Limits on freedom of contract in the transfer pricing area of the kinds suggested above should be enough to deal with such basic paper shuffling devices. The second stage of the developments is more substantive. The main impact is on the three areas to be considered next but the development of the approach to risk is discussed here.

This next stage in the rise of the importance of risk in transfer pricing can be traced to work at the OECD, though there was considerable parallel work in many OECD countries, including the US.⁵⁴ For present purposes, four developments in the approach to risk emerged. These developments occurred in the context of PEs and apparently under an assumption that freedom of contract was not to be applied to PEs, even though freedom of contract for PEs was actively being contemplated.⁵⁵

First, analysis of financial innovation involved the decomposition of a broad range of not just financial transactions and assets into two components: a standard risk-free loan and a bet with all the risk obviously residing in the bet. Financial innovation was generally all about the risk side of the transaction – whether taking or eliminating risk through a

⁵² *WD &HO Wills* (1996) 32 ATR 168 which held that the Australian general anti-avoidance rule (which overrides tax treaties) did not apply in this situation; presumably the revenue did not argue transfer pricing on the basis that the price was within the bounds of market prices.

⁵³ See Vann, Reflections note ? at 153-157 for elaboration.

⁵⁴ There were three interrelated events at the OECD during the 1990s: work on the tax implications of financial innovation, work on the taxation of PEs and work on taxation of e-commerce. The interrelationship was that the PE work was initially concerned with financiers which were the main businesses to operate in branch form, while e-commerce raised questions about whether the PE threshold was still appropriate as the foundation of international taxation.

⁵⁵ It is not surprising that the various relevant documents produced by the OECD over several years in trying to find consensus on PE transfer pricing issues do not speak with the one voice even in the same document on freedom of contract and other issues. The documents are drafted by committees and seek to satisfy simultaneously the positions of as many countries as possible. Consensus is the goal not avoidance of contradiction.

variety of derivatives etc.⁵⁶ The analysis suggested that returns on assets were relatively standard and that major profits (and losses) were generated by the exploitation and management of risks related to assets and liabilities.⁵⁷

The second development linked the exploitation and management of risk to specific personnel in corporations. The particular issue was the allocation among countries of the profits from 24-hour trading in capital markets by global financial institutions involving personnel in several countries and the profit was seen to arise largely from the activities of the traders who took or eliminated the risks involved through various trading strategies.⁵⁸ This idea was elaborated and generalized as the “key entrepreneurial risk taking functions” (KERT functions) understood as the “people” functions “which require active decision making with regard to the most important profit generators of the business.”⁵⁹ As for the rest of the firm’s employees, the treatment was the same as assets – a basic (small) reward for routine functions.

The third element links equity capital of corporations with risk in the determination of the allocation of interest deductions for firms between the countries where the firms operate. The route here was via capital allocation of banks and the international use of the risk weighting of assets found in banking regulation.⁶⁰ Apparently inconsistently this

⁵⁶ The OECD produced a 1994 report *Taxation of new financial instruments* which was concerned with domestic as well as international issues. Many in the academy were at the same time working on financial innovation, for example, Warren, “Financial Contract Innovation and Income Tax Policy” 107 *Harvard Law Review* 460 (1993), Strnad, “Taxing New Financial Products: A Conceptual Framework” 46 *Stanford Law Review* 569 (1994), Edgar *Income Tax Treatment of Financial Instruments: Theory and Practice* (Toronto, Canadian Tax Foundation, 2000).

⁵⁷ An analogous result was reached in the area of e-commerce. Hardware is an asset which generates little return; all the profit is generated by the (writers of) software, see OECD, *Taxation and Electronic Commerce* (Paris, OECD, 2001) which brought together some of the early OECD work on e-commerce to this effect, see ch 4.

⁵⁸ The 1994 OECD report note ? led to the creation of the OECD Special Sessions on Innovative Financial Transactions which started to work on the taxation problems of global trading in financial instruments,. Detailed analysis of global trading by the OECD led to two draft reports in 1997 and 1998 which emphasized the role of the traders, see *The Taxation of Global Trading of Financial Instruments* (Paris, OECD, 1998).

⁵⁹ OECD, note ? at 23

⁶⁰ Another part of the OECD (dealing with transfer pricing) started work on the taxation of PEs after the work on the 1995 Guidelines was substantially completed in the late 1990s, being particularly concerned with capital allocation within banks. The capital allocation effectively determines how much equity and debt are treated as located within particular countries and therefore how much interest expense can be deducted in each country. The OECD looked in this process at the regulation of banks which had come to be governed internationally by the Bank for International Settlements Basel accords (now Basel II Revised international capital framework available at <http://www.bis.org/publ/bcbsca.htm>). Under this approach the home jurisdiction of each bank is responsible for its regulation, but using generally uniform standards. The minimum capital requirement of banks is set by reference to the value of their assets weighted by risk and so it was natural for the OECD to seek to adopt risk-weighted assets as the basis of their approach. The 2002 draft on the taxation of banks proposed that the capital allocation approach based on risk-weighted assets be used for tax purposes and introduced the KERT terminology. In the event it turned out not to be possible to get consensus on this single approach to capital allocation, but there was consensus on the KERT functions approach. In the meantime the work on global trading was amalgamated with the PE transfer pricing work and KERT terminology was included in the third draft in this area which appeared in 2003. Transfer pricing concepts are applied to the financing of firms as well as their activities. As the focus

approach linked risk to assets rather than people but the fourth element seemed to eliminate the inconsistency in that it “located” assets in the country where the risk with respect to the assets was managed, that is, where the KERT personnel were.⁶¹ Inexorably it seemed that all profit derived from risk and that risk could be identified with a relatively small number of people in the firm – the KERT people.⁶² While more substantive than the freedom of contract approach to risk, the idea that a small group of people attracted the major share of the profit was quickly seized on by tax advisers and used in the restructuring of firms by moving such personnel to more attractive tax climates.

Such restructures were not necessarily tax driven in the sense that the structure of multinational firms has continued to evolve with business conditions, new technologies and changing views on management.⁶³ Many manufacturing and other processes have been shifted to low labor cost countries and firms have increasingly adopted regional structures and the consolidation of common functions such as treasury and back-office activities. This process has involved devolution of certain functions from central headquarters to regional headquarters and the movement of particular functions that were scattered in different locations to a common, typically regional, location. That is, a new regional level of management has been created in many firms. While structural evolution in firms has been occurring for many years, the emergence of the KERT functions approach in transfer pricing meant that a considerable amount of tax planning has occurred under the cover of the recent restructures and significantly affected the way they were implemented.⁶⁴

here is on the activities of firms, financing issues are left aside as being in a different category. They tie back in part to the taxation of corporations and their shareholders that was discussed in Section II.

⁶¹ This link appeared in the second draft on general principles for attributing profits to PEs (that is, outside the financial sector as well as within it) which also adopted KERT terminology generally, OECD, note ? at 47.

⁶² As this work was generalised to all PEs, assets of all kinds, not just financial assets, are now seen as involving a risk-free rate of return. Virtually all value and profit generated by firms is seen to reside in the management of risk in relation to their assets and indeed all their activities generally. The generalisation of the downgrading of assets and the rise of KERT functions (and people) was extended by the OECD work on taxation of e-commerce which took place contemporaneously in the period 1998-2005. Among other things this work concluded that the current central place of the PE concept in international tax arrangements is still justified, “[A]t this stage, e-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules” OECD, *E-commerce: Transfer Pricing and Business Profits Taxation* (OECD, Paris, 2005) “Part II Treaty Rules and E-commerce: Taxing business profits in the new economy” at 151. It is true that technology developments have not meant that corporations can simply abandon their physical presence in countries and do business remotely, contrary to earlier expectations, but the concept of the multinational firm more generally of which the PE concept is part is a major structural problem in current transfer pricing rules as argued above and further developed below.

⁶³ The e-commerce debate was premised on a view that business was now operating in completely different ways from the past, despite the meltdown of the tech sector in 2000-2001. Restructuring of old economy businesses to meet the challenge of the new economy was seen as natural and indeed necessary. What was and is happening is an on-going evolution rather than a revolution and one that is only partly related to e-commerce and new technology, for example, Sautet note ? at 108ff.

⁶⁴ In particular it affected the country where regional headquarters were located (countries with favorable headquarters tax regimes) and the people who were relocated to such headquarters. Tax advisers had to decide who the KERT people were.

It may turn out that the tax planning was premature. The transfer pricing developments in relation to risk outlined above have not yet been finalized and current signs are that there will be significant modification of the positions that seemed to be emerging. Rather than risk being treated as a separable and the chief key to corporate profit, the direction may well become that risk is an overall attribute of the firm. That is, risk cannot be separately located but is rather co-located with all the activities of the firm. At this stage it is not possible to be definitive but some of the signs of such an approach which have broad ramifications are referred to in the following parts of this section. At the most general level, the major sign of retreat is the indication by OECD officials that KERT terminology will be dropped from the general principles for attributing profits to PEs and confined to the finance sector where it originated.⁶⁵ What is not so clear is if this is more a strategic move to abandon unpopular terminology or really means that risk generally will not be treated separately.

The emphasis on risk in transfer pricing reflects developments in the theory of the firm highlighting the entrepreneur as the explanation for the existence of firms and as the generator of value within the firm which cannot be captured by market transactions. Recall the KERT terminology – “key *entrepreneurial risk taking*” functions. It is natural in the light of the growth of the technology and allied sectors to emphasise the importance of key personnel to the emergence of new firms – Bill Gates and the early decades of Microsoft et al – but the generalisation to all firms is not so obvious either in theory or in the way it has been developed in transfer pricing. With regard to theory it was noted above that the variants on the Coasean view of the firm are not contradictory and it has been suggested that entrepreneurship is important to the start of the firm but becomes less important as the firm matures, or becomes dispersed throughout the firm, which leads to similar conclusions for our purposes.⁶⁶ Most, but by no means all, multinational firms are relatively mature. In the transfer pricing area, the KERT personnel are not identified as the Bill Gates of the world – the makers of the initial breakthrough or high level firm strategy – but in a general sense mid level personnel on the ground in management and operations. Why the value generation in the firm should be specifically located at this mid level has not been clearly articulated and is taken up in the next part.

In this part of the article I have argued that the growing emphasis on risk in transfer pricing analysis has been counter-productive as it has facilitated tax avoidance rather than prevented it. Theories of the firm which stress the entrepreneur seem to lie behind the focus on risk. The structural problem is not this focus so much as the way it has been implemented. The assumption of freedom of contract is a particular problem here as it is more generally and reinforces the conclusion in the immediately preceding part that contractual approaches to allocation of value within the firm need to be severely constrained if they are to work appropriately. To the extent that the assumption of

⁶⁵ Comments of Mary Bennett, Head of OECD Division on Tax Treaties and Transfer Pricing as reported by Sheppard, “OECD Makes Nice to Americans, Part 3” 113 Tax Notes 37 (2006).

⁶⁶ Baumol, “Entrepreneurship, Innovation and Growth: The David-Goliath Symbiosis.” 7(2) *Journal of Entrepreneurial Finance and Business Ventures* 1 (2002)

freedom of contract is not operative (or less so), as in the PE context, the identification of value creation with risk and of risk in turn with a narrow range of personnel have provided significant scope for group (re)structures that seek to identify and locate these personnel in favorable tax locations.

D Personnel

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

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

Another problem with KERT in practice to date, if not in theory, is that it tends to ignore heterogeneity in firm structure. The structures of firms have evolved over time and at any given time there is a wide variety of firm structures including very flat and highly hierarchical management. Trying to identify relatively few very specific personnel in these structures as responsible for a major share of the profits will not reflect reality for many firms as well as being very difficult and contentious for the firm and the tax administration.⁶⁷

The only practical approach and one that will cohere best with the theory of the firm is to regard all employees as contributing to the profit that the firm makes. Salary levels reflect market judgments as to value contributions of particular employees and these are a more reliable guide to contribution than picking and choosing among employees depending on exactly what they do in the firm.⁶⁸ It is not only total salaries of employees that are

⁶⁷ As tax administrations have started to challenge the claimed tax effects of various firm restructures, the tax profession has become disenchanted with KERT functions partly because it is very difficult to get a common interpretation on what it means.

⁶⁸ Using the cost of all labor inputs does not imply that uniform profitability per dollar of salary need be assumed. The firm will have accounting records that divide profits on transactions with independent parties in the market among the various product categories and individual products often at a highly disaggregated level. The same records will also necessarily have allocated costs, including employee salaries, across the categories and products. This information can be combined to work out the contribution of labor to the various elements of the firm's profits. There are various measurement problems involved but they are not anything new. Current practice recognizes that it is often necessary to aggregate in transfer pricing analysis, Transfer Pricing Guidelines, note ? paras 1.42-1.44. Nonetheless there are important areas where full

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

There are some presumed transaction rules in this area which at first sight look to be out of line with the recent development of the idea of KERT functions but in fact provide a clue to the solution that can be generalized across several areas. In the PE area it was the case that no profits were to be allocated to internal management activities to the extent they were provided at a separate location from other activities (if provided at the same place they would generally be captured by the market pricing of the outputs there when transferred to other parts of the enterprise).⁶⁹ The OECD is proposing to change this presumption so that in future management services will be treated in the same way as for associated corporations.⁷⁰ For this case a transfer price is established which generally provides a profit for the internal management activity, but the rules are relatively prescriptive so that only a modest part of the overall profit is awarded to the country where the services are rendered.⁷¹ The issue is becoming more important because of the centralization of internal management functions under restructures of the kind discussed above.

This presumed approach seems to be in some tension with the KERT functions approach because in many cases the internal management services may be seen as KERT functions yet they are only rewarded with a relatively small part of the overall profit.⁷² In fact it is thought that another important principle is at play here. The underlying assumption in the transfer pricing discussion of services above is that profits attributable to labor income are appropriately allocated to the place where the services are performed. This is also generally the approach in traditional source rules for services income. Increasingly the place where services are rendered is much less tied to other production processes than was the case previously. Moreover individuals can provide services to the same geographical part of the firm from a variety of locations as they move around the world

international agreement is lacking, most particularly the measurement and treatment of compensation in the form of equity in the corporate group (stock options etc), OECD, *Tax Policy Studies No 11: The Taxation of Employee Stock Options* (2005) ch 4. Entrepreneurs and many managers in particular will be partly rewarded in this way and it is important if labor cost is being used in the allocation process that this amount be fully captured.

⁶⁹ OECD note ? Commentary on article 7 paras 17.5-17.7 at 123-124.

⁷⁰ OECD, note ?, at 58-59.

⁷¹ Corporate groups are effectively allowed to use the PE rule of no profit for the internal management services if they wish, Transfer Pricing Guidelines, note? para 7.37. The US is currently revising its regulations in this area in ways which are more prescriptive and do not permit an effective election to use the PE rule. The proposed changes have got a mixed reception.

⁷² The way only a modest profit is normally allocated is by calculating the profit allocated to the service provider on a cost plus basis with a relatively low cost plus percentage. It may be in the circumstances that a greater share of the reward should be allocated, see the discussion in note ? below.

for meetings and other activities related to their work. This is one instance where communication and transportation technology have a real impact.

There is an alternative source rule (as opposed to a transfer pricing rule) that would allocate income from technical services and the like to the place where the services are used but this rule is widely resisted in treaty negotiations.⁷³ This rule partly reflects general difficulties tax systems have long had with the way in which services merge into property (especially intellectual property). Technology has given many more services some of the characteristics of property in that services can be used in a location other than where they were performed even if they are not regarded as having become property. It is considered that this source rule is implicitly being adopted for internal management services on the basis that it is the user (place of use) of the services which takes the risk with respect to the services. The provider of the services is treated similarly to a contract manufacturer, in this case appropriately, as the risk of loss (and opportunities for profit) are in an economic sense more truly located in the part (place) of the corporation that uses the services, not the part (place) that provides them.

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

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

E Assets

The approach that emerged in the finance area regards assets as giving rise to relatively uniform basic risk free market returns and allocates the rest of the profit to where risk is managed in relation to the asset. By contrast Coasean theories of the firm often emphasize asset specificity as one of the reasons for the formation of the firm and the

⁷³ India routinely seeks to insert this rule in its tax treaties, including in its treaty with the US. The US has for many years been seeking to whittle the rule away, see India US Tax Treaty, article 12, and Memorandum of Understanding concerning Fees for Included Services, May 15, 1989, OECD note ? at 98-101.

capturing of profits on the assets which are not possible in normal market transactions.⁷⁴ The result is that many of a firm's major assets are specific to the firm and produce above risk free rates of return. This view applies particularly but not only to the intangible assets of the firm.

In this regard the transfer pricing issue for property has similarities to personnel and services. Risk should not be regarded as separate from firm specific assets but as integrated with them. The loan and bet view of the world may be appropriate for many financial instruments but not for the kind of assets that characterize many multinational corporations. The move by the OECD to confine the KERT functions approach to the finance sector is understandable (though its need even there is doubtful for reasons given above) if it allows a proper appreciation of the role of firm assets in the allocation of profits between countries. There are some particular signs that risk will not be treated separably in the case of non-financial assets.

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

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

⁷⁴ As in other areas of the theory of the firm, there are several interpretations of the reasons why firms are necessary to protect and maximize the value of assets, for example, Joskow, "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence" in Williamson and Winter note ? at 117, Sautet note ? at 32-34, 79-81.

While contracts of all these types exist in the market, freedom of contract within the firm makes allocation of the profits arising from the research a matter of election for the firm. This is another case where freedom of contract needs to be constrained to produce a robust and meaningful allocation of profit within the firm. A significant part of transfer price structuring involves the location of ownership of intangibles within the corporate group. Even if intangibles are originally located where the research is done, they can be relocated by transfer of ownership within the group. There may be some upfront tax cost involved in such transfers. Still they figure significantly in current transfer pricing tax planning and are often associated with business restructures which were discussed above. The firm seeks to centralize the management of its intellectual property interests (coincidentally in a tax favorable location) and rolls the transfers into a larger restructuring project which gives cover for the tax planning. Stripping of intangibles from higher tax jurisdictions in this way has been nominated by the OECD as one of its current concerns.⁷⁵ Accordingly freedom of contract in the ownership of asset area is a significant structural flaw in current transfer pricing rules.⁷⁶

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

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

After initially leaning to freedom of contract for constructed transactions of PEs so that the status of an asset used by a PE would be at the choice of the corporation, the OECD is now going to take the position that assets are generally owned by the PE where they are used (owned in the sense that the PE will have whatever interest in the asset that the corporation does). The effect is that if the asset is transferred to the PE from elsewhere in the corporation, there will effectively be a transfer of the interest to the PE. In other

⁷⁵ See note ?.

⁷⁶ The 1986 changes in the US were driven by this problem. Rather than adopting the approach referred to in the following text, US law sought only in minor ways to constrain freedom of contract – by seeking to tax outbound transfers of intellectual property fully and allowing adjustments of royalty rates over time even if the original royalty rate were based on market prices when it was struck. Neither has proved effective to deal with the restructuring activity.

words there will be a presumed sale transaction of the kind that has been discussed earlier (manufacture at head office, sale by PE, presumed sale by head office to PE). Depending on relevant national law, gain may be recognized at the other part of the corporation that transfers the asset physically to the PE on the basis of the market value of the asset. Again depending on relevant national law the PE will take the asset as owner and depreciate it or follow any other similar treatment that applies in the PE country.⁷⁷ If the asset is created by the corporation, any gain recognized in the transferring country is likely to be more significant than if the asset were acquired but otherwise this approach can work equally well for created and acquired assets. It follows from this approach that if the asset is real estate in the PE country, it is treated as held by the PE always.⁷⁸

For intangibles, the issues are not so easily resolved. Initially it is important to distinguish production and marketing intangibles. The discussion here focuses on the former; the latter are left to the discussion of sales below on the preliminary assumption that they relate exclusively to the country of sale and so do not raise issues of allocation between the country of sale and another country. As noted above such property is usually created by the firm rather than acquired. The position before the recent review of PE taxation was that a PE could only deduct its appropriate share of royalties paid on intangibles by the corporation to third parties, that is, no royalties on intellectual property created by the corporation as opposed to acquired were permitted. This was justified on the basis that,⁷⁹

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

⁷⁷ One of the benefits of this approach is that it is not necessary to rely on constructed transactions producing a different kind of interest in the asset for the PE from the interest held by the corporation. Constructed transactions would be particularly difficult in this area as the concept of ownership of tangible assets for tax purposes is a very nuanced one that would require very precise definition of the constructed transaction. If the PE takes the same interest as the corporation, the nature of the interest will be sufficiently defined for the application of national tax rules.

⁷⁸ Real estate posed a particular problem under the freedom of contract approach originally proposed. [Technical explanation to be inserted].

⁷⁹ OECD, note ? Commentary on Article 7 para 17.4. The “rule” about no deduction for internal royalties was stated in the 1950s but the rationale quoted was only inserted in the Commentary in 1994.

The property in effect is treated as an attribute of the corporation as a whole. The non-rival nature of intellectual property means that it is not possible to treat the property as owned where it is used in the same way as for tangible property. Rather all parts of the enterprise that make use of the intangible deduct a share of the costs of creation of the intangible and are effectively its owners. The presumed transaction is a cost contribution arrangement with all contributions valued at cost. It is considered that this is the appropriate outcome with one modification – the research location should be rewarded with some of the profit as a contract researcher as discussed above for internal management services.⁸⁰ The outcome is appropriate as the risk inheres in the intellectual property and is borne by those parts of the enterprise that use the property (that is, those parts for which it was created) but the place where the services of creating the intellectual occurred should have a part of the profit.⁸¹ This outcome is also consistent with the theory of the firm. The firm specific assets are located where they are used in the firm's productive processes and services involved in their creation are rewarded.⁸²

The contrast with source rules noted above in relation to services is even more striking here. It is generally accepted that income from intellectual property is sourced under traditional source rules where it is used, rather than where it is created yet current transfer pricing rules for associated corporations which allow freedom of contract locate the profit where the property is owned. As a result intellectual property is at the centre of international arguments over division of taxing rights among countries. The solution offered here is that in a broad sense the traditional source rule is the appropriate approach for transfer pricing;⁸³ ownership is irrelevant but the place of creation of intellectual property should share in the profit as well. This approach can be extended to tangible property. It was noted above that the place of use of tangible property should be treated as its owner. Based on the discussion of intangible property, the place of acquisition or creation of the property should be rewarded for that activity if it were performed for another part of the corporation.

⁸⁰ If the research location also uses the intellectual property, effectively its contribution to that part of the intellectual property is valued at cost and it is not rewarded for that part of the services. The discussion in the text implicitly assumes a steady state firm with the use of the intellectual property by the various parts of the firm remaining constant over time. The analysis becomes more complicated in the real world where steady state does not apply. Current transfer pricing rules have to deal with this problem and have mechanisms for doing so which can be adapted to the approach in the text.

⁸¹ It is likely that the reward to the researcher will be greater than the normal cost plus amount that goes to the contract researcher for a number of reasons but mainly because the researcher itself will often be using intellectual property of the firm in its research.

⁸² The position that the OECD will take on this issue is not yet clear. Currently the approach is driven by KERT functions and for PEs attributes ownership of intangibles to the parts of the enterprise which bear those functions in relation to the intangible, OECD, note ? at 50-58. The shift from the KERT approach and the direction adopted for tangible assets discussed above may suggest an ultimate outcome that the place of use of intangibles will be the main place to which profits are allocated under a cost contribution presumed transaction.

⁸³ There remains the significant difference that source taxation of royalties is on a gross basis whereas the transfer pricing rules tax on a more appropriate net basis.

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

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

F Sales

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

Because the sale is the end point of the firm it needs to be identified carefully in the international context in a geographical sense. This takes us back to the boundaries of the firm discussed previously. It was noted there that the firm is identified geographically by what was called the dependency attachment. While that attachment includes employees and assets of the firm, it goes further to include non-employees and other assets which the firm directs without necessarily owning them in any legal sense, if the necessary dependency exists. The current PE definition is defective in not being fully based on dependency. Dependency does apply in the agency context and considerable tax planning occurs to avoid a legal agency for what is essentially agency in a commercial sense. In

this way the firm is kept out of a country for international tax purposes and so the country is not allocated any profits of the firm. This tax planning is directed at the sale of the firm's products into the market and so is a major structural fault in the rules that affect sales. The fault was noted earlier but is repeated to emphasize its significance for sales.⁸⁴

The tax planning is necessary because it is in fact difficult for firms not to establish a presence in a country if they have a significant market there for their products. Even though it was thought that e-commerce would make such presence less common in future, that outcome has not occurred significantly to date. Other variations on the earlier themes are used to move as much of the profit out of the country of sale as possible – freedom of contract among associated enterprises, shifting of risk by contract, movement of KERT personnel to other more tax favorable places and ownership of intellectual property in tax haven corporations. Together these strategies have been used in corporate restructures of the kinds described previously to remove profits primarily for the country of sale – in many cases the country of manufacture and sale.⁸⁵

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

The way in which firms have dealt with this issue has been implicit rather than explicit. The incompleteness of contracts within firms allows marketing tangibles to be simply left out of the analysis of profit allocation if they are not dealt with by contract and not recognized or properly valued for financial accounting purposes. In cases where trademarked goods are imported, the transfer price for the goods will often include the value of the trademark which effectively allocates it to the place of manufacture, not sale. Yet while the trademark was attached at the point of manufacture, its value is not generated there so far as the sales market is concerned. In recent years the importance of marketing intangibles and the circumstances of their creation and use has come to be recognized in transfer pricing as well as the fact that they are inherently connected to the market of sale. While freedom of contract, risk and other problems of the kinds noted above are present in the OECD discussions, the direction of official thinking is similar as

⁸⁴ As noted earlier, the rules are even more defective on the purchase side as purchasing activities on their own do not give rise to a PE, and if there is otherwise a PE, no profit is attributable to it based on the purchasing activity.

⁸⁵ See Vann, Reflections note ? at 153-157.

for assets with the qualification that any difference between the places of creation and of use is not present to any degree.⁸⁶

The recognition of marketing intangibles as created and used in the market of sale (that is, generally where the buyer is) in turn suggest that the boundary of the firm should be extended to include the market of sale. The firm has assets there whose use is directed by the firm and so the assets have a dependency attachment to the firm and constitute part of the firm. In the case of tangible assets it is recognized that a fixed place of business PE can exist where the assets are used in the firm's business even if there are no firm personnel where the asset is located.⁸⁷ The same principle should be applicable to intangible assets of a firm which are used in a jurisdiction but this is not possible under current PE law which requires a physical presence in the jurisdiction in the form of tangible assets or personnel.

For now this particular limitation on the boundary of the firm is not greatly troubling as it is in fact difficult for a firm to avoid a physical presence of the kinds discussed above in a market where it sells its products. Recognition of the importance of marketing intangibles and allocation of part of an appropriate part of the profit to them will represent a considerable advance in transfer pricing that will deal with the great majority of cases.⁸⁸ If, however, the original predictions come to pass that e-commerce will allow significant sales of a corporation's products in a market where it has no physical presence, it will be necessary to consider this extension to current PE rules. There are other more pressing problems in PE rules that require attention now.

I have discussed at a number of points the relationship of transfer pricing to traditional source rules. Traditional source rules in relation to sales are quite varied across countries but they have in common some connection with the market of sale. The analysis above again can unify transfer pricing and traditional source concepts. Although it has not been highlighted before, the discussion of the relationship of source and transfer pricing rules has been in the context of intra-firm dealings, not sales by the firm into the market. Unlike transfer pricing rules, source rules apply to market transactions whether or not firms are involved in the transactions. In that sense they are broader in operation than transfer pricing rules and that is why no final reconciliation of transfer pricing and source rules is attempted here. Up to and including the point of sale by the firm it is possible in my view to have consistency of transfer pricing and source rules. This implies that general consistency is achievable since traditional source rules do not seem to vary depending on whether the income is intra-firm or not.

⁸⁶ OECD, note ? at 50-58 represents a considerable advance from my perspective over the Transfer Pricing Guidelines, note ? at paras 6.36-6.39

⁸⁷ OECD, note ? Commentary on article 5 paras 8-9, 42.1-42.10. The tendency to downplay the significance of assets to value is apparent here, however.

⁸⁸ The recent \$3.4 billion transfer pricing settlement between the IRS and GlaxoSmithKline indicates the magnitude of the issue as the amount concerned profits from selling Zantac in the US market and significant re-allocation to the place of sale, see Nutt, "Glaxo, IRS settle transfer pricing dispute" 112 *Tax Notes* 1020 (2006)

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

In this part of the article it is suggested that many of the same flaws in transfer pricing rules identified previously are relevant to sales. Focus on one type of asset that is unique to sales, marketing intangibles, yields some further important conclusions about the current rules. First, marketing intangibles are often invisible in the analysis which is possible because of the incompleteness of contracts within firms. Secondly, the existence of important firm specific assets in the market of sale suggests that the definition of the firm needs to be expanded to include that market, though this will only be a pressing issue if it is possible for firms to make substantial sales in markets without any other presence there. As sales do involve an actual market price, that price should be the starting point of the allocation of profits to the sales jurisdiction.

IV Possible solutions

This section first brings together the discussion above of the major structural flaws in transfer pricing and explores how those flaws may be remedied. It then considers if there are other rules that can support the specific rules in dealing with tax avoidance arising from transfer pricing or overcome flaws in transfer pricing rules which cannot be or are not remedied directly. In keeping with the rest of the article, the solutions are not provided in detail rather the direction and framework of possible changes are indicated.

A Fixing the transfer pricing rules

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

A major structural flaw in current rules is the freedom of contract that is permitted to associated corporations. Firms are often considered to be characterised by incompleteness of contracts and this freedom allows firms to fill in the details or not as they desire and whether or not the details reflect the economic substance of what is occurring. Profit

allocation can work through transactions but only if freedom of contract is abandoned and if the permitted transactions are constrained, or certain types of transactions are simply presumed. In terms of the Coasean theory of the firm, the idea is the direction of resources within the firm towards an ultimate sale in the market. The officials who formulated transfer pricing rules for PEs until recently implicitly took the idea of direction as applying to the transactions used in transfer pricing analysis. The direction of supplies of assets or services under intra-firm contracts, whether constrained or presumed, was to be from inputs to outputs. Although it may seem formalistic, this linear concept of contract direction was assumed to produce the appropriate allocation of profits as it would be implicitly rewarding assets and services used at each point in the production process with part of the profit generated by the firm from its direction of resources.⁸⁹

The discussion concerning dependent agency PEs and whether the appropriate contract for transfer pricing purposes is the contract of agency or a presumed sale of goods by the principal to the agent is an example of the issue. Much of the tax planning in the transfer pricing area involves reversing the direction of contracts as is possible with freedom of contracts generally applied to associated corporations so that they are away or sideways from the ultimate sale by the firm in the market and allocate the largest part of the profits backwards out of the country where the part of the firm making the sale is located or off to the side in a tax favored location.⁹⁰ While relatively crude and dependent for its effectiveness on the prices placed on the presumed contracts (as demonstrated in the discussion of trademarked goods), this restriction on contractual freedom reduces the scope for tax planning under freedom of contracts and seems a sensible starting point in using transaction prices as a method for allocating profits.

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

For assets the primary allocation of profit should be based on their place of use with the place of creation of assets, if different, being given usually a lesser reward. Risk should

⁸⁹ It is possible to trace the idea of the direction of contracts back to the origin of transfer pricing rules, yet it is hardly ever clearly articulated. The nearest to a clear expression occurred only in 1994. OECD, note? Commentary on Article 7 at paras 17-17.3. It will be noted from the passage quoted, n ? that Carroll took a different view. His view was not for freedom of contracts but rather a presumed contract. Nevertheless reversal of the direction of the contract had the effect (which he wished to achieve) of moving profit out of the country of sale.

⁹⁰ See the discussion in Vann, Secret Agent note ?.

not generally be treated as separable from the place of use of assets, especially firm specific assets that are often regarded as one of the hallmarks of firms under Coasean theories. This approach can be applied to both tangible and intangible assets but is particularly important to the latter. For marketing intangibles this means that the appropriate share of profits is allocated to the market of sale. In a transactional setting for allocating profits among the parts of the firm, these views imply the presumption or constraint of a complete sale of the asset or services rather than some other form of provision from one part of the firm to another. This sale presumption also underlies the linear view of transactions from inputs to outputs discussed above. These various constraints or presumptions seem to be workable, indeed they already exist in various areas.

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

Formulary apportionment has become more problematic in practice over the years for a variety of reasons.⁹¹ Because the formula is arbitrary and is not based on any accurate assessment of the relative contributions to profit for firms generally, let alone specific firms, there is always a great temptation for states to change the formula when that seems to be in their favor. Moreover it has not been possible to get any enduring agreement on the formula. Even if a formula based on the average firm is adopted, the heterogeneity of and evolution of firms means that it will not be accurate for any of them except by accident. In turn firms will feel less constrained in manipulating the formula on the basis that it is essentially unfair to individual firms. The use of sales in the formula potentially involves double counting. While the sales market should and will be allocated profits to tax under appropriate transfer pricing rules, this is because of the personnel and assets there involved in the sale (especially marketing intangibles). Using a fixed formula also means that measurement of the factors in a jurisdiction becomes critical and there are a host of measurement problems. In any event it is clear that there is not going to be any international agreement on simple formulary apportionment.

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

⁹¹ Bankman, Roin and other recent work

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

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

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

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

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

It has recently been suggested that countries with CFC regimes (typically OECD countries with significant numbers of multinational firms based there) should coordinate their regimes so that the CFC regime of only one of them would apply in a given case in a uniform way.⁹² Even though such overlap may not be an issue for transfer pricing if the CFC rules of each country are limited to transfer pricing out of that country, the idea could usefully be extended to cover transfer pricing more generally. Each country with a CFC regime would become the enforcer of transfer pricing out of all countries in the coordinated regime, rewarded by the revenue from enforcing transfer pricing rules more generally. The justification for such an extension would be on a knock for knock basis, that is, each country would on average collect at least the same amount of revenue if it limited its CFC regime to transfer pricing only out of that country. There is some voluntary coordination of CFC regimes at the moment but nothing more concrete than that.

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

If we lift our gaze from the individual trees for a moment to look at the forest, we should note that the US tax system has been plagued in recent years by corporate tax shelters,⁹³ in which the US system is not alone.⁹⁴ Although the shelters often involve international tax issues in the plan to reduce tax, the use of such shelters applies across the whole spectrum of the system, domestic and international, and indeed may be thought mainly to apply to domestic income. It is true that corporate tax shelters often are devised after the event to eliminate large taxable gains that have already arisen or are reasonably certain and have one-off effects, whereas transfer pricing tax planning is applied in an on-going way to reduce tax on future income that it is hoped but not certain will arise. Nonetheless, it seems plausible to assume that if multinationals are prepared to enter into one-off corporate tax shelters, they are also likely to plan in a systematic way to reduce tax on future income.

The implication is that while fixing the particular rules is one possible strategy to deal with transfer pricing as well as other abuses, other possible rule based strategies include the use of business purpose and economic substance judicial tests and/or the adoption of a

⁹² Burnett, “Replacing CFC regimes with a collective attribution system” 38 *Tax Notes International* 1109 (2005).

⁹³ Bankman, “The New Market in Corporate Tax Shelters” 83 *Tax Notes* 1775-1795 (1999).

⁹⁴ In 2005 Australia, Canada, the UK and the US established the Joint International Tax Shelter Information Centre for the sharing of information on the latest tax shelter activity, see <http://www.irs.gov/pub/irs-utl/jitsic-finalmou.pdf>.

legislative general anti-avoidance rule.⁹⁵ It was noted above that transfer pricing rules in the past were regarded as anti-avoidance measures, though in recent years they have become systemic rules. Form over substance and similar rules could be applied to transfer pricing avoidance strategies where nothing of economic substance happens such as risk shifting by contract within the corporate group. In many cases, however, there is economic substance. As noted above corporate restructures often have commercial purposes as well as tax purposes. In that event the application of general anti-avoidance rules becomes more problematic.

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

Beyond substantive tax rules, it is also possible to address the incentives to enter into tax motivated transactions through tax administration related measures such as increased auditing, higher penalties and greater information requirements (as to both record creation and reporting). In recent years many countries have taken action of this kind directed at transfer pricing in particular. The most important of these measures probably are requirements of contemporary documentation of transfer pricing practices. Nonetheless it may be thought that these rules have increased compliance costs without having much impact on tax avoidance through transfer pricing, if we are to judge by claims of continuing tax avoidance with which the article started. Further there are issues of the kind already noted of which country requires which documentation given that the countries are concerned with their own transfer pricing issues, not the problems of other countries, and of international coordination. In contrast to the CFC and anti-avoidance areas, international cooperation in this area is well advanced so that corporate groups can use common information and common formats of information to satisfy the documentation requirements of several countries.⁹⁶

Continuing the metaphor of trees and forests, if we look beyond the tax forest to corporate behavior more generally, there seems to be a fairly clear link between the recent problems in corporate governance and the growth in corporate tax shelters.⁹⁷ If a firm is reporting fake profits for financial and corporate law purposes, it certainly does

⁹⁵ In 2003 the OECD took the controversial position that tax treaties are subject to domestic anti-avoidance doctrines, see OECD, note ? Commentary on article 1 paras 7-26 at 53-64 which have attracted considerable debate, for example, Ward et al, *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (Amsterdam, IBFD, 2005) at 78-92. Whether domestic anti-abuse rules can be used in treaty cases is an issue that will take some time to reach finalization in many countries.

⁹⁶ Pacific Association of Tax Administrators (PATA – Australia, Canada, Japan and the United States) Transfer Pricing Documentation Package available at <http://www.irs.gov/businesses/international/article/0,,id=156266,00.html>, EU Code of Conduct on transfer pricing documentation available at http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm.

⁹⁷ [Enron Congress reports]

not want to pay tax on them. And if the managers of the firm are rewarded by reference to the (after-tax) profits of the firm, they certainly have an incentive to reduce the tax paid by the firm which may encourage aggressive tax avoidance, including transfer pricing. Perhaps the remedy lies in corporate law either generally or in some tax-specific elements of corporate law (such as special corporate procedures or reporting in relation to corporate tax risk). There is some evidence of tax administrations taking this approach⁹⁸ but whether corporations are becoming more sensitized to the issue and more cautious as a result is unclear.

The issue once more is which country will apply the necessary corporate governance measures. In practice corporate governance strictures will be at their greatest at the level of the parent, usually listed, multinational corporation.⁹⁹ In this case risky behavior by firms from a corporate governance perspective would seem to be a concern even if it involves tax avoidance in another country. If corporate governance rules of countries take what is a selfless view from the tax perspective, then corporate governance rules may be an additional (and potentially more effective) international enforcement mechanism of transfer pricing rules.

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

In conclusion, in terms of own tax revenue it is important to recall that not all countries may have the same interests. It is a fundamental policy assumption of the levy of corporate tax in a country other than that of the shareholder that the tax is not shifted. It has been suggested that developing countries in particular are wary of enforcing transfer pricing tax rules because of a fear that the tax will simply be shifted to immobile factors in the developing country.¹⁰⁰ This may make the countries less interested in and thus likely to cooperate effectively with developed countries in dealing with transfer pricing. For this reason it is in the interest of developed countries to resolve a constant source of tension with developing countries, the nature and extent of source country taxation on a traditional source basis. This article suggests, without finally resolving, that a revision of

⁹⁸ In 2005 the Commissioner of Taxation in Australia wrote to the chairs of the boards of major Australian corporations about tax risk and the Australian Taxation Office since has been very active in linking tax compliance and corporate governance, see

<http://www.ato.gov.au/corporate/content.asp?doc=/content/56224.htm>. The issue recently featured at the OECD Forum on Tax Administration in September 2006, including remarks for the IRS Commissioner.

⁹⁹ Clark, "Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too" *Georgia State Law Review* (2006) forthcoming sets out the various levels at which corporate governance rules operate so that for a listed corporation in the US the total package is quite formidable.

¹⁰⁰ Baistrocchi, "The Structure of the Asymmetric Tax Treaty Network: Theory and Implications" paper presented to conference on Tax and Development, University of Michigan, November 2006 at 15.

transfer pricing rules as proposed above may go a considerable way to resolving the differences between transfer pricing and source taxation principles.

Appendix: Integration of corporate and shareholder taxation

Part I Relative tax at corporate and shareholder level under integration

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

Table 1

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

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

Assuming that there are substantive reasons to levy the corporate tax in the country where the corporation is located and to integrate that corporate tax with taxation of the

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

Imputation is much more difficult to operate in this context as it generally tries to tax distributed corporate income at the actual marginal tax rate of the shareholder which requires refund of the corporate tax if the shareholder's tax rate is below the corporate rate. The country of the shareholder will not wish to refund foreign corporate tax. Mechanisms to deal with this problem are complicated but countries were experimenting until the European Court of Justice unfortunately and needlessly held that imputation was contrary to EU non-discrimination norms and killed the system off in Europe where it had begun.¹⁰¹ The ripples from Europe spread and only relatively few countries like Australia maintain the system nowadays. In its place have sprung up systems which are more approximate in their relief of double taxation, like the US system.

Part II Integration where income derived by permanent establishment of corporation

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

¹⁰¹ Graetz and Warren. "Income Tax Discrimination and the Political and Economic Integration of Europe" 115 *Yale Law Journal* 1186 (2006).

Table 2

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

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

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