APPENDIX 1.3
DIFFERENCES IN ECONOMIC AND ACCOUNTING METHODOLOGIES

Unit of analysis	Economic concepprs	AccouDling concepts
The finn	single proprietorship wirh one entrepreneur-cum-manager running the business and receiving all profits	legal entity
Profit	normal profit (opponunity cost of entrepreneur) and econonric profit (,my return over and above nonnal profit, competed away in perfect competition)	accounting profit
Costs	ei.:onornic costs	accounting costs
How costs an;, mcm;urcd	opponunity cost (next best alternative use, so that sunk costs are sunk)	contractual outlays
Garns	gains on an accrual basis	gains on a reahzation basis
Model of firm bchavl0ur	profit maximitation	market share plus profit floors; dividends to shareholders
Model of cornpellllon	perfect competition, all finns arc price takt'.n.	oligopoly, finns are price makers but compete primarily on the basis of nonprice competition
How as::;ets arc valued	value assets at current replacement cost	value assets at historical cost

Eden - Taxing Multinationals 1998

2

The International Tax Transfer Pricing Regime

Introduction

The purpose of this chapter is to explain how and why tax authorities regulate the transfer pricing policies of multinational enterprises. We see these regulations as having a coherent structure and focus, such that they may he characterized as part of an ***international tax tramfer pricing regime*** (the ***ITP regime).*** International regimes are sets of functional and behavioural relationships among national governments in particular issue areas of the international political economy. We argue that there exists an international ·n'P regime in which national tax authorities have cooperated to develop certain principles, norms, rules, and procedures designed to facilitate state regulation of multinationals and to reduce conflicts between MNE, and nation-states in the corporate income tax area.

In this chapter, we first outline the general theory of international regimes and provide one example. We next develop the concept of an international tax regime, and examine its characteristics (purpose and scope, principles and norms, and rules and regulations). We argue that nested within the international tax regime is an international tax transfer pricing regime and then we explore the characteristics of this regime. Appendix 2.1, at the end of the chapter, outlines a variety of approaches to international taxation of multinationals that have been recommended by the United Nations, the Organization for Economic Co-operation and Development (OECD), and the Harvard University Model Tax Code.

The Theory of International Regimes[1]

Here we outline the theory of international regimes and then illustrate the theory with one well-known application, the international trade regime based on the General Agreement on Tariffs and Trade (GATT), before turning to apply this theory to international taxation.

What Is an International Regime?

Problems of interdependence at the international level can be handled through *international regimes*. A regime is an international governance structure, a way to reduce international transactions costs in an interdependent world.[2] Regimes can be seen as sets of functional and behavioural relationships among national governments in a particular issue area of the international political economy. These relationships embody the principles underlying the regime, the expected behaviour patterns associated with the regime, and the formal arrangements that implement the international agreements and understandings that form the regime (Preston and Windsor 1992, 7). Thus regimes are a way to manage interdependencies among nations.

The generally accepted definition of a regime is:

> Regimes can be defined as of sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations. *Principles* are beliefs of fact, causation and rectitude. *Norms* are standards of behaviour defined in terms of rights and obligations. *Rules* are specific prescriptions or proscriptions for action. *Decision-making procedures* are prevailing practices for making and implementing collective choice. (Krasner 1983, 2; italics added)

When a clear legal framework establishing property rights and liability is missing, markets for information are imperfect, and/or incentives exist for actors to behave opportunistically, regimes can improve the functioning of international markets. International regimes can increase the predictability of behaviour, provide generalized sets of rules, and improve the information available to participants.

A formal international organization may be either involved or absent from an international regime. For example, there are international regimes in international finance (centred around the International Monetary Fund and the Bank for International Settlements), debt (based on the World Bank), and security (based around NATO and the Nuclear Nonproliferation Treaty). On the other hand, the gold standard was an important international monetary regime in the early twentieth century, a regime that did not have an international organization at its centre. Similarly, the international trade regime is based on the General Agreement on Tariffs and Trade (GATT), where GATT is an international treaty, not an organization. One can also hypothesize that there exists a foreign investment regime, based on the UN Code of Conduct for Transnational Corporations (TNCs), the Freedom of Commerce and Navigation clauses, and bilateral investment treaties, although there is no international organization at its centre.

International regimes vary in their characteristics. We can distinguish three general categories: purpose and scope, principles and norms, and rules and procedures (Haggard and Simmons 1987; Keeley 1990; Krasner 1983; Preston and Windsor 1992, 90–1). The strength of the regime depends on the extent to which the members conform to the characteristics of the regime.

The *purpose* of the regime refers to the objectives the regime is supposed to accomplish, as seen by the participants. The purpose is normally defined by the problems to be managed. The *scope* of the regime refers to both the issue area and the geographic area covered by the regime. Regimes may be narrowly or broadly defined by subject matter, and cover many or few countries.

The *principles* of the regime are the beliefs that underlie the regime. These may include principles such as equity, efficiency, neutrality, and/or nondiscrimination. The countries participating in an international regime commit themselves to certain *norms*, or standards of behaviour, designed to achieve the principles of the regime. These norms are expressed in terms of the rights and obligations of the parties. Norms can be descriptive or prescriptive. A descriptive norm is a course of conduct everyone follows in practice, whereas a prescriptive norm is a course of conduct individuals should follow (Langbein 1986, 628).

The *rules and procedures* refer to the organizational structure of the regime. This includes such factors as membership requirements, presence or absence of an international organization, method of sharing the benefits and costs, and the specific, detailed procedures involved in the regime. Through international regimes, nation-states cooperate to regulate crossborder activities. As an example of an international regime let us look at the international trade regime.

An Example: The International Trade Regime

The international trade regime, or GATT regime as it is known, is perhaps the regime most familiar to the general public and certainly the one that occupies the most space in the newspapers. In this section, we outline its purpose and scope, principles and norms, and rules and procedures. These are summarized in Box 2.1.

The purpose of the postwar international trade regime has been to reduce tariff barriers on international trade in goods (Jackson 1989, Zacher and Finlayson

BOX 2.1
Comparing the International Trade and the International Tax Regimes

	Definition	International trade regime	International tax regime
Purpose	Goals to be achieved by the regime, problems to be managed.	To reduce tariffs and prevent tariff warfare. Seen as problems that lower world welfare by preventing gains from specialization and exchange.	To reduce double or under-taxation caused by overlapping tax jurisdictions. Seen as problems that cause distortions in capital markets and inequities among taxpayers.
Scope	Breadth of regime in terms of issue areas covered, number of members, geographic spread.	Trade in goods, broadened to include nontariff barriers. New areas include intellectual property and trade-related investment measures. About 140 contracting parties around the world.	Anything involving crossborder transactions that is subject to national taxation. OECD member countries and their tax treaty partners.
Principles	Beliefs of fact, causation, and rectitude that underlie the regime.	(1) most favoured nation treatment (MFN) and (2) nondiscrimination between domestic and members' products (National Treatment).	Three principles: inter-nation equity, international neutrality, and international taxpayer equity.

BOX 2.1 (concluded)

	Definition	International trade regime	International tax regime
Norms	Standards of behaviour, rights, and obligations of members, as identified in the general patterns in international agreements. Norms can be either prescriptive, proscriptive, or descriptive.	The GATT provides a general code of conduct on trade. Members commit themselves to the nondiscrimination principle and to GATT articles. Central obligation is to limit tariffs levied on contracting parties. Are protected from arbitrary impositions of tariffs on domestic products.	Tax conventions establish general norms as to which country has the right to tax, what the tax base and rates should be – e.g., the source country has the primary right to tax business income, the residence country is obligated to eliminate double taxation.
Rules	Specific prescriptions or proscriptions for action as identified in the provisions of international agreements.	Rules on voting, admission of new members. Cannot raise tariffs above bound levels. Rules on legal exceptions to GATT.	Rules defining nexus. Specific rules on the use of corporate income and withholding taxes. Tax deferral, exemption or credit rules for residence countries.
Procedures	Prevailing practices for making and implementing collective choice.	Antidumping duty and countervailing duty procedures. Dispute settlement procedures. Practice of trade negotiation rounds and reciprocal tariff cuts in these GATT rounds.	Auditing and dispute settlement procedures, both domestic and international. Includes the mutual agreement procedure under bilateral tax treaties (competent authority), penalties, advance pricing agreements, and arbitration of transfer pricing disputes

1981). Tariffs are barriers to the efficient flow of international trade; when tariffs are reduced, the volume of international commerce can be increased and countries can reap the benefits of international specialization and the division of labour in terms of higher incomes and welfare levels.

The issue scope of the international trade regime historically has been quite narrow: the GATT was set up after the Second World War to deal with tariffs levied by the developed market economies of Europe and North America on their imports of goods. However, the range of issues has broadened significantly since the 1979 Tokyo Round and the recently concluded Uruguay Round. The issue scope now includes new markets (services, intellectual property, agriculture) and new policies (nontariff barriers, trade-related investment measures [TRIMs], and trade-related intellectual property measures [TRIPs]). The geographic scope of the regime has also broadened as the number of signatories has increased from the original 23 contracting parties to almost 140 countries today.

The basic principle that underlies the GATT trade regime is *nondiscrimination (ND)*.[3] Nondiscrimination has two parts: the *most-favoured nation (MFN) principle* (ND between the products of the different contracting parties) and the *national treatment principle* (ND between domestic and member country products). The MFN principle means a country must treat the activities of any particular foreign country at least as favourably as it treats the activities of any other foreign country. In terms of GATT, this means that each contracting party must grant every other contracting party the most favourable treatment which it grants to any country in terms of exports and imports. National treatment means that a country treats foreign activities performed within its borders the same as it treats domestic activities; both are provided with the same treatment. In GATT terms, this means that foreign goods must be treated the same as domestic goods, once they have cleared customs and become part of a country's internal market.

The norms of the trade regime are standards of behaviour defined in terms of rights and obligations. Contracting parties commit themselves to certain GATT obligations. The primary obligation is to limit the level of tariffs imposed on other contracting parties; in addition, countries commit themselves to the nondiscrimination principle and to the various GATT articles (e.g., on antidumping and countervailing duties, the customs valuation code, a subsidies code, various procedures).[4]

The rules and procedures – the organizational structure of the international trade regime – are centred around the GATT treaty to which countries sign on as contracting parties, not as members since there has been, until perhaps in 1995, no central international organization.[5] Each contracting party agrees to specific rules (e.g., on voting, admission of new members) designed to support the principles and norms of the regime (Jackson 1989). The procedures or activities of

the GATT regime include: multilateral tariff-round negotiations; publication by the GATT Secretariat of studies on national trade barriers;[6] and the provision of GATT dispute mechanisms through which countries can bring their bilateral trade disputes for settlement. In successive GATT tariff-cutting rounds, one common procedure has been the practice of *reciprocity* – that is, the removal of tariff barriers by the major negotiating parties on a mutual and equivalent basis (Jackson 1989, 123–5).[7]

In sum, the theory of regimes is a useful and illuminating exercise to conceptualize certain problem areas in international political economy as being organized through an international governance structure. The international trade regime, organized around the GATT, provides a well-known example. Let us now see if these concepts and characteristics also can be used to describe an international tax regime.

The International Tax Regime[8]

We describe the problems countries face in taxing multinationals, and then examine the existing sets of functional and behavioural relationships that have developed among national tax authorities to manage these interjurisdictional interdependencies. These relationships embody the principles, expected behaviour patterns, and formal arrangements that implement the agreements and understandings that form the international tax regime.

The Problem: Overlapping Tax Jurisdictions

Tax authorities have had to deal with entities doing business across international borders for a long time. Multinational enterprises, in industries such as automobiles and petroleum, have been with us since the late 1880s. However, the rapid growth in MNEs in the post–World War II period has significantly increased the degree of interdependence between national economies and reduced the sovereignty of national tax authorities. To quote the preface to the 1979 OECD report on transfer pricing:

> While taxation problems arising from international investment are not new, they have become more important in recent years as a consequence of the growing internationalization of economic activity. One characteristic of this process is the development of so-called 'multinational enterprises' ... This increasingly common phenomenon of related companies operating in a group with some degree of centralized management, yet with individual members of the group operating under different national law, has given rise to important problems regarding the taxation of corporate profits. (OECD 1979, 7)

Some examples of important problems in taxation raised by MNEs are the following: How should we define the MNE's tax base – its income – for purposes of calculating the corporate income tax? What if the tax base arises in more than one country? Which government should have the right to tax this income base? If two governments both claim the same right to tax, should one government's claim have priority over the other's? Should tax relief be given to prevent double taxation of the income? These are all questions of overlapping tax jurisdictions, caused by the integrated nature of the multinational enterprise.

Multinationals are integrated businesses. A working definition of an MNE is that it consists of two or more firms located in different countries, where the firms are under common control and share common goals and a common pool of resources. By definition, the MNE's activities cross national borders and thus bring it under the jurisdiction of more than one tax authority.

The enterprise therefore poses certain problems for tax authorities:[9]

- *More than one country*: The MNE has transactions, income, and assets in more than one country. This creates the key problem with respect to taxing MNEs: that of jurisdictional allocation. Which nation has the right to tax the income base, and how can double taxation and conflicts between tax jurisdictions be avoided?
- *Common control*: The *sine qua non* of the MNE is intrafirm trade, the enterprise's way of integrating affiliates across national borders. As the per cent of intrafirm trade rises, open economies find that MNEs are setting trade, output, sales, and pricing policies as an integrated business. Domestic firms that decide to reduce their tax payments have ample opportunities to do so; global corporations have many more opportunities to hide profits and reduce taxes on a worldwide basis.
- *Common goals*: The MNE maximizes global after-tax profits. This brings it into conflict with national jurisdictions which focus on national variables. Governments are defined by their borders, MNEs by their share of world markets. The global reach of MNEs gives them the ability to avoid the national reach of government regulations. By shifting activities outside the reach of a national government, the MNE can avoid paying taxes. Thus underpayment of taxes is a problem for governments.
- *Common pool of resources*: The affiliates of the MNE share common overhead and resources. How should these resources be allocated among jurisdictions? Common resources are a source of competitive advantage for the members of the MNE family. They also are a source of interdependencies that make it difficult to disentangle the MNE for tax purposes.

The problems created for governments by the integrated nature of the multinational enterprise make it difficult to regulate MNEs at the domestic level alone. Governments are aware of these conflicts and inefficiencies, and, as a result, international taxation is one of the few areas where governments and MNEs have sat down to develop rules and procedures to manage these interdependencies. As Ray Vernon argues:

> I can find only one functional area in which governments have made a serious effort to reduce the conflicts or resolve the ambiguities that go with the operations of multinational enterprises. The industrial countries have managed to develop a rather extraordinary web of bilateral agreements among themselves that deal with conflicts in the application of national tax laws. Where such laws seemed to be biting twice into the same morsel of profit, governments have agreed on a division of the fare. Why governments have moved to solve the jurisdictional conflict in this field but not in others is an interesting question. Perhaps it was because, in the case of taxation, the multinational enterprises themselves had a major stake in seeing to the consummation of the necessary agreements. (Vernon 1985, 256)

The results of government cooperation in the tax area include a variety of national tax policies, bilateral tax treaties (BTTs), and model treaties and guidelines. The latter have been developed by institutions such as the Organization for Economic Co-operation and Development (OECD), founded in Paris in 1960 to facilitate cooperation among developed market economies, and the United Nations. International bodies of experts such as the Committee on Fiscal Affairs at the OECD and the International Fiscal Association (IFA) have played important roles in developing international policies and norms. In Appendix 2.1 to this chapter, we review the guidelines and model income tax conventions that represent tangible evidence of intergovernmental cooperation to deal with the problems of overlapping tax jurisdictions.

We argue that the combination of these government behaviours and functional relations can be seen as constituting an international tax regime. The regime reduces transactions costs associated with international capital and trade flows; resolves conflicts between tax authorities and multinationals, and between home and host governments; and reduces the possibilities for opportunistic behaviour by MNEs and nation-states.

We now turn to outlining the characteristics of the regime: its purpose and scope, principles and norms, and rules and procedures. These are also summarized in Box 2.1 (see above).

Purpose and Scope

The purpose of the international tax regime is clearly outlined by Stanley Surrey:

> We live in one world with many national tax jurisdictions and with taxpayers whose activities cross national boundaries. As a consequence, countries have in various ways sought harmonization and coordination of national assertions of jurisdiction in order to reduce undue overlapping of tax burdens on investment and trade. (Surrey 1978, 410)

The OECD expands on Surrey's point about overlapping tax burdens:

> Since 1956 the OECD has sought to build-up a set of internationally accepted 'rules of the game' which govern the ways in which Member countries tax profits arising from international transactions. The main instrument used to achieve an internationally consistent approach to the taxation relating to such international transactions has been the development of an OECD Model Tax Convention ... [Its] purpose is the avoidance of international double taxation and to assist tax authorities in counteracting tax evasion and avoidance. (OECD 1993b, 1)

The goals of the international tax regime, following the OECD, are therefore (1) the avoidance of double taxation of income and (2) the prevention of tax avoidance and evasion. These goals, according to Surrey, are to be achieved through coordination and harmonization of national tax systems.

The principal method for encouraging such harmonization is through bilateral tax treaties. The OECD has played an important role in the development of the tax treaty network through its own model tax convention. Indeed, the purposes of the international tax regime are clearly visible in the title suggested by the OECD (1963, 1977) for bilateral tax treaties: 'Convention Between (State A) and (State B) for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital.'

As we saw in the general section on international regimes, the scope of a regime is a function of its issue coverage and geographic reach. Since the purpose of the international tax regime is the avoidance of over- or undertaxation of income, anything that involves crossborder transactions is potentially subject to tax and therefore potentially covered by the tax regime. Any income earned in or received from another location is potentially subject to taxation by two jurisdictions: where the income arose and where it was paid. The types of taxes involved are also numerous: corporate and personal income taxes, withholding taxes, value-added taxes, and mining taxes, for example. The issue scope of the regime is therefore potentially very broad.

The geographic scope of the regime is also extensive. Its progress has been strongly influenced by the OECD. The OECD has encouraged the growth of tax treaties through its own Model Tax Convention. The United Nations has performed a similar function for developing countries. (See Appendix 2.1 for more

details.) The network of these intergovernmental agreements is now vast. In 1995, Tax Analysts catalogued over 2,800 tax treaties, agreements, protocols, and similar documents; for example, the United States has signed tax treaties with 82 countries (Tax Analysts 1995, 5, 333–6).

Principles and Norms

Principles: Equity and Neutrality

The principles of an international regime are the 'beliefs of fact, causation and rectitude' that underlie the regime (Krasner 1983, 1). We argue that three key principles underlie the international tax regime: (1) the *inter-nation equity* principle, determining which jurisdiction has the right to tax; (2) the *international neutrality* principle, ensuring that the international tax system does not distort private decisions; and (3) the *international taxpayer equity* principle, ensuring that taxpayers are treated fairly by the tax authorities.[10] We examine each in turn.

Inter-Nation Equity. The inter-nation equity (or, as it is sometimes called, the jurisdictional allocation) principle requires that tax shares be allocated fairly among countries. The problem is how to define 'fairness' since it involves several issues: which jurisdiction has the right to tax, the selection of a tax base, and the method for providing relief from double taxation (Arnold 1986, 54). In terms of which country has the right to tax, there are two possibilities under generally accepted international law, the source and residence principles.[11] In the *source principle,* the country that is the source of the business income (called the *source or host country*) has the right to tax business income earned within its borders regardless of to whom that income is paid. Thus, income arising within a country is taxed whether or not the recipient is a resident of that country. The key criterion for source taxation is a nexus between the economic activities producing the income and the taxing jurisdiction. In the *residence principle,* the country where the owners reside (called the *residence or home country*) has the right to tax the owners of the business that creates the income. The residence principle looks at the relationship between the taxpayer and the taxing jurisdiction; if the taxpayer is a resident of the jurisdiction, his/her income can be subject to tax. The source of the income does not affect the right to tax; the key criterion is residency.

The source and residence principles, by definition, generate conflict between tax authorities in different countries. The classic type of conflict arises between the home and host countries. A foreign subsidiary earns income and remits it in the form of dividends to its parent. At least three possible taxes are involved here: the subsidiary's income can be taxed in the source country (the host country's corporate income tax or CIT); the dividends, when repatriated, can be taxed by the source country (the dividend withholding tax); and lastly, the dividends, when received, can be taxed by the residence country as income of the parent (the home country's CIT). The potential for double taxation of foreign source income is therefore real. Conflicts can also arise between two residence countries or two source countries. For example, even if all countries were to tax on a source (territorial) basis, the question of defining where an activity takes place (nexus) remains.[12]

Tax authorities are concerned about the conflicts inherent in the source and residence principles because they interfere with the goals of avoiding the double taxation of income and preventing tax avoidance and evasion. Double taxation and undertaxation are seen both as distorting the international allocation of capital and as being inequitable – that is, as interfering with the economic principles underlying a good tax system. This brings us to the second principle underlying the international tax regime.

International Neutrality. A fundamental principle guiding national tax systems is tax neutrality. A neutral tax system for business income would leave business decisions unaffected by the tax. This means that governments should levy taxes in a manner that does not affect the taxpayer's choice of corporate form, location of the tax base, debt–equity level, choice of pricing policy, and so on, within domestic borders.

The principle of tax neutrality is somewhat different from the principle of economic efficiency. A neutral tax means that the tax does not affect private decisions, whether or not these decisions are efficient (i.e., whether or not market price equals marginal social cost).[13] The principle of economic efficiency, on the other hand, requires intervention by the government so as to ensure that private decisions equate market price with marginal social cost. Tax neutrality, therefore, is a weaker condition than economic efficiency. It implies a less interventionist government, one that desires only to avoid distorting private decisions and does not correct for private inefficiencies.

The domestic neutrality tax principle has its equivalent at the international level. An internationally neutral tax system would neither encourage nor discourage choices such as whether to invest at home or abroad, work at home or abroad, or consume foreign or domestic goods. The decisions of individual decision makers (investors, workers, consumers) in terms of location would not be affected by the international tax system (Musgrave 1983, 280). While tax neutrality should apply to all types of taxpayer decisions, within the public finance literature neutrality is generally defined in terms of business investment decisions. We will follow that practice here.

Where tax rates and/or tax bases differ between countries, we can conceptualize of international neutrality from the perspective of either the source country or the residence country.[14] Therefore we must distinguish between capital export neutrality and an alternative view, capital import neutrality. The *capital export neutrality (CEN)* perspective sees the home investor as choosing between a domestic investment and a foreign investment (FDI). At the margin, the investor, in the absence of tax considerations, would attempt to balance the returns from the two investments. For CEN, this choice should not be affected by the tax system. An investor should be indifferent between domestic and foreign investments with the same pre-tax returns. Thus tax rates should be the same for investments with the same pre-tax return.

Under *capital import neutrality (CIN)*, who owns the investment should not affect the taxes paid on the investment. The relevant criterion is that domestic and foreign investors located in the same country should receive equal after-tax returns from identical pre-tax investments; that is, all capital within a jurisdiction should be treated similarly by the tax system regardless of ownership. Capital import neutrality is therefore equivalent to the nondiscrimination principle in the international trade regime, since nondiscrimination under GATT requires that imported goods be treated the same as domestic goods.

CEN focuses on investments from the perspective of the home country (i.e., the choice between domestic investment and FDI), whereas CIN focuses on nondiscrimination among capital owners with investments in the same host country. The first gives primacy to the residence principle, the second to the source principle.

An internationally neutral tax system, however, would not necessarily be a fair one. Thus the third fundamental tax principle is international equity.

International Taxpayer Equity. Domestic tax systems also have the principle of fairness or equity in terms of the tax treatment of residents. Equity or fairness in taxation has several dimensions. First, fairness means that two taxpayers in similar economic circumstances should pay the same tax – this is, 'equal treatment of equals' or *horizontal equity*. Second, *vertical equity*, the appropriate treatment of unequals, must also be addressed by the tax. Generally, economists argue for progressive income taxation on the grounds that richer taxpayers have the ability to pay more than poorer ones; in addition, they may receive more benefits and thus should pay more using a benefit-cost approach.[15]

At the international level, the tax system should also be equitable. International taxpayer equity requires that all taxpayers resident in the same jurisdiction receive equal tax treatment regardless of the source of their income. This means that if the pre-tax returns from foreign source income and domestic income are the same, so should be the after-tax returns. Equity is even more difficult to define at the international level than at the domestic level. Which persons should be treated equitably: only residents, or should nonresidents also be included? Should equity be defined in terms of domestic taxes only, or in terms of the total burden of domestic plus foreign taxes? Should we distinguish between individuals and corporations, or between branches and subsidiaries, on equity grounds? These issues historically have been left to the residence country on the grounds that only the home country can tax global measures of income (Musgrave 1983, 281).

In sum, three principles should guide the architecture (Shoup 1991) of a good international taxation structure: inter-nation equity, international neutrality (defined as capital export or import neutrality), and international taxpayer equity. These principles are explained in mathematical terms in Box 2.2.

Norms: Separate Entity, Water's Edge, and First Crack

The norms of the international tax regime represent standards of behaviour, defined in terms of rights and obligations of the national tax authorities, which are designed so as to achieve the principles of the regime. Norms are captured in double tax conventions. As Langbein (1986, 629) notes:

> While the particular provisions of double taxation conventions constitute rules, the *general patterns* of the conventions constitute norms. Moreover, there exist international model conventions which embody, and indeed direct, the general patterns, and thus explicitly constitute prevailing prescriptive norms.

The norms of the international tax regime must therefore satisfy the three principles of the regime: inter-nation equity, international neutrality, and international taxpayer equity.

To satisfy the principle of inter-nation equity, tax conventions must agree:

> (a) to establish a generally acceptable entitlement rule which spells out the source country's right to tax, (b) out of that entitlement rule to establish the base which may be taxed, (c) to lay down common definitional rules to ensure that there are no overlaps or gaps in the tax base which is divided among the countries of source, and (c) to set mutually agreed rates of tax which may be applied to that base. (Musgrave 1983, 282)

Since the 1963 convention, the OECD has endorsed the concept of the *separate entity* as the underlying basis for allocating taxing rights between countries. Permanent establishments within a country are treated as separate entities. Each taxing authority has jurisdiction over the income and assets of this sepa-

BOX 2.2
International Neutrality and International Equity

Let H be the residence country and F be the source country.

Capital export neutrality (CEN)
Residents in H must be indifferent, after tax, between identical pre-tax investments at home or abroad. That is, if $r_{h(H)}$ and $r_{h(F)}$ are before-tax returns to investments in H and F made by residents of H, and $r_{h(H)} = r_{h(F)}$, CEN requires that:

$$(1 - t_{h(H)})r_{h(H)} = (1 - t_{h(F)})r_{h(F)}$$

where $t_{h(H)}$ is the tax rate on investments in H and $t_{h(F)}$ is the rate on investments in F, made by residents of H.

Capital import neutrality (CIN)
Identical pre-tax investments in the source country, F, must be treated the same by the tax system, regardless of ownership of the investments. That is, if $r_{f(F)}$ is the pre-tax return to investments in F made by residents of F, and $r_{h(F)}$ the pre-tax return to investments in F made by residents of H, and $r_{f(F)} = r_{h(F)}$, then CIN requires that:

$$(1 - t_{f(F)})r_{f(F)} = (1 - t_{h(F)})r_{h(F)}$$

where $t_{f(F)}$ is the tax on investments in F by residents of F and $t_{h(F)}$ is the tax on investments in F by residents of H.

International taxpayer equity
All residents in H should be treated equally in terms of taxation of their investments, regardless of the location of their investments. This principle, in practice, is the same as CEN since residence is the basis for comparison:

$$(1 - t_{h(H)})r_{h(H)} = (1 - t_{h(F)})r_{h(F)}$$

Inter-nation equity
The international allocation of income among countries should be fair. This principle is harder to specify since definitions of fairness vary. One possibility is that the tax rates on equal-yield foreign investments, $r_{h(F)} = r_{f(H)}$, should be the same in both countries. That is, F's investments in H should be taxed by H at the same rate as H's investments in F are taxed by F, so that host countries treat foreign investors reciprocally. The reciprocity principle would be:

$$(1 - t_{h(F)})r_{h(F)} = (1 - t_{f(H)})r_{f(H)}$$

Reciprocity is currently followed for withholding taxes negotiated under bilateral tax treaties, but could be defined more generally as 'eciprocally equal *total* taxes on capital income accruing to non-residents' (Musgrave 1983, 284).

rate entity, earned or received within the country up to its *water's edge*. Where MNEs are involved, affiliates are treated as separate legal entities and income is apportioned between them, assuming intrafirm transactions take place at arm's length prices.

The right to tax depends on the existence of a connection or *nexus* between the taxing jurisdiction and the business enterprise. The nexus differs under the source and residence principles. For a taxable nexus to be established under the source principle, the business must have a 'permanent establishment' in the taxing jurisdiction.[16] Once the MNE's income is effectively connected to a country, the source country can tax all items of income that arise within its borders.

Under the residence principle, the definition of residency can vary between countries. In some countries (e.g., the United States), a business is resident in the jurisdiction where it is incorporated; in others (e.g., Canada, the United Kingdom, Australia), location of the 'seat of management' determines residency. In the latter case, *de facto* control matters more than *de jure* control (Arnold 1986, 10). The jurisdiction of residence has the right to tax both the domestic and foreign source income (i.e., the 'worldwide income') of its residents. Some countries follow an exemption system and exempt income earned abroad from taxation; others tax worldwide income.

Under the jurisdictional norms, 'first crack,' or the primary (but not exclusive) right to tax business profits, is given to the country of source. The residence country has the primary right to tax most other categories of income (Arnold 1986, 174; Langbein 1986, 630). Examples of different types of income and which country normally has the primary right to tax are illustrated in Box 2.3.

The principles of international neutrality and taxpayer equity are recognized through the obligation placed on the residence country to eliminate double taxation. Since the source country has the prior right to tax, the residence country is expected to modify its rules to take account of source country taxation.

The tax boundaries established in most developed countries are therefore roughly the same: the fiscal authority taxes the worldwide income of its residents and the domestic source income of its nonresidents (Arnold 1986, 3). Many countries – for example the United States – tax worldwide income of their residents, but defer tax on foreign source income until it is repatriated. In calculating the home country tax, a foreign tax credit is granted for the corporate income taxes and withholding taxes paid in the host country, up to the level of the home country tax. In certain cases, the residence country exempts all foreign source income from tax and taxes only on a territorial basis. In still others, certain categories of foreign source income are exempt while others are taxable as earned. For example, in Canada active business income earned abroad is not

BOX 2.3
Source Rules for Taxation of Business Income

Type of business income	Jurisdiction for tax purposes
Dividend income paid by X to Y	where X, the paying corporation, is resident
Interest income paid by X on a loan borrowed from Y	where X, the debtor, resides
The income from personal services provided by X to Y in location Z	in Z where the services are physically performed
Rents received by X from personal property owned by Y in location Z	in Z where the property is put to use
Royalties received by X from the licensing of technology to Y for use in location Z	in Z where the licensed property is put to use
Income received by X from real property owned by X in location Z	in Z where the property is situated
Gain/loss received by X on the sale of real property in location Z	in Z where property is located
Gain/loss received by X on sale of personal property in location Z	passage-of-title test (if sold in X, location in X)

SOURCE: Based on Hufbauer (1992, 203–7)

TABLE 2.1
Statutory Marginal Federal Corporate Income Tax Rates, Selected OECD Countries, 1981–1992

	1981	1985	1989	1992
Australia	0.46	0.46	0.39	0.39
Canada	0.483	0.483	0.391	0.391
France	0.50	0.50	0.39	0.34
Germany	0.56	0.56	0.56	0.519
Ireland	0.45	0.50	0.43	0.40
Japan	0.42	0.43	0.40	0.384
Netherlands	0.48	0.43	0.35	0.35
Sweden	0.58	0.52	0.52	0.30
Switzerland	0.098	0.098	0.098	0.098
United Kingdom	0.52	0.40	0.35	0.33
United States	0.46	0.46	0.34	0.34

SOURCE: Data from Cummins et al. (1995, 195)

taxable in Canada, while income from passive investments is taxable as earned (Brean 1993).

Rules and Procedures

Rules: Corporate Income and Withholding Taxes

The international tax regime has specific rules, embodied in double tax conventions, which are designed to allocate the tax base to either the residence or source country. The source country, for example, normally levies a corporate income tax (CIT), allowing the enterprise to deduct expenses incurred in the production of the income.[17]

Up to the mid-1980s, tax incentives were widely used by OECD governments to encourage investment. As a result, statutory CIT rates (i.e., posted rates) could vary significantly from marginal effective rates (i.e., rates taking account of incentives, credits, and deductions). Led by the United Kingdom in 1984, which announced the elimination of tax incentives and reduction in statutory tax rates, most governments have been flattening their rates and broadening their tax bases over the past ten years (OECD 1990, 152). Table 2.1 shows this trend to reducing statutory federal CIT rates for selected OECD countries over the 1981–92 period.

Most countries grant tax incentives for particular types of activities. For example, it is common to differentiate by asset type (machinery versus buildings), industry (manufacturing versus commerce), and source of finance (debt

TABLE 2.2
Marginal Effective Corporate Tax Rates, Selected Countries, 1990

	Canada	U.S.	U.K.	Japan
Asset type:				
Machinery	15.5	18.5	8.0	8.8
Buildings	35.9	25.3	49.7	2.5
Inventories	30.7	26.3	39.8	7.0
Industry type:				
Manufacturing	24.5	34.0	24.8	6.7
Other industry	29.1	11.7	21.2	5.9
Commerce	25.0	21.8	37.8	5.2
Sources of finance:				
Debt	–6.3	–14.7	–15.9	–74.6
New share issues	47.2	44.1	4.1	70.9
Retained earnings	47.3	43.7	40.5	62.8
Overall corporate tax rate	25.9	24.0	28.0	6.1

The marginal effective corporate tax rate (MECTR) is calculated for the corporate income tax (CIT) at the corporate level only, ignoring the personal income tax. The MECTR is the difference between the before-CIT rate of return to the after-CIT rate of return (this difference is called the 'tax wedge') divided by the before-CIT rate of return (also called the 'marginal product of capital.' Thus the MECTR is the ratio of the tax wedge to the marginal product of capital.
SOURCE: Data from Jorgenson (1993, 984)

versus equity). As a result, the marginal effective tax rate varies widely across assets, industries, and sources of finance. Some evidence on source country corporate income tax rates from Jorgenson (1993) is provided in tables 2.2 (for the CIT) and 2.3 (for the CIT and personal income tax combined).

Table 2.2 focuses on the corporate level, with data on 1990 marginal effective CIT rates for Canada, the United States, the United Kingdom, and Japan in terms of taxation for various assets, industries, and sources of finance. Table 2.3 focuses on the shareholder, looking at the combined corporate and personal income tax rates on corporate source income. Canada's overall corporate income tax rate is 25.9 per cent for corporations (higher than the U.S. and Japan but lower than the U.K.) and 40.2 per cent on corporate source income (highest of all four countries).

Economic theory predicts that marginal, not statutory, tax rates affect real investment decisions (see Chapter 6 for details). Differences in marginal CIT rates provide opportunities for multinationals to arbitrage these imperfections, shifting activities to lower-taxed locations. For example, since Canada's marginal effective tax rates are at the high end of the range, the tax differential may

TABLE 2.3
Marginal Effective Tax Rates on Corporate Source Income, Selected Countries, 1990

	Canada	U.S.	U.K.	Japan
Asset type:				
Machinery	32.9	34.1	23.0	29.4
Buildings	47.2	39.6	55.2	25.3
Inventories	44.0	40.3	47.2	28.3
Industry type:				
Manufacturing	38.5	46.4	35.5	27.8
Other industry	42.1	28.8	32.7	28.2
Commerce	41.1	36.8	45.6	27.3
Sources of finance:				
Debt	33.7	8.8	35.1	−8.3
New share issues	60.3	64.1	25.5	76.7
Retained earnings	49.6	53.3	43.8	66.2
Overall corporate tax rate	40.2	38.5	37.9	27.7

The marginal effective tax rate on corporate source income (METRcsi) is calculated for the corporate income tax (CIT) and personal income tax (PIT) combined. The METRcsi is the difference between the before-CIT-and-PIT rate of return to the after-CIT-and-PIT rate of return (we can call this difference the 'joint tax wedge') divided by the before-CIT-and-PIT rate of return. Thus METRcsi is the ratio of the joint tax wedge to the marginal product of capital.
SOURCE: Data from Jorgenson (1993, 989)

significantly affect multinational behaviour in Canada, particularly longer-run investment responses by footloose MNEs.

One way to deter mobile financial flows is through withholding taxes. Withholding taxes are generally levied on income paid to nonresidents that arises from passive investments or casual, nonrecurring activities in the source country. Interest, dividends, rents, royalties, and management fees are examples of types of income remittances that normally attract a withholding tax. Tax rates are normally in the 10–25 per cent range, but are generally reduced through bilateral tax treaties to zero to 10 per cent. The practice of cutting withholding taxes through bilateral tax treaties provides an example of using reciprocity on the grounds of inter-nation equity.[18]

The residence country normally levies a corporate income tax on the enterprise's income, however defined, allowing the enterprise to deduct expenses incurred in the production of the income. Generally, the net income from all the units of the enterprise are consolidated for tax purposes.

Procedures: Dispute Settlement
Both domestic and international procedures are part of the international tax

regime. For example, at the domestic level, national tax authorities publish regulations and have auditing and dispute-settlement procedures. At the international level, a network of bilateral tax treaties is used to settle interjurisdictional disputes. Most tax treaties are based on the OECD Model Tax Convention (see Appendix 2.1). The basic purpose of a tax treaty between two countries is to clarify their respective tax jurisdictions – that is, the nature of the transactions to be taxed and the per cent of the tax base each country has the right to tax (Kwatra 1988). Where disagreements occur, tax treaties contain a Mutual Agreement Procedure for cooperation where the representatives of each government (called the Competent Authorities) get together to resolve disputes (Skaar 1992). Where two countries do not have a tax treaty between them, there is no easy method at present for resolving interjurisdictional taxation disputes.

Within the international tax regime we can see at least two regional groupings emerging, the first in North America and the second in the European Union. The North American tax regime consists of the domestic tax rules and procedures for taxing MNEs in each of the three countries (Canada, the United States, Mexico) and the bilateral tax treaties that they use to determine tax jurisdictions, define tax bases, and settle crossborder disputes. In the following section, we outline the principal components of this regional tax regime.

The North American Tax Regime

The North American tax regime consists of three national tax systems for taxing multinationals – that is, the foreign-source income of domestic MNEs, and the domestic income of foreign MNEs, together with three bilateral tax treaties. We examine each country's approach to taxing multinationals below, and then review their BTTs. Table 2.4 provides some information on U.S. and Canadian corporate income tax rates on MNEs, and the withholding taxes negotiated under the Canada–U.S. tax treaty, as of 1995.

The U.S. Approach to Taxing Multinationals[19]

In the previous section, we outlined the principles, norms, rules, and procedures of the international tax regime. Now let us look at the U.S. approach to taxing multinational income.

Taxing the Foreign Source Income of U.S. Multinationals
In terms of the residence principle, the United States taxes its residents – persons and corporations – on their worldwide income. U.S. rules distinguish between a *foreign branch* (an entity, owned 100 per cent by its parent, which

TABLE 2.4
U.S. and Canadian Corporate Income Tax (CIT) and Withholding Tax Rates, 1995
(in percentage terms)

Type of tax	U.S.	Canada
Federal CIT rate – general	34	29
Federal CIT rate – manufacturing		22
Subfederal adjusted CIT rate – general*	12	15
Subfederal adjusted CIT rate – manufacturing*		14
Federal plus subfederal CIT – general	46	44
Federal plus subfederal CIT – manufacturing		36
Withholding tax on investment dividends#	10 (5)	
Withholding tax on interest payments#†	15 (10)	
Withholding taxes on royalties#	10 (zero)	
Withholding tax on management fees#	zero	
Withholding tax on copyright income#	zero	
Total CIT plus dividend withholding tax – general**	51	50
Total CIT plus dividend withholding tax – manufacturing**		42

*Subfederal U.S example is New York State (state CIT rate varies from 0–12 across all U.S. states). State CITs are deductible against federal tax, deductibility already factored in for ease of comparison. Subfederal Canadian example is Ontario (varies from 8–17 percent across all Canadian provinces). Provincial CITs are additional to the federal CIT.
**Calculated as w (1 – CIT) where w is the withholding tax rate.
#As in the Canada–U.S. tax treaty; the 1995 Canada–U.S. tax protocol rates are in parentheses.
†Since 1984, portfolio interest paid by U.S. borrowers to unrelated foreign lenders (other than banks lending in the normal course of business) has been exempt from the U.S. withholding tax.
SOURCE: Author's calculations using Boidman (1995b, A8–A11), Boidman and Gartner (1992, 30, 34), and the bilateral tax treaties.

does not have an independent legal existence separate from the parent) and a *controlled foreign corporation (CFC)* (an entity, more than 50 per cent owned by U.S. shareholders, incorporated in the foreign country and thus considered an independent entity). Branch profits are taxed as earned, but U.S. firms are permitted to defer U.S. taxes on income earned by their foreign subsidiaries until the CFC income is repatriated.

The U.S. CIT applies to domestic income of U.S. MNEs plus accrued foreign branch profits, head office fees, and interest payments remitted from foreign affiliates. Dividends are grossed up by the amount of foreign CIT and brought into taxable income. A foreign tax credit (FTC) is provided for (1) withholding taxes on remitted interest, head-office payments and dividends, (2) foreign

branch taxes, and (3) foreign CITs on dividends.[20] The credit cannot exceed the U.S. rate of tax. Since 1986, the U.S. rules 'look-through' or characterize types of incomes and place them in separate baskets with separate FTC calculations, in order to reduce tax avoidance.[21] Foreign earnings must be pooled and the FTC calculated using cumulative rather than annual foreign-source income and taxes. The rules also require U.S. parents to allocate a percentage of overhead to their foreign subsidiaries; creditable expenses are calculated, however, on a consolidated basis rather than by affiliate.

In addition, since the Subpart F rules were passed in 1962, passive income earned by foreign subsidiaries with U.S. parents, in situations considered abusive, has been taxable as earned. These situations primarily involve income in tax haven countries. For example, dividends, interest, rents, and royalties received by a U.S. citizen from a closely held company in Bermuda or the Cayman Islands would be taxable as accrued.[22]

Taxing the U.S. Income of Foreign Multinationals

In terms of the source principle, the United States taxes the income of permanent establishments and any income effectively connected to the United States at the basic federal CIT rate. (In 1995 this was 34 per cent; see Table 2.4 for details.) A U.S. corporation owned by nonresidents is subject to the CIT on its profits. American states and some cities also tax corporate income. The rates vary from zero to 12 per cent, and are deductible against the federal CIT (Boidman and Gartner 1992, 30–1).

In addition, when the corporation remits dividends to its parents, a withholding tax of 30 per cent is levied on the dividends. The dividend withholding tax can be reduced to as low as 5 per cent through BTTs; under the Canada–U.S. tax treaty the rate is 10 per cent.[23]

Before 1986, no tax comparable to the dividend withholding tax was levied on U.S. branches with foreign parents. In the 1986 Tax Reform Act, the U.S. government introduced several reforms that reduced tax rates and widened the income tax base.[24] A 30 per cent branch profits tax was introduced as a de facto withholding tax on profit remittances by U.S. branches to their foreign parents.

The U.S. government has become increasingly concerned with the (apparent) underpayment of U.S. taxes by foreign-owned firms in the United States. The U.S. Department of Commerce refers to these firms as 'foreign affiliates' or 'foreign-controlled corporations' (FCCs). We discuss this issue in Chapter 7, (Taxing MNEs in Practice), and provide new evidence on the tax payments of FCCs and of U.S. majority-owned foreign affiliates (MOFAs) located abroad. In chapters 8 and 9, on U.S. tax transfer pricing regulations, we review and assess the ways the U.S. Treasury and the Internal Revenue Service have attempted to increase the surveillance of, and taxes paid by, MNEs in the United States.

The U.S. Tax Treaty Network

As of 1992, the United States had signed 42 bilateral income tax treaties with other countries (Hufbauer 1992, 216–19). In 1995, the United States had bilateral treaties, of various types (information sharing, social security, income, defence spending, estate and gift, income from shipping and aircraft), with over 80 countries and principalities (Tax Analysts 1995, 136–43). Generally, the treaties define residency, taxation of business profits, attribution of profits, allocation of expenses, and treatment of sources of income. As a home country, a major goal of U.S. treaty policy has been to convince treaty partners to reduce their withholding taxes on remitted dividends, royalties, and head-office fees. The U.S. competent authority is responsible for administering and implementing tax treaties. Given the enormous size of Canada–U.S. intrafirm trade and financial flows, probably the most important of these tax treaties is with Canada.

The Canadian Approach to Taxing Multinationals[25]

Taxing the Foreign Source Income of Canadian MNEs

Canada taxes residents – individuals and corporations – on their worldwide income; nonresidents are taxed only on their Canadian source income.[26] Taxation of worldwide income means residents pay Canadian taxes on their foreign-source income. However, Canada distinguishes between two types of foreign-source income.

Income earned through a foreign corporation (called a 'foreign affiliate') owned by a Canadian firm is not taxed as earned. The tax treatment depends upon whether the foreign affiliate earns *exempt surplus* or *taxable surplus*. Exempt surplus can be defined as 'active business income earned in certain listed countries (generally countries with which Canada has or is negotiating a tax treaty)' (Arnold 1986, 154–5). Dividends paid from foreign direct investments are exempt from Canadian taxation if they are paid out of exempt surplus in the foreign affiliate. Foreign-affiliate active business income losses cannot be deducted from the parent's income.

Taxable surplus basically consists of passive income and active business income earned in unlisted countries. Under the Foreign Accrual Property Income (FAPI) rules, dividends paid out of taxable surplus (e.g., foreign portfolio dividends) are included in the Canadian parent's income and subject to tax at the basic Canadian CIT rate; foreign withholding taxes are creditable, or may be deducted, against the Canadian tax (Arnold 1986, 153–4). Passive income is

taxed only when repatriated because the foreign firm is considered to be a separate entity and not resident in Canada, for tax purposes. The definition of what is and what is not FAPI income is difficult. The FAPI rules, which apply only to controlled foreign affiliates, operate such that if the income is classified as active business income then it is not subject to the FAPI rules.[27] Therefore FAPI income is basically passive investment income – for example, income from property, inactive businesses, and certain types of service income and capital gains.

Thus, Canada has a mixed exemption-credit system: exemption for active business income while dividends out of other income are taxed when repatriated with a foreign tax credit given for host country taxes. This regime was instituted in 1972; up to that point all foreign-source income was exempt from Canadian tax.[28] Now dividends out of ABI in listed countries can be repatriated tax free; dividends out of other income are taxed when repatriated.

In 1992, the Auditor General of Canada, in his annual report to Parliament, questioned the amount of taxes paid by Canadian MNEs on their foreign-source income, arguing that hundreds of millions of dollars was not being paid due to weaknesses in the Canadian regulations. Specifically, the report questioned: (1) the tax-exempt status of certain dividends received by Canadian MNEs from their foreign affiliates; (2) problems with the anti-avoidance FAPI rules; and (3) the tax-deductible status of interest on borrowed money used by Canadian MNEs to earn foreign-source income. The Department of Finance, however, disagreed with the Auditor General, arguing that Canadian tax regulations had to conform to international norms as established by the OECD; that the rules were designed not only to raise revenues but also to facilitate the competitiveness of Canadian MNEs on their foreign activities; and that little tax revenues would be gained by tightening the rules. We discuss this dispute, and the hearings held by the House of Commons Committee on Public Accounts, in Chapter 10 (Canadian rules and procedures).

Taxing the Canadian Income of Foreign Multinationals

In Canada, in terms of the source principle, foreign-controlled permanent establishments are taxed at the federal plus provincial statutory corporate income rate, with most tax deductions and credits available to domestic firms also available to foreign establishments. Profits earned from manufacturing and processing activities are taxed at a lower rate. In 1995, the federal rate was 29 per cent on general profits, reduced to 22 per cent for manufacturing profits (see Table 2.4); additional provincial CITs were payable, varying from 8–17 per cent depending on the province. Foreign-owned branches pay an additional 25 per cent of taxable income, from which the CIT is deductible, as a branch tax. Withholding taxes on remittances (except interest payments) are levied when these funds are repatriated. The general withholding tax rate on dividends is 15 per cent; since 1980 under the Canada–U.S. tax treaty the rate has been 10 per cent. The 1995 Canada–U.S. tax protocol reduces this rate to 5 per cent (see Table 2.4).

The Canadian Tax Treaty Network

Canada has an extensive network of bilateral treaties of various kinds (income, social security, capital gains, income from shipping and aircraft) with 59 countries (Tax Analysts 1995, 17–21). Canada's first income tax treaties were signed, not surprisingly, with the United Kingdom (1935) and the United States (1936). Based on Canada's long-standing concern with the inward FDI, the tax structure is set up so as to not directly discriminate against nonresidents, but tax preferences are generally restricted to residents. Canadian tax treaties only include a narrow definition of nondiscrimination, compared with the definition in article 24, of the OECD Model Tax Treaty (Eden 1988a,b). Canada typically precludes discrimination against resident nationals of the treaty partner and against residents of the treaty partner with permanent establishments in Canada. These groups receive treaty protection equivalent to Canadian nationals in Canada. Canadian tax treaties, however, do not include the second paragraph of article 24, which extends nondiscrimination protection to nationals of a treaty country that are not residents of either of the treaty countries. Nonresidents of Canada generally receive only most-favoured-nation (MFN) treatment, not full nondiscrimination. This means that Canada is committed to treating foreign-owned enterprises the same as other foreign-owned firms, but not equivalently to resident-owned enterprises. Nondiscrimination applies only to the taxes specified in the treaty, not to all forms of taxation.

The Mexican Approach to Taxing Multinationals[29]

Taxing the Foreign-Source Income of Mexican MNEs

Mexico taxes individuals and businesses on their worldwide income. In 1988, the rate was 42 per cent, which was subsequently reduced to 35 per cent, and then, in 1994, to 34 per cent for both individuals and corporations (Perez de Acha 1994, 623). A foreign tax credit is offered up to 34 per cent of taxable foreign-source income. Table 2.5 provides some information on Mexican, U.S., and Canadian CIT and withholding tax rates, as of 1995.

While the Mexican income tax at first looks similar to the U.S. and Canadian systems, there are some striking differences (del Castillo et al. 1995; McLees 1992, 1994). First, the definition of income in Mexico is different. Most income bases and deductions, unlike those in the United States and Canada, are indexed

TABLE 2.5
Statutory Corporate Income Tax Rates within North America, 1995
(in percentage terms)

	United States	Canada Mfg.	Canada Non-Mfg.	Mexico
Federal corporate income tax rate	34	**22**	29	34
Subfederal CIT rate (see note below)	12	14	15	**0**
Profit sharing tax	**0**	**0**		10
Combined federal/state CIT rate	46	**36**	44	44
Withholding tax on direct dividends	Canada 10 Mexico 5	10		0
CIT plus dividend withholding tax	Canada 51 Mexico 49	**42**	50	**44**

NOTES:
1 The lowest tax rate in each category is in bold.
2 Subfederal U.S. example is New York State (state CIT rate varies from 0–12 across all U.S. states). State CITs are deductible against federal tax; deductibility already factored in for ease of comparison. Subfederal Canadian example is Ontario (varies from 8–17 percent across all Canadian provinces). Provincial CITs are additional to the federal CIT. There are no state income taxes in Mexico.

for inflation (for example, real not nominal interest costs are deductible expenses). Thus the tax base can differ even if rates are roughly equivalent. Second, net income is generally subject to a mandatory 10 per cent profit-sharing payment, which is not deductible against the CIT to the extent that the firm's Mexican employees receive nontaxable fringe benefits. Third, Mexico also levies a 2 per cent business assets tax as a minimum income tax, unless the taxpayer declares at least a 5.7 per cent taxable return on the assets tax base.[30] Lastly, Mexico has no state income taxes. Assuming a corporation pays more than the minimum income tax, the effective statutory CIT rate in Mexico is therefore 44 per cent.

Taxing the Mexican Income of Foreign Multinationals

Nonresident individuals working in Mexico pay a statutory withholding tax rate of 30 per cent on gross income, regardless of where it is paid or the form it takes, even if the company does not have a permanent establishment in Mexico. Reduced rates apply to tax treaty countries and to the maquiladoras (McLees and Reyes 1992). Dividends paid either to residents or nonresidents from previously taxed income are not taxable, so there is no withholding tax on dividends.

Thus the statutory rate of tax on remitted profits of permanent establishments is 44 per cent. The business assets tax applies to permanent establishments and can be a source of double taxation.[31]

The Mexican Tax Treaty Network

As of 1995, Mexico has a limited, and very recent, group of bilateral tax treaties (BTTs) with 12 countries (Tax Analysts 1995, 82). Its first treaty was an exchange of notes in 1964 with the United States on taxing income from shipping and aircraft. The first income tax treaties (with Canada, France, and Italy) were signed in 1991; by 1993, Mexico had 12 BTTs in place, including treaties with the United States and United Kingdom. Clearly, the prospect of Mexico becoming a member of the OECD and setting up the NAFTA were strong impetuses to formalizing a BTT network with the other OECD and NAFTA countries.

Bilateral Tax Treaties in North America

The history of bilateral tax treaties in North America is only a long one in the case of Canada and the United States, reflecting their long history of cross-border tax and FDI flows. Mexico's BTTs with Canada and the United States are both quite recent. Table 2.6 outlines the key features (withholding tax rates, national treatment norms, other provisions) of the current BTTs among the NAFTA countries.

The 1980 Canada–U.S. Tax Treaty and 1995 Tax Protocol

Canada and the United States have had a bilateral tax treaty since 1936 (Tax Analysts 1995, 137). The 1980 Canada–U.S. tax treaty, as amended by protocols in 1983 and 1984, was ratified and came into effect on 1 January 1985. Starting in 1990, the two governments began negotiations on a new protocol, which was first signed in August 1994, revised and re-signed in March 1995, and came into effect on 1 January 1996. The main components of the new protocol, as related to multinationals, are (Arnold 1994; Boidman 1994a, 1996a,b):

- *Nondiscrimination*: The nondiscrimination clause, which previously had applied only to the CIT in both countries, is extended to all taxes imposed by Canada and the United States. Thus the principle of nondiscrimination is extended to all taxes as they apply to Canadian and U.S. multinationals.
- *Withholding taxes*: The protocol substantially reduces withholding taxes on crossborder financial flows. Withholding taxes on investment dividends fall from 10 to 5 per cent, on interest payments from 15 to 10 per cent, and are

TABLE 2.6
Bilateral Tax Treaties in North America

	1991 Canada–Mexico tax treaty	1992 U.S.–Mexico tax treaty and 1994 tax protocols	1995 Canada–U.S. tax protocol
		Withholding tax rates	
Direct dividends[1]	10%	5%	5% (7%, 6%, then 5%)
Portfolio dividends	15%	10% (15% for 5 years)	10%
Interest[2]	15%	4.9% (bank, 10% for 5 years) 15% (other)	10%
Royalties	15%	10%	0
		National treatment and most-favoured-nation norms	
National treatment	(1) The tax on non-nationals shall be no more burdensome than that levied on nationals in the same circumstances. (2) The tax on a permanent establishment shall be no less favourable than that levied on residents carrying on the same activities.		
National treatment for NAFTA investors		A resident of a state that is a NAFTA party may qualify for treaty benefits in certain circumstances.	
Most-favoured nation (MFN)	The tax on a company owned or controlled by residents of the treaty partner shall be no more burdensome than that levied on companies owned or controlled by residents of a third country.		
Restricted MFN	If Mexico signs a treaty with an OECD state setting a withholding tax on interest or royalties below 15%, Mexico grants Canada the lower rate, but not below 10% (1994 protocol).	If the U.S. signs a treaty with a third country that provides a lower withholding rate on direct dividends, both parties shall apply the lower rate (protocol).	

TABLE 2.6 (concluded)

	1991 Canada–Mexico tax treaty	1992 U.S.–Mexico tax treaty and 1994 tax protocols	1995 Canada–U.S. tax protocol
	Other clauses in the bilateral tax treaty		
Exchange of information	The parties agree to exchange information about taxes covered by the Convention.	The parties agree to exchange information about all taxes (protocol).	The parties agree to exchange information about all taxes.
Assistance in tax collection			The parties agree to help collect each other's taxes.
Arbitration panels		After 3 years the parties shall consult about exchanging notes to establish a binding-arbitration procedure for disputes that cannot be resolved by competent authority (protocol).	After 3 years the parties shall consult about exchanging notes to establish a binding-arbitration procedure for disputes that cannot be be resolved by competent authority.

NOTES:
1 Mexico does not levy a withholding tax on direct dividends.
2 The United States does not levy a withholding tax on interest payments.

eliminated on royalties.[32] See Table 2.4 for a comparison with existing withholding tax rates.

- *Exchange of information*: The Canada–U.S. tax treaty allows the exchange of information on income, estate, and gift taxes between the two federal taxing authorities. The new protocol expands the exchange to cover all taxes imposed by two countries, and to allow the disclosure of information related to income or capital taxes to provincial and state tax authorities.
- *Tax collection assistance*: The protocol adds a new article, XXVIA, dealing with mutual assistance in tax collection; each country undertakes, but is not obliged, to collect the other's 'finally determined' taxes as if they were its own taxes.
- *Secondary adjustments*: Under article IX of the Canada–U.S. Treaty, if a tax authority (e.g., the IRS) adjusts the transfer prices, and thus the taxes payable, of a taxpayer, the other authority (Revenue Canada) must make a corresponding adjustment if it agrees with the adjustment and if it is notified within six years. If the requisite notice is not given to the competent authority and the taxpayer, the first authority (i.e., the IRS) cannot adjust the transfer prices to the extent that such adjustment causes double taxation. This last obligation (on the IRS) to not adjust the transfer price is removed from the protocol; the taxing authority may grant tax relief but is not obliged to do so.
- *Arbitration*: A voluntary arbitration procedure may be added to the mutual agreement article if the two parties agree; this decision is to be made three years after the protocol enters into force.

Starting in January 1996, the statutory withholding taxes on intracorporate financial flows between Canada and the United States began, with the exception of interest payments, to fall to negligible levels and will soon cease to have any real impact on MNE financial decisions. Statutory CIT rates in the two countries, as Table 2.4 shows, are already similar, although there are some differences at the subfederal level and in terms of specific activities.[33]

Recently, both Canada and the United States have also signed bilateral tax treaties with Mexico. In addition, the North American Free Trade Agreement (NAFTA) will, by 2003, lead to the removal of all tariffs on Canada–U.S.–Mexico intracontinental trade, and to the removal, reduction, or harmonization of most nontariff barriers (e.g., quotas, subsidies, preferential procurement policies). NAFTA also puts into place strong investment legislation protecting the rights of North American investors and investments in terms of the principles of national treatment and most-favoured nation. The net impact of these changes is to substantially eliminate or harmonize the national treatment of North American firms and investors in the three countries.

The prospect of NAFTA was one of the factors which led Mexico to seek bilateral tax treaties with Canada and the United States, as one way to encourage inward FDI (i.e., by providing a more secure and similar tax regime for foreign investors).

The 1991 Canada–Mexico Tax Treaty

In 1990, Canada and Mexico signed their first information-exchange agreement, which was followed in 1991 by their first bilateral tax treaty, effective 1 January 1992. The treaty reduced Canadian withholding taxes on direct dividends paid to Mexican investors from 30 to 10 per cent; Mexico does not levy a withholding tax on direct dividends. Withholding taxes on portfolio dividends, interest income, and royalties were reduced to 15 per cent.

The treaty provides several examples of a move towards harmonization at the tax level. First, national treatment is provided both in terms of taxes being no more burdensome on non-nationals than on nationals, and in terms of being no less generous to nonresidents than to residents. Second, two types of MFN clauses are introduced. The first is a general commitment to ensuring that the tax on a nonresident company be no more burdensome than that afforded to residents of a third country. For example, if the Canada–U.S. tax treaty offered U.S.-controlled permanent establishments in Canada a better tax rate than Mexican-controlled affiliates received under the Canada–Mexico tax treaty, this article would ensure Mexican affiliates received MFN treatment. Subsequently in the 1994 protocol to the treaty, an additional article was added providing Canada with partial MFN treatment for Mexican withholding taxes on interest and royalties.

The 1992 U.S.–Mexico Tax Treaty and 1994 Tax Protocols

The United States and Mexico signed their first bilateral tax treaty[34] in September 1992; it took effect in January 1994, followed quickly by two protocols.[35] As Table 2.6 shows, the withholding tax rates are generally lower than those negotiated under the Canada–Mexico tax treaty. As these rates are phased in, the MFN clauses in the second treaty should provide additional treaty benefits to Canadian investors in Mexico.

One of the interesting components of the U.S.–Mexico tax treaty is Mexico's 4.9 per cent withholding tax on interest payments. Almost all interest payments flow north from Mexico to the United States; therefore any reduction in the withholding tax reduces Mexican tax revenues per dollar of interest outflows. U.S. banks, however, want a low withholding tax rate so their income falls in the general financial services basket rather than in the high withholding tax basket. Five per cent was the rate at which interest payments would have to move into the U.S. high withholding tax basket, so a 4.9 per cent rate was the maximum Mexico was able to negotiate (Morrison 1994).

The U.S.–Mexico treaty incorporates the same national treatment article as the Canada–Mexico treaty. In addition, it provides a (so far unique) form of national treatment for NAFTA investors. The definition of subsidiaries eligible for benefits under the U.S.–Mexican tax treaty is any subsidiary that is wholly owned, directly or indirectly, by publicly traded companies in any of the three NAFTA countries, with a minimum 50 per cent ownership in either the United States or Mexico. Thus a 51/49 per cent U.S.–Canadian joint venture in Mexico is eligible for U.S.–Mexico tax treaty benefits (Morrison 1994, 829–31). While no general MFN clause exists, there is a restricted clause whereby the United States agrees that if it should negotiate lower withholding taxes on direct dividends with a third country, both parties will adopt that lower rate.

Two interesting extensions appear in the 1994 protocols to the treaty. In anticipation of NAFTA, U.S.–Mexico crossborder flows have significantly increased and are expected to do so in the future. Therefore tax authorities on both sides of the border have become more interested in data collection for tax purposes. In one protocol the two governments agree to exchange information on all taxes, not just those listed in the Convention (which is the standard article; see the Canada–Mexico treaty for an example). Second, the two governments have agreed to discuss in three years' time the establishment of a binding-arbitration procedure for resolving bilateral tax disputes. The 1994 protocol also details how such a procedure would work.[36]

Summary: The North American Tax Regime

The evolution of corporate income taxation in North America is interesting to study, and offers opportunities for speculation about future directions. All three countries tax foreign-source income of domestic MNEs and domestic income earned and repatriated by foreign MNEs. Excluding preferentially treated sectors (e.g., manufacturing in Canada, the maquiladoras in Mexico, possessions corporations and tax incentive zones in the United States), statutory CIT rates are roughly similar (see Table 2.5), at 44–6 per cent of taxable income. Withholding tax rates are being harmonized through BTTs and the most-favoured-nation clauses in the Mexico treaties.

However, the three approaches do differ in significant ways. Both Canada and the United States have federal as well as subfederal CIT rates; Mexico does not. Mexico has a profit-sharing tax; the other two countries do not. Canada and the United States levy withholding taxes on dividend repatriations; Mexico does not. Canada exempts foreign-source income, if it is active business income, from taxation; the United States and Mexico tax MNEs on their worldwide income and offer a tax credit for foreign income taxes.

As long as tax bases and rates differ, the potential for undertaxation or double taxation of MNE income remains. Thus, the North American tax regime is only a partial one: it is in place, it is deepening (particularly since the Mexico–Canada and Mexico–U.S. treaties were signed), but it is not complete. The same can be said for the international tax regime, as we conclude below.

An Assessment of the International Tax Regime

We have outlined the goals, scope, principles and norms, and rules and procedures of the international tax regime. Developed on a piecemeal basis by national tax authorities to deal with the problem of overlapping tax jurisdictions caused by multinational enterprises, the goals of the international tax regime are to avoid the under- or overtaxation of corporate income. The three principles underlying the regime are inter-nation equity, international neutrality, and international taxpayer equity. Achieving these principles has led to a complicated system based on the rules for nexus and the methods for coordinating source and residence taxation.

International regimes are generally assessed on the basis of their strength. A regime's strength depends upon answers to questions like the following: Are the rules and procedures of the regime an accurate reflection of the underlying principles and norms? Do the actors abide by the regime's principles, norms, rules, and procedures? Is adherence to the regime in terms of numbers of states and geographic areas increasing or decreasing over time? Can the regime effectively monitor and punish offenders? Are there defectors/renegade states that do not abide by, or act so as to deliberately undermine, the regime? Are the regime's norms more honoured in the breach than in practice? Is there a hegemonic state with the willingness and capacity to underwrite the costs of the regime?

Space precludes a full answer to this question in terms of the international tax regime. Suffice it to say that the evidence is mixed. The OECD and the U.S. government, in particular, have been the basic forces behind the development, support, and extension of the tax regime. The OECD model tax treaty is widely copied as a model for bilateral tax treaties. Tax treaty states commit themselves to international equity and neutrality principles, expressed in terms of the avoidance of double taxation and the prevention of tax evasion and abuse. A degree of uniformity does exist in terms of the source and residence principles as applied to the corporate income and withholding taxes; that is, the source country has 'first crack' at taxing MNE profits while the residence country is supposed to prevent double taxation.

On the other hand, tax havens do exist, and there have been strong criticisms of the international tax system as it currently functions. We address each of this weaknesses below.

Tax Havens: Renegades in the International Tax Regime[37]

Tax havens[38] are countries that enable MNEs to escape the consequences of the international tax regime. Most, with the exception of Switzerland and the Netherlands, are outside the OECD and thus may be considered outside the tax regime as it currently exists.

Tax havens generally have (1) zero or low rates of income tax[39] (e.g., a low tax on foreign investment or sales income and a low dividend withholding tax on dividends paid to the parent firm); (2) an absence of foreign currency controls (minimal regulation); (3) strong bank, commercial secrecy laws or administrative practices which the country is unwilling to breach; (4) modern communications facilities to support financial services; (5) a stable currency; and (6) aggressive self-promotion as an offshore financial centre (IRS 1981, 14–19). Tax havens often have a disproportionately large banking and finance sector measured as a per cent of gross domestic product, or measured in terms of the size of foreign assets of deposit banks relative to foreign trade.[40] A 'smell' or reputation test is also one way to recognize a haven: if it looks like a haven and taxpayers treat it as a haven, it probably is a haven.

MNEs engage in transactions through tax havens for very different reasons (IRS 1981, 60–1). First, there are transactions with no tax motivation per se in that total tax payments are unaffected by the transaction through the haven. Second, a transaction may have a tax effect, but be completely within the 'letter and the spirit of the law" (IRS 1981, 61); this is *tax planning*. Putting the headquarters of a shipping firm in a flag-of-convenience location would be an example. Third, *tax avoidance* is aggressive tax planning that takes advantage of loopholes in the domestic tax system to shelter income from taxation – for example, shifting the ownership of high-profit intangible assets to tax havens, and allocating R&D expenses to high-tax locations. Tax avoidance is legal, at least on the surface.

Fourth, *tax evasion* is the escape of legal obligations through illegal means – that is, the activity is a 'sham' (an artificial transaction that unduly reduces taxable income) or it involves the illegal hiding of taxable income.[41] Tax evasion can be of two kinds: evasion of taxes on legally earned income and evasion of taxes on illegal income (e.g., from narcotics). It is this fourth category, tax evasion, which distinguishes renegade states from simple free riders in the international tax regime.

MNEs and private individuals use tax havens, first, because of their low tax rates, but also for other reasons such as confidentiality, freedom from currency controls, freedom from banking controls (such as domestic reserve requirements which restrict bank loans), and the attractiveness of high interest rates on bank deposits and/or lower rates on loans. In fact, tax havens may not provide much of a tax advantage to MNEs in high-tax locations. The advantage only occurs if the home country does not tax income earned in havens on an accrual (earned) basis but either exempts such income from home country tax or permits deferral of the tax until the income is repatriated.

In spite of the reduced tax advantages, secrecy laws, high rates of return on capital due to minimal regulation, and low lending rates continue to be powerful magnets. Not surprisingly, tax havens only afford this special status to nonresidents. This extreme need for secrecy has led many tax havens to become subjects of controversy. Tax havens are often home to laundered and criminal money or to flight capital – 'hot money' (Friman 1994; Gilmore 1992; Naylor 1987; Palan 1994; Strange 1986). Many MNEs have set up 'letterbox" companies to collect patent royalties, licensing fees, and loan interest tax-free (Johns 1983, 64). Due to the unwillingness of tax havens to provide information on banking activities to third countries, clients can keep their financial activities hidden (whether legal or illegal).

Let us define a *renegade state* in the international tax regime as a state that does not comply with the practices of the majority of members of the regime; that is, a tax renegade is an 'abusive tax haven' (Eden and Hermann 1995). It has some or all of the following characteristics: (1) the state has a zero or very low tax rate on business income in general; (2) domestic secrecy laws are strong and the state refuses to exchange information with other tax authorities; (3) the state actively promotes itself as a tax haven where tax avoidance and evasion practices are allowed – for example, money laundering and tax evasion are not illegal; (4) the state is known as a drug conduit state; and (5) the state does not have a network of bilateral tax treaties. We argue that the key characteristic is tight domestic secrecy laws, including the refusal to exchange information with other tax authorities. This encourages the movement of illegal activities into these havens.[42]

We need to distinguish free riders from renegade states. Free riders abide by the general practices of regime members but cannot or do not contribute their proportionate share to the costs of regime maintenance (the collective costs). For many developing countries, building the tax infrastructure needed to comply with the OECD's practices would be an onerous burden. Such small states are likely to be free riders. Renegade states, on the other hand, do not comply with the regime's practices.

Some renegade states are inside the international tax regime because they are members of the OECD. These states would include Switzerland[43] and the Netherlands (through the Netherlands Antilles). Others are outsiders (non-OECD members). These would include most Caribbean tax havens (e.g., Bahamas)[44] together with countries such as Hong Kong and Liberia.

The reasons why some states become renegades in the tax arena, engaging in abusive tax behaviour, may be due to simple economic motivation. Small, poor states lacking natural resources or other obvious attractions to foreign direct investment may turn to tax haven status in order to induce inflows of foreign banking and commercial activities. Historical ties with rich countries that included preferential status for their investments in the poorer partners also encourage low tax rates since the home country effectively engages in 'tax sparing'; the effective tax rate is therefore the host country rate (e.g., Puerto Rico and the United States). These motivations, however, suggest reasons for tax haven status per se, and not for abusive status. We hypothesize that the more important are criminal elements (e.g., proximity to narcotics-producing countries so that this state becomes a transit state), the more likely is the tax haven to become a renegade state. Tight secrecy laws and unwillingness to exchange information also encourage abusive haven activities.

In terms of dealing with renegade states in the international tax regime, it is clear that reducing tax evasion and avoidance on a global basis cannot be accomplished by individual states. The Gordon report (IRS 1981) notes in this regard:

> The United States alone cannot deal with tax havens. The policy must be an international one by the countries that are not tax havens to isolate the abusive tax havens. The United States should take the lead in encouraging tax havens to provide information to enable other countries to enforce their laws ... However, such steps taken unilaterally would place United States businesses at a competitive disadvantage as against businesses based in other OECD countries. Accordingly, a multilateral approach to deal with tax havens is needed. (IRS 1981, 10)

On the other hand, most of the legislation so far has been domestic. Many OECD countries have enacted domestic tax rules designed to lessen the attractiveness of tax avoidance and evasion through tax havens. Eliminating tax deferral for foreign branches and subsidiaries in 'blacklisted' countries, or for certain types of passive income earned in these locations, is one common approach (e.g., the U.S. Subpart F rules,[45] the Canadian FAPI rules). Transfer pricing regulations (e.g., section 482) that ensure intrafirm prices must be based on the arm's length standard are another method of reducing the possibility of tax avoidance. Doctrines of sham (artificial transactions designed so as to unduly reduce taxes) and general anti-avoidance legislation are also used, together with tax regulations that shift the burden of proof to the taxpayer and/or require substantial amounts of information about the transactions from the taxpayer.

Refusing to sign tax treaties with haven states unless they commit to information exchange and anti-abusive rules is another common response. Many tax havens have historically had a special relationship with an onshore economy, often as remnants of the colonial period. The Netherlands Antilles, for example, has taken advantage of its privileged relations with the Netherlands; as a Dutch protectorate, the 1948 U.S.–Netherlands tax treaty was applicable on its territory. A similar arrangement existed between Britain and numerous Caribbean islands. When many British colonies achieved nation status in the 1960s, the 1945 U.S.–British tax treaty was simply extended to these new nations (IRS 1981, 149).

TABLE 2.7
U.S. Bilateral Tax Treaties with Tax Havens, 1995

	U.S. tax treaties with this country [date signed in brackets]			Number of countries signing treaties with this country
	Exchange of information	Taxation of shipping and/or air transport income	Income tax treaty-notes-protocol	
Bahamas		X [1987]		1
Barbados	X [1984]		X [1984, 1991]	8
Bermuda	X [1988]		insurance income only [1986]	1
Costa Rica	X [1989–91]			1
Hong Kong		X [1989]		1
Isle of Man		X [1989]		2
Jamaica	X [1988]		X [1980–81]	9
Liberia		X [1982, 1987]		3
Libya				5
Liechtenstein				1
Luxembourg		X [1989, 1993]	X [1962]	28
Netherlands*		X [1926]	X [1948, 1955, 1963, 1965, 1986, 1987, 1992–3]	65
Panama		X [1941, 1987]	withholding tax only [1963]	1
Singapore		X [1985, 1988]		32
Switzerland			X [1951]	62
Trinidad & Tobago	X [1989–90]		X [1966–70]	11

*U.S.–Netherlands income tax treaty extended to Netherlands Antilles [1955, 1963]; benefits terminated in 1987. Benefits to Aruba terminated in 1995.
SOURCE: Calculated from data in Tax Analysts (1995)

As a result of the 1981 Gordon report, the U.S. government terminated several tax treaties with Caribbean havens. New treaties are only negotiated if there is a strong exchange-of-information clause attached that overrides foreign bank secrecy laws in the tax havens.[46] U.S. bilateral treaties are to be restricted to residents of a treaty country, so that 'treaty shopping' cannot be used by nonresidents to gain the benefits of the tax treaty (IRS 1981, 12–13).[47] In the absence of a tax treaty, firms located in these states do not get treaty benefits – in particular, access to bilateral dispute-settlement procedures is denied. MNEs in these countries face much higher withholding tax rates and lose other tax privileges.

Table 2.7 provides some evidence on U.S. bilateral tax treaties with haven

countries, as of 1995. It is clear from the table that the United States has primarily shipping and air transport treaties with tax havens, other than countries that are OECD members (Switzerland, Netherlands), and that these treaties have mostly been signed in the late 1980s. In general, few countries have signed income tax treaties with havens (see the last column of Table 2.7).

Non–tax haven countries also find themselves in an extremely hypocritical position, for it is their citizens that make the most use of tax havens. In the majority of instances, it is OECD companies and/or elites that carry out businesses and maintain their private savings in tax havens. Tax havens thrive precisely because of the existence of foreign banks and service companies, largely from non–tax haven countries. The so-called 'high tax' countries are, therefore, under pressure from their own financial sectors to ensure a certain regulatory laxity (Palan 1994, 11). It is as though tax haven and high-tax countries have implicitly agreed to allow for a certain amount of deviant behaviour within the global financial system.[48]

In summary, tax haven countries are a 'hole' in the international tax regime – areas where the principles, norms, rules, and procedures of the regime do not apply. There are strong political economy motivations on the parts of haven governments and multinationals for these holes to exist. However, they represent a clear weakness in the regime.

Is There an International Tax Regime?

There have been strong criticisms made of the international tax system as it currently functions. One long-time critic, Richard Bird, a well-known Canadian economist and international finance expert, argues that

> strictly speaking, there is no such thing as an international tax system. No law limits national jurisdiction. Each country may adopt whatever taxing rules it sees fit (whether it can enforce the rules it adopts is quite another matter) ... Often ... the key features affecting international income have been accidental ... [or] they have been additions patched onto the system to cope with specific problems as they became apparent ... In yet other instances, countries seem simply to have copied such complex rules as those on transfer pricing and controlled foreign corporations from the United States, which has been the dominant exporter of both capital and tax policy notions throughout most of the postwar period. The taxation of international income ... has thus developed more by chance than by design. The present international tax order as a whole is a patchwork structure that makes little sense in terms of its purported objectives. (Bird 1988, 293)

Bird goes on to argue that bilateral tax treaties are principally designed to reduce withholding tax rates on payments to nonresidents because capital exporting countries like the United States have a vested interest in negotiating lower withholding taxes on payments from foreign affiliates to their parent firms. At the same time, tax competition among host countries to attract inward foreign investment also persuades these countries to reduce their withholding taxes; once a few countries reduce or eliminate withholding taxes, others follow in order to prevent capital flight. Interest payments, for example, are now generally free from withholding tax by source countries for this reason. And, given the fungibility of different categories of financial payments and the freedom of the MNE to choose the way it remits income to the parent firm, the net effect may be to reduce the effective withholding tax on foreign portfolio income to near zero. The net result is to encourage outward investment at the expense of domestic investment.

From the perspective of the home country, the taxing authority must make the following choices: between exempting or taxing foreign-source income, between taxing on an accrual or deferral basis, between a foreign tax deduction or credit. Where foreign-source income is tax exempt (as it is in Canada), the residence country simply cedes jurisdiction to the host country. This however encourages outward investment in low-taxed countries and favours foreign capital over domestic investment. Exemption is likely to encourage the growth of tax havens since the effective tax rate for local investment is not the home rate (as it would be under an accrual with foreign tax credit scheme) but the host rate, and competition among host countries for investment will most likely drive down tax rates. Tax deferral, Bird argues, is equivalent to tax exemption with a penalty added for repatriation, so it makes even less sense than exemption. His conclusion therefore is that 'the present treatment of international capital flows is inefficient and inequitable" (Bird 1988, 295). He goes on to propose several radical solutions: (1) replacing the corporate income tax with a consumption-based business tax; (2) eliminating tax deferral; or (3) moving to a global formulary apportionment system (unitary taxation) for allocating MNE worldwide profits. His preferred solution is the third because of the integrated nature of the multinational enterprise.

Is the Glass Half Empty or Half Full?

Our view in this book is not as pessimistic as Bird's. We do see a structure to the international tax system that has the characteristics of an international regime, with regime supporters, underlying principles, an international organization at its centre, and so on. Clearly, there are problems with the way the regime functions in practice, problems that the OECD's Committee on Fiscal

Affairs, the International Fiscal Association (IFA), and the competent authorities of various countries debate regularly. In the absence of this structure, the system would most likely rapidly degenerate into wholesale international tax competition, with significantly higher non-neutralities and inequities compared with the current international tax regime. In part, the issue is the base comparison with which the current structure is compared: an ideal world with complete international neutrality and equity (however defined) or no regime at all.

Transfer pricing issues are clearly part of this regime. MNEs through their intrafirm trade in intermediate goods, technology, and services create opportunities for overlapping tax jurisdictions. Governments have developed specific principles, norms, rules, and procedures with regards to the taxation of transactions among related parties. These form the basis of the tax transfer pricing regime, to which we now turn.

The International Tax Transfer Pricing Regime

Nested within the international tax regime is the international tax transfer pricing (TTP) regime, centred around the international norm of the arm's length standard. Government cooperation in the transfer pricing area is based on a variety of national corporate income tax regulations, BTTs, and model tax treaties. The OECD's Committee on Fiscal Affairs and the International Fiscal Association have also played important roles in the TTP regime.[49]

The characteristics of the tax transfer pricing regime are outlined in Box 2.4 and discussed below. Box 2.4 is set up in the same manner as Box 2.1 in order to facilitate comparisons between the international trade, tax, and tax transfer pricing regimes.

The Problem: Allocation of Income and Expenses

Because their activities cross national borders, multinational enterprises fall under the jurisdiction of more than one tax authority. MNEs therefore create problems in regulation; in particular, the integrated nature of the enterprise makes it difficult for governments to devise tax rules to allocate income and expenses among the units of the MNE. As Jill Pagan and Christopher Wilkie, two well-known international tax lawyers, state:

> Transactions where transfer pricing is relevant are increasing rapidly and the tax authorities are having to devote more and more resources to dealing with transfer pricing inquiries. The first stage towards finding a solution is to recognize the difference between tax authority thinking and commercial thinking. Tax authority thinking is national, not

BOX 2.4
The International Tax Transfer Pricing Regime

Purpose	To avoid double taxation of MNE income and prevent tax avoidance and evasion caused by overlapping tax jurisdictions. Seen as problems that lead to distortions and inequities.
Scope	Issue area: the appropriate allocation of income and expenses among members of a related group of businesses located in different jurisdictions; the valuation of all crossborder transactions among related parties. Geographic area: OECD members and their bilateral tax treaty partners.
Principles	Three principles: Inter-nation equity, international tax neutrality, and international taxpayer equity.
Norms	The arm's length standard: each unit of the MNE is expected to declare, for tax purposes, the profits it would have made had it been a distinct and separate enterprise operating at arm's length from its parent and sister affiliates.
Rules	Governments adopt a transactions-based, water's-edge approach to allocating the MNE's income and expenses among jurisdictions. Different rules or methods apply for valuing goods, services and intangibles, but all follow the arm's length standard. Acceptable methods include comparable uncontrolled price (CUP), cost plus (C+), resale price (RP), and fourth methods.
Procedures	Domestic procedures: • Auditing process with appeals through the domestic courts • Publication of rules, procedures, acceptable methods • Functional analysis to evaluate the functions of the MNE's entities • Advance Pricing Agreements • Penalties and documentation regulations to ensure compliance. International procedures: • Bilateral tax treaties based on OECD Model Tax Treaty defining jurisdiction • Mutual agreement procedure using competent authorities for interjurisdictional disputes • International arbitration • Exchange of information among tax authorities • Simultaneous examination procedures.

global, and principally uses methodology for establishing individual transaction profit. By contrast, the commercial thinking of the MNE is global, not national, and the emphasis is on consolidated accounts or results. (Pagan and Wilkie 1993, 26–7)

The characteristics of the MNE that we identified earlier – common control, common goals, and common resources – all complicate international valuation of the MNE revenues and expenses, and thus the taxation of its worldwide profits. Transfer prices, as we saw in Chapter 1 are unlikely to be the same prices arm's length parties would negotiate. The prices of traded tangibles, intangibles, and services within the various units of the enterprise are basically accounting or bookkeeping prices set for internal reasons. However, since MNE activities cross national borders, transfer prices must be provided to tax authorities and used to calculate both border taxes (tariffs, export taxes) and corporate income taxes. Therefore internal and external factors will influence the MNE's choice of transfer prices. The fear of tax authorities is that external factors will dominate and the MNE will set its transfer prices so as to avoid or evade taxes.

However, tax avoidance is not the only reason national authorities regulate transfer pricing. As Jeffrey Owens, Head of Fiscal Affairs at the OECD, admits,

the OECD and national tax authorities have never regarded transfer pricing issues as being 'mainly about tax avoidance.' ... Neither the 1979 report nor our current work assumes that all multinational enterprises (MNEs) are manipulating transfer prices to minimize their tax liability, although it would be naive to believe that the temptation is not there and that none will succumb. (Owens 1994, 877)

Even if MNE transfer prices are set for reasons other than taxes, genuine disputes between tax authorities and multinationals can occur as to the proper valuation of the revenue and expenditures incurred by the various affiliates of the MNE around the world. We expand on this below.

Purpose and Scope

The TTP regime was developed in order to deal with the complexities of determining the appropriate allocation of MNE revenues and expenses, at the national level, in a global economy.[50] The concern is that MNE transfer pricing policies might distort these allocations and thus not accurately reflect an 'appropriate' amount of taxable profits to individual tax authorities, and, in particular, that profits might be too low so that undertaxation occurs.

The purposes of the TTP regime are the prevention of tax abuse (i.e., the underpayment of taxes) and double taxation of income (i.e., the overpayment of taxes). The 1979 OECD report on transfer pricing clearly enunciates these objectives. The first statement below focuses on undertaxation of income, the second on overtaxation, as rationales for government intervention. Thus the purpose of the TIP regime is the 'proper' taxation of income. On undertaxation:

> Multinational enterprises may adopt transfer prices which are not arm's length prices in order to minimize tax ... or they may adopt them for other reasons, but whatever the reason, whenever intra-group transfers are not carried out at arm's length prices, the result is likely to be that profits are shifted from one company to another in the group and the tax liability of the relevant companies distorted in consequence. Since national tax authorities need to determine the proper allocation of taxable profits of the affiliated enterprises operating within their respective jurisdictions, the transfer pricing policies of MNEs are of great importance to them. (OECD 1979, 8)

Therefore, if MNEs choose transfer prices to minimize tax, the authorities have the right to intervene; that is, the first goal of the tax transfer pricing regime is to eliminate undertaxation through transfer price manipulation. And, even if the MNE's choice of a transfer price was not chosen to minimize taxes, the tax authorities can also intervene to impose the arm's length price. Thus transfer prices set even for legitimate internal or external reasons can be overturned for tax purposes; motive is not a relevant criterion (see also Pagan and Wilkie 1993, 52-3).

The second rationale is avoidance of double taxation. On overtaxation, the 1979 OECD report states:

> In the organization of their intra-group relations MNEs are necessarily confronted with transfer pricing problems – essentially a price has to be charged for every transaction ... One of these problems could be the danger of double taxation, if national authorities differ in their approach for tax purposes. It is therefore of importance to multinational enterprises also that common approaches to the resolution of transfer pricing problems should be developed. (OECD 1979, 9)

The overall impact is that the tax authorities have the right to adjust the MNE's income and expenses whenever the authorities believe the firm has not chosen a 'proper' allocation of income for tax purposes. Clearly, disputes are likely to arise with such a broad definition of transfer pricing problems. This leads us directly into the question of the scope of the TIP regime. The scope of the TIP regime is broad in both issue area and geographic area. The issue area covers the valuation of all activities of multinational enterprises that affect their

global income, and thus their tax base. Thus the valuation of tangibles, intangibles, and services is included within the scope of the regime. As we have seen above, any valuation that might result in an 'improper' allocation of taxable income can be questioned by the tax authorities.

In terms of geography, the scope of the TIP regime is less broad. All members of the OECD have adopted the 1979 OECD report on transfer pricing, although they may apply the report in varying ways and to varying degrees (see Pagan and Wilkie 1993).[51] Langbein (1986), in particular, argues that the arm's length principle is more honoured in the breach than in practice. Outside the OECD, there is little legislation in this area, although many governments historically have been concerned that MNEs might be using transfer prices to avoid taxes and other regulatory barriers such as foreign exchange controls (UNCTAD 1978). In 1994, the OECD began a dialogue with the East Asian governments and with the newly reforming countries of the ex-Soviet Union, to help these countries develop transfer pricing guidelines based on the OECD standard. Thus we anticipate that the geographic scope of the regime will spread.

Principles and Norms

Principles: Equity and Neutrality

The principles of the TIP regime are the same ones that characterize the international tax regime - that is, inter-nation equity, international neutrality, and international taxpayer equity.

National governments are concerned with transfer pricing for two reasons. As explained above, transfer pricing can be used to avoid or evade taxes. Where tax havens exist or MNEs can find tax loopholes to reduce their tax burden through under- or overinvoicing intrafirm trade flows, both international taxpayer equity and international neutrality are compromised. A domestic firm dealing at arm's length with another party, even if the party is located in a tax haven, cannot arrange its transactions in this manner. Thus taxpayers in the home country are not being treated equally and taxpayer equity is not achieved. The choice of investment location is also affected, as more investment is directed into low-tax activities, so the tax neutrality principle is also violated. Second, where government regulations of transfer pricing differ, double taxation is also possible. In such cases, international neutrality and equity are also violated. As Jill Pagan recently noted:

> No two countries have exactly the same (or same combinations of) tax rates, tax bases, levels of withholding taxes, and tax treaty networks and provisions. As long as this state of affairs exists, there are tax arbitrage possibilities. (Pagan 1994b, 1391)

Therefore national regulation of transfer pricing, by itself, cannot satisfy the basic principles of public finance: tax neutrality and equity. The need for intergovernmental cooperation is clear, and the tax transfer pricing regime was developed for this purpose.

Norms: The Arm's Length Standard

The fundamental norm or standard behind the current TTP regime is the *arm's length standard*.[52] Every member of the OECD has adopted arm's length as the basic standard for valuing MNE income and expenses. As Stanley Langbein (1986) shows in great historical detail, the arm's length standard as an international norm developed through two distinct historical episodes.[53] We would update his analysis by arguing that a third period began in 1994 with the finalization of the U.S. section 482 regulations and the first draft of a new OECD report on transfer pricing.

The first period, the 1920s through the early 1960s, was characterized by meetings of experts held first under the auspices of the Financial Committee of the League of Nations, and subsequently under the OECD's Committee on Fiscal Affairs and the United Nations. During this period, the *separate entity or independent enterprise* standard and the first tax convention models were developed by the League of Nations in 1928. The models were integrated and revised at a Mexico meeting in 1943 (becoming the precursor of the United Nations model tax convention) and in London in 1946 (the precursor of the OECD model).

The second period, tentatively dated 1968 to 1993, began when the U.S. Treasury under Assistant Secretary Stanley Surrey developed the methodology of the arm's length standard (published in 1968 as the Internal Revenue Code's Section 482 Regulations) and persuaded the OECD Committee on Fiscal Affairs to adopt the *transactions-based approach* to this standard. Under the transactions approach, an integrated group of business enterprises (a multinational) is separated according to transactions between related parties, with each of the transactions being valued according to the arm's length standard.

The 1977 OECD Model Tax Treaty and its 1992 update incorporate an arm's length standard for allocating income between firms and their subsidiaries, parents, or sister enterprises.[54] Article 9 of the 1977 Model Tax Convention defines the arm's length standard. The full quote is in Appendix 2.1, but we can paraphrase it here as: Each unit of the MNE is a separate legal entity for tax purposes. The entity is expected to declare, for tax purposes, the profits it would have made had it been a distinct and separate enterprise operating at arm's length from its parent and sister affiliates. Where the affiliate has not done so, a taxing authority may reallocate the profits and tax the entity accordingly.

In 1979, the OECD's Committee on Fiscal Affairs issued its first transfer pricing guidelines on the allocation of income and expenses between related enterprises (OECD 1979). The guidelines, developed over five years, apply generally to all MNE transactions. The model tax conventions (see Appendix 2.1) are designed to deal primarily with international double taxation, while the concerns of the transfer pricing guidelines focus not only on double taxation but also on tax abuse and, more generally, on the 'proper allocation' of income among countries. The transfer pricing guidelines, which are meant to apply to all MNE transactions, endorse the arm's length standard for allocations among related parties, although, somewhat surprisingly, the report does not contain a formal definition of the arm's length principle. Four regulatory methods are set out in the report: comparable uncontrolled price, resale price, cost plus, and other methods. The report argues strongly against the use of formulary apportionment (unitary taxation). These guidelines have been widely adopted as the basis for transfer pricing regulations by OECD member countries.

In 1984, the OECD published another report dealing with three specific issues in transfer pricing: (1) corresponding adjustments and Mutual Agreement Procedures, (2) the taxation of multinational banking enterprises, and (3) the allocation of central management and service costs. Due to its specific nature, this report has had much less circulation, or impact, compared with its earlier sister document. In addition, parts of the document were controversial (e.g., the allocation of management fees) and were not adopted by certain countries such as Canada. See Chapter 5 (the simple analytics of transfer pricing) and Chapter 10 (the Canadian regulations) for more details.

The third period is perhaps now just beginning. A six-country group within the Committee on Fiscal Affairs has been working on new transfer pricing guidelines for MNEs and tax administrations, updating the OECD's 1979 and 1984 transfer pricing reports. Preliminary versions of the report were published in 1994 and 1995, consisting of three documents: Part I: Principles and Methods; Part II: Applications; and Part III: Special Topics (OECD 1994b, 1995a,b, 1996, forthcoming; Hay et al. 1994). The draft report is heavily influenced by the new 1994 section 482 regulations (see Chapter 13 for details). It endorses the arm's length principle as the international transfer pricing standard for tax purposes (OECD 1994b, 160), provides several justifications for this standard, and recommends against the use of formulary apportionment. Although there was no formal definition of the standard in the OECD 1979 report, the 1994 transfer pricing guidelines endorse the definition in article 9 of the 1992 OECD Model Tax Convention. We discuss the OECD's new proposals in chapters 5 (simple analytics of transfer pricing) and 13 (rules and procedures).

The arm's length standard is not the only norm that could be used to guide the international tax transfer pricing regime. There is an alternative to the arm's length standard: the global or unitary method of taxing the MNE. Under this norm, what we could call the *integrated enterprise standard* or *global formulary approach*, the MNE's worldwide income would be taxed and allocated among countries according to a formulary approach. Respected international public finance economists such as Richard Bird and Charles McLure and international tax lawyers such as Stanley Langbein have been strongly supportive of unitary taxation (see Chapter 12 for details). However, both the OECD and the United Nations have been quite hostile to global methods of taxing MNE income, preferring to rely on the transactions-based, arm's length standard. The OECD argues that global methods are incompatible with articles 7 and 9 of the Model Tax Treaty. Moreover:

> Proposals for radical reformulations of the approach to intragroup transfer pricing would move away from the arm's length standard towards so-called global or direct methods of profit allocation ... are not endorsed in this report ... Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts. (OECD 1979, 14)

We will come back to the issue of global methods for taxing multinationals in Chapter 12.[55]

Rules and Procedures

Rules: CUP, Resale Price, and Cost Plus

The rules of the tax transfer pricing regime have to do with putting the arm's length standard into practice. In general, the arm's length standard has been interpreted to mean arm's length pricing of individual transactions.[56]

Under the corporate income tax, governments normally tax the net income of firms located in their jurisdictions, minus any tax deductions or credits. Net income is defined as gross revenues (product sales to households and other firms, royalty income, licence fees, etc.) minus cost of goods sold (factor costs, materials purchased from other firms), general expenses, and other allowable expenses. Where firms are unrelated, governments take the firm's prices as market or arm's length prices and accept the transactions as being determined in the marketplace. However, where the firms are related, the MNE must prove that its transfer prices are equivalent to those that would have been negotiated by unrelated parties engaged in comparable transactions or the tax authorities will substitute their calculation of arm's length prices.

Many different pricing methods are consistent with the arm's length standard, but four methods are the most widely adopted by tax authorities: the comparable uncontrolled price, resale price, cost plus, and 'fourth or other' methods. These are transactions based methods in that they are based on pricing individual transactions in accordance with the prices that unrelated parties in similar circumstances would have negotiated. These four methods were the formulas specified for intrafirm trade in tangibles in the 1968 U.S. Treasury regulations. The 1979 OECD transfer pricing report recommends that its members adopt these U.S. methods not just for tangibles but also for transactions in services and intangibles.

The traditional, transactions-based methods (CUP, resale price, cost plus) are also recommended in the draft OECD transfer pricing guidelines (1994b, 1995a,b, 1996), but the guidelines suggest occasions when moving beyond these methods may be necessary (e.g., global trading). The profit split method and the transactional net margin method (which is similar to the comparable profits method) are specified as alternatives, to be used as a last resort when the traditional methods do not work. The guidelines focus on comparability of transactions – that is, the arm's length price is determined through comparisons with the pricing of transactions between unrelated parties. Transactions should be comparable in terms of: the characteristics of the property or service, functions performed by the parties, contractual terms, economic circumstances, and business strategies of the firms.

Procedures: Dispute Settlement

As far as procedures are concerned, several methods are available at both at the national and international levels to facilitate common standards and rules across tax authorities (see Box 2.4). These include, at the domestic level, auditing and appeals processes, the use of functional analysis by the tax authorities to evaluate MNE activities, the introduction of Advance Pricing Agreements, and documentation requirements and penalties. The OECD report also recommends the use of functional analysis – a direct survey of the contributions an enterprise makes to the overall MNE – as important to determining the facts and circumstances of the case.

At the international level, procedures include bilateral tax treaties that include the Mutual Agreement Procedure (MAP) to settle interjurisdictional disputes, possible international arbitration of disputes, and information exchanges among tax authorities. BTTs are probably the most important of these international procedures.

Tax treaties can affect transfer price regulation in one of four ways. First, they define a particular basis for allocating income and help establish international standards for the treaty network as a whole. For example, the OECD Model Tax Treaty defines associated parties, outlines the arm's length pricing and the various pricing methods, and recommends corresponding adjustments to eliminate double taxation (see Appendix 2.1). Second, tax treaties identify transactions to which the basis will apply, such as trade between related parties in goods, services, and intangibles. Third, treaties provide for resolution of disputes, and fourth, they provide for mutual assistance between the tax authorities. This latter involves the mutual agreement procedure and exchanges of information. The MAP, as Kwatra (1988) notes, has been primarily used to settle transfer pricing disputes.

The North American Tax Transfer Pricing Regime

Just as we argued above that a North American tax regime was forming at a regional level within the international tax regime, so too can we argue that a North American tax transfer pricing regime is forming at a regional level within the international TTP regime. We outline the main features of this North American TTP regime below.

The U.S. Approach to Transfer Price Regulation[57]

The most important part of the U.S. corporate income tax law in the transfer pricing area is Internal Revenue Code section 482, which applies to all intracorporate transactions, tangible and intangible. The U.S. regulations, first developed in 1968, identify five types of intrafirm transactions: loans, rentals, sales of tangible property (i.e., goods), transfer or use of intangible property (e.g., patents, copyrights), and performance of services (e.g., managerial, technical). Section 482 requires that the income earned on transactions between related parties be determined on an arm's length basis.

Sales of tangible property are tested against an arm's length standard based on one of four methods (in order of priority): comparable uncontrolled price (CUP), resale price (RP), cost plus (C+), and the so-called 'fourth methods.'[58] The most difficult problems associated with section 482 arise in the pricing of intangibles, particularly where non-U.S. MNEs are involved since information is less readily available. The IRS and the U.S. courts often use the fourth method where a functional analysis is used to split profits on the transaction between the related parties. A recent tax change is the introduction of section 1059, which requires transfer prices on import transactions between related parties to not exceed those prices used for U.S. customs valuation purposes. The U.S. customs value therefore becomes a quasi-fifth method (IRS 1988, 520).

Since the early 1980s the United States has engaged in major – and frequent – revisions to its transfer pricing regulations. In 1986 Congress added the 'commensurate with income' standard to section 482, making it applicable to valuation of intangibles.[59] As a result, the revised section 482 now requires the tax authority to allocate the actual profit from the intangible to the related parties in proportion to their contributions to that income.

In 1988 the Treasury White Paper suggested that a functional analysis based on arm's length rates of return (the basic arm's length return method, or BALRM) should be used to satisfy the commensurate with income standard for intangibles (U.S. Department of the Treasury, 1988, Chapter 11). Where both marketing and manufacturing intangibles are involved, they should be separated and the residual income after the arm's length rate of return analysis should be split between these categories.

After the White Paper, the Internal Revenue Service, in 1992, issued proposals for reforming section 482 based on the comparable profits method. The proposals were roundly condemned by domestic and international experts, including the OECD, as inconsistent with the arm's length principle (OECD 1993a,b). In February 1993, the IRS issued temporary regulations reaffirming the U.S. government's commitment to the arm's length standard, revising and clarifying its proposals but keeping a modified form of the computed profit method. In June 1994 the Treasury issued final regulations similar to the temporary ones (see Chapter 8 for more details).

A recent procedure introduced by the IRS is the Advance Pricing Agreement (APA). This policy allows a multinational to sit down with the IRS and to negotiate an acceptable transfer pricing policy in advance of the actual transactions. This pricing policy remains in force for up to three years, after which the IRS and MNE can renegotiate the APA. In effect, the IRS is setting up a 'safe harbour' for specific transactions with particular multinationals. The first APAs are being negotiated primarily by MNEs, which are already subject to repeated audits by IRS investigators (e.g., Japanese auto and consumer electronics MNEs).

The Canadian Approach to Transfer Price Regulation[60]

The Canadian regulations, section 69 of the Income Tax Act together with Information Circular 87-2, are much less developed than the corresponding U.S. regulations. Section 69(1) of the act is designed to prevent related domestic firms from artificially shifting income and/or deductions among their divisions. Sections 69(2) and 69(3) apply to international transactions; 'reasonable under the circumstances' is the criterion for ensuring arm's length transactions.

Section 69(2) insists that intracorporate crossborder payments do not exceed a reasonable amount, whereas 69(3) insists that such receipts are not less than a reasonable amount. Revenue Canada basically follows the approach outlined in the OECD 1979 report on MNEs and transfer pricing (OECD 1979, Messere 1979).

Although the 1987 Canadian tax reform did not directly involve transfer pricing, Revenue Canada issued Information Circular 87-2, which was designed to set out its approach to applying section 69.[61] The circular defines 'fair market value' in 69(1) and 'reasonable under the circumstances' in 69(2,3) as the same and equivalent to the arm's length price. The circular states that the primary method for calculating arm's length prices is the comparable uncontrolled price. Other methods include resale price and cost plus. A functional analysis is recommended when exact comparables do not exist. Revenue Canada has also recently introduced its own Advance Pricing Agreement based on the U.S. model. Thus the Canadian rules and regulations, while not as detailed as their U.S. counterparts, do follow the same path.

The Mexican Approach to Tax Transfer Price Regulation

Mexico, until 1991, did not have a transfer pricing standard in its tax code, although the Mexican tax authority has generally recognized the OECD standards since 1976 (del Castillo et al. 1995). The 1991 amendments, under article 64A of the corporate income tax code, now grant specific authority for applying the arm's length standard to transactions involving the use of funds; rendering of services; the use, enjoyment, or disposal of tangible assets; and the use of intangible property (McLees 1992, 999, n. 19).

In 1994, the transfer pricing provisions were amended and four methods introduced: CUP, RP, C+, and profit splits (del Castillo et al. 1995, A111–15; Perez de Acha 1994, 624–5). Profit splits are to be applied solely to permanent establishments and fixed bases in Mexico of residents abroad. The method allocates the total profits of these residents in proportion to the income or the assets these establishments represent in Mexico to the total. Mexico began transfer pricing audits in 1994, after hiring and training tax auditors, with the assistance of the IRS (Matthews 1993a, 233). The first transfer pricing adjustment was collected by the government in October 1994.

The Mexican CIT and transfer pricing rules were initially not intended to apply to the maquiladoras because the Mexican government did not treat them as typical permanent establishments. They were treated as cost centres for purposes of calculating the Mexican corporate income tax and were also exempt from the business assets tax.[62] This situation has now changed.

The Mexican tax authority, Secretaria de Hacienda y Credito Public (Hacienda, the Mexican counterpart to the IRS), began to apply the new transfer pricing rules to the maquiladora plants effective January 1995, requiring that prices for maquiladora exports be set according to the arm's length standard. In effect, this meant that profits on maquila operations would be shared between the U.S. and Mexican tax authorities. Hacienda, however, agreed not to audit a maquila for compliance if its taxable income meets a five per cent of asset value test.[63] In March 1995, the government changed the maquilas' exemption from the Mexican business assets tax. The maquilas could continue to avoid the business assets tax but only if (1) they paid taxes amounting to at least five per cent of the value of assets employed in the maquila, or (2) the firm obtained a ruling from Hacienda that a lower transfer pricing would satisfy Mexico's transfer pricing regulations. Just over half of the 2,200 maquiladoras opted to elect one of the two options instead of paying the tax; of those, only 20 per cent chose to ask for a ruling from Hacienda (Fernandez 1995, 1276–7).

In 1994, Mexico initiated an Advance Pricing Agreement process and has encouraged firms to apply for rulings. Formal APA regulations were issued in July 1995. The new rules recommend the 'return on capital employed' method to establish an arm's length price – in effect, treating the maquila like a contract manufacturer for its U.S. parent.[64] The first APA was issued in November 1995, and used a cost plus approach with comparables from a group of U.S. service providers, on the grounds that the maquila was in the business of providing labour services (Fernandez 1995, 1276).

It is clear from the above that Mexican transfer pricing regulation is coming more and more to resemble the U.S. regulations.[65] Since Canada's rules are also based, like the U.S. ones, on the arm's length standard, does this mean that the potential for tax transfer pricing disputes should lessen, so that the concerns expressed by MNEs in the Ernst & Young survey are temporary? In Chapter 7 we return to this issue and provide estimates of the incentives for tax transfer price manipulation; these estimates suggest in fact that the reverse may be the case.

Summary: The North American Tax Transfer Pricing Regime

The United States, as the headquarters for one-third of the world's multinationals and simultaneously the major attraction of inward foreign direct investment in the 1980s, has been the leader in developing new rules and procedures to deal with these large, integrated businesses in a globalized economy. However, the U.S. rules and procedures in the transfer pricing area change constantly and are often driven by domestic political processes, rather than by the need to develop internationally acceptable standards. As a result, the United States has also been the most destabilizing member of the international tax transfer pricing regime.

Canada, on the other hand, has played quite a different role in the TTP regime. Canada has been active as a major host country to U.S. multinationals and as a middle power within the regime, supporting the development of international tax norms and principles, working to strengthen its own rules and procedures in line with the arm's length principle, and adopting defensive mechanisms to deal with the capricious and rapidly changing policies of the U.S. tax authorities.

The third country, Mexico, is new to the game, and, not surprisingly, is taking its rules and procedures from the OECD and U.S. practice. The government has clearly adopted the arm's length standard and is moving to establish detailed policies and dispute-settlement mechanisms (through its BTTs) to deal with transfer pricing issues.

An Assessment of the International Tax Transfer Pricing Regime

We have argued above that there exists an international tax transfer pricing regime nested within the international tax regime. Section 482, the OECD Model Tax Treaty, and the OECD reports on transfer pricing have been important in the development of this regime. Most members of the OECD adhere to the arm's length standard and have developed regulations loosely based on the U.S. regulations or the 1979 OECD report. The TTP regime has its own norm (the arm's length standard), principles (international equity and neutrality), rules (the four methods), and procedures (e.g., competent authority rules, advance pricing arrangements, appeals and arbitration).

The rest of this book is devoted to an analysis of the international TTP regime, focusing in particular on the roles played by the OECD, the U.S. Treasury, and Revenue Canada. Our assessment of the overall regime – its strengths and weaknesses – can be found in chapters 12 (principles and norms of the regime), 13 (rules and procedures of the regime), and 14 (conclusions).

Conclusions

The main goal of *Taxing Multinationals* is to assess international regulation of transfer prices, particularly as the regulations are applied in Canada and the United States. In this chapter we have attempted to show that international regime theory can be usefully applied to the issue areas of international taxation and, in particular, to regulation of transfer pricing. We have discussed each regime in terms of its purpose and scope, principles and norms, and rules and

procedures. In subsequent chapters we go into more detail on each of these topics, returning in chapters 12 through 14 to the question of problem areas with the tax transfer pricing regime, and possible solutions for strengthening it.

This concludes Part I of *Taxing Multinationals*. We return to the U.S. and Canadian tax treatment of transfer pricing in Part IV, and to an assessment of the international tax transfer pricing regime in Part V. We move first, however, to look at the theory of the multinational enterprise as an integrated business and to examine statistical evidence on the size and characteristics of intrafirm trade in North America in Part II, 'Multinationals and Intrafirm Trade.'

APPENDIX 2.1
INTERNATIONAL GUIDELINES ON TAXING MULTINATIONALS

There are at least three sources of international guidelines on taxing multinationals. First, both the OECD and the United Nations have developed codes of conduct or guidelines for MNEs and nation-states that deal with taxation issues. In addition, the OECD, United Nations, and Harvard University have model tax conventions which can be used as guides when individual countries negotiate bilateral tax treaties. The third source are guidelines on transfer pricing issued by the Committee on Fiscal Affairs of the OECD (OECD 1979, 1984, 1994b, 1995a,b, 1996, forthcoming). We outline the first two below; the third group is not reviewed here since the reports are discussed throughout this book, particularly in chapters 2, 5, 12, and 13.

The OECD Guidelines and Model Tax Conventions

The OECD's involvement with taxation of MNEs goes back to the first guidelines it issued in 1976. The most recent is the ongoing work on new guidelines on transfer pricing.

The 1976 OECD Guidelines on Multinationals

In 1976, the OECD countries adopted a *Declaration on International Investment and Multinational Enterprises*, to which was appended *Guidelines for Multinational Enterprises*. The purpose of the OECD guidelines is to inform MNEs about matters host countries see as sensitive, and to encourage MNEs to behave in appropriate ways vis-à-vis host countries. Host governments are encouraged to treat domestic and foreign firms in a similar fashion (national treatment) and to abide by their contractual, international obligations (e.g., full and fair compensation for expropriation). Dispute-settlement procedures are encouraged. The guidelines are not binding on MNEs, but states can publicize the names of persistent offenders.

In terms of transfer pricing, the 1976 OECD guidelines direct MNEs to provide information necessary to correctly determine taxes and to refrain from using transfer prices that do not conform to an arm's length standard, as below:

> Upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries; and refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to any arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed. (Dunning 1993, 525)

The 1963, 1977, and 1992 OECD Model Tax Conventions[1]

The OECD's Committee on Fiscal Affairs has also developed an income tax convention which serves as the model for bilateral tax treaties between OECD member countries and their treaty partners. Thus, the OECD model is primarily used by developed market countries. There have been three model conventions: a 1963 draft convention, the first formal convention in 1977, and a new model issued late in 1992. In between these periods, the Committee collected proposed amendments to the treaty before issuing the new model. The OECD calls the new loose-leaf version an 'ambulatory model tax convention' (Turro 1994d, 211) because the Committee intends to provide periodic updates rather than wait for several years to issue another model.

The model convention incorporates an arm's length standard in two contexts: for allocating income both between home firms in one state and their branches in another state, and between firms and their subsidiaries, parents, or sister enterprises. The OECD has, from the first model convention in 1963, endorsed the concept of the *separate entity* as the fundamental basis for allocating taxing rights between countries. The MNE's tax base is to be allocated internationally according to the concept of a permanent establishment, with affiliates treated as separate legal entities and income apportioned between them assuming intrafirm transactions take place at arm's length prices.

Article 7 (business profits), paragraph 2, provides that where an enterprise of one state carries on a business through a permanent establishment in another

state, the establishment has attributed to it '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.' The 1992 commentary to this article notes that the allocation is to be based on the arm's length principle, and applies this to the allocation profits on transactions between permanent establishments in the same MNE group.

Article 9 (associated enterprises), paragraph 1, defines the arm's length standard. The paragraph provides that where an enterprise of one state 'participates directly or indirectly in the management, control or capital' of another enterprise, or where the same persons do so, in another contracting state, and

> where conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would have been 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.

Article 7, but not article 9, explicitly qualifies the commitment of the model to pure 'arm's length' theory. Article 7(4) says that insofar as it has been customary in one state to determine profits of a branch by apportioning the total profits to the various parts of the enterprise, the state can continue to use apportionment.

Where one government reallocates taxable income according to the arm's length standard, the question immediately arises as to how the other government will respond. If no change in assessment is made, increased taxation by the first government leads to double taxation of the MNE's profit. Therefore the OECD model treaty spells out the situation when the second government should provide a corresponding adjustment. Paragraph 2 of article 9 says:

> Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting State shall if necessary consult each other.

The commentary on article 24 in the 1992 OECD model income tax convention recognizes that tax problems often arise in triangular situations, not just bilateral ones between two tax jurisdictions. The typical triangular case deals with dividends, royalties, or interest income paid by a firm in A (the country of source) to a permanent establishment in B owned by an enterprise in C (the country of residence). Who should credit the withholding tax levied by A's government, the government in B or C? The commentary proposes that state B should credit the withholding tax, but only up to the level allowed by the tax convention between A and C (Matthews 1993b, 254).

Article 25 (mutual agreement procedure, or MAP) permits a resident taxpayer to petition his or her tax authority for relief from double taxation caused by the unilateral actions of one of the two authorities. MAP requests are generally made for issues such as determining whether or not a permanent establishment exists or what is the residence of a taxpayer; the most common MAP request is to settle transfer pricing disputes (Kwatra 1988).

The commentary, written by the OECD Committee on Fiscal Affairs, to article 25 in the 1992 model treaty states that the MAP can be used to determine (1) whether a transfer pricing adjustment is well founded and (2) whether the size of the adjustment is appropriate. The amount of the adjustment must be justified under the arm's length principle before a corresponding adjustment would be required of the other competent authority. This proposal was suggested in response to the U.S. proposals for changing its section 482 regulations, in ways that the OECD considered to be moving away from the arm's length standard. With respect to corresponding adjustments of profits after a transfer pricing adjustment, the commentary encourages communication between the competent authorities and the taxpayers. The MAP should be kept flexible, with few formalities.

The United Nations Guidelines and Model Tax Treaty

Here we have the 1977 UN Code of Conduct on transnational corporations (TNCs), which has not formally been adopted, the 1978 UN Model Tax Convention, and the 1993 World Bank guidelines on TNCs (UNCTAD 1993).

The 1977 UN Draft Code of Conduct on TNCs

The United Nations Economic and Social Council set out a proposed text for a Draft Code of Conduct on Transnational Corporations in 1977.[2] The code is designed particularly for MNEs with activities in developing countries. It generally proscribes MNE activities while giving rights to host countries. For example, host governments are given the right to regulate the entry and establishment of MNEs, and the right to nationalize or expropriate MNE assets in return for adequate compensation. As a result, the Code of Conduct has not be adopted.

In terms of transfer pricing, the UN code says:

> *Transfer Pricing*
> 33. In respect of their intra-corporate transactions, transnational corporations should not use pricing policies that are not based on relevant market prices, or in the absence of such prices, the arm's length principle, which have the effect of adversely affecting the tax revenues, the foreign exchange resources or other aspects of the economy of the countries in which they operate.
> *Taxation*
> 34. Transnational corporations shall not, contrary to the laws and regulations of the countries in which they operate, use their corporate structure and modes of operation, such as the use of intra-corporate pricing which is not based on the arm's length principle, or other means, to modify the tax base on which their entities are assessed. (Preston and Windsor 1992, 257–8)

Clause 44(e), on disclosure of information, also commits firms to providing information on their transfer pricing policies to national governments.

The 1978 UN Model Tax Treaty

In 1967, the United Nations established the UN Group of Experts on Tax Treaties between Developed and Developing Countries. Stanley Surrey wrote the introduction to the UN Group of Experts report. The commentary is explicit in its requirement to use arm's length prices (unlike the OECD Model Tax Treaty). The group produced a model tax convention in 1978 for use between developed countries and developing countries. Articles 7(2) and 9(1) of the UN model are identical to the corresponding articles in the OECD model. Unlike the OECD model, the UN model includes provisions regarding transfer pricing in the commentary in article 25, Mutual Agreement Procedure.

The 1992 World Bank Guidelines on TNCs

The World Bank guidelines contain prescriptions to host-country governments on how to treat foreign investors; the guidelines do not discuss how MNEs should treat host countries. Thus they are written from the opposite perspective to the United Nations Draft Code of Conduct (see UNCTAD 1993, 29). The guidelines encourage governments to admit foreign investors, while preserving the state's right to regulate FDI. National treatment, and fair and equitable treatment, are to be accorded foreign investors after entry. Specific guidelines on expropriation are outlined; the state can expropriate but only in return for prompt and adequate compensation. Lastly, dispute settlement through MNE–host country negotiations or United Nations–sponsored dispute-resolutions mechanisms is recommended.

The 1992 Harvard University Model World Tax Code

More recently, Harvard University's International Tax Program has developed a new model tax code for use in developing countries or economies in transition to a market economy. A preliminary edition of The Basic World Tax Code (Hussey and Lubick 1992) contains only one reference to transfer pricing – section 77, which is very similar to IRC section 482:

> *Section 77: Allocation of Income and Deductions Among Taxpayers*: In the case of two or more organizations or businesses (whether or not incorporated, whether or not organized in Progress, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the designated officer may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations or businesses if the designated officer determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any such organization or business.

Brian Arnold has criticized section 77 as being 'incredibly broad' with 'a number of technical difficulties' (1993b, 265). For example, Arnold argues that transactions between almost any two firms, however related, are covered since no equity ownership threshold is specified; also, whether only tax evasion, or avoidance and evasion, is to be included is not clear. Arnold's criticisms are typical of the ones OECD member countries have levied against the wording of U.S. Internal Revenue Code section 482; in fact, the wording of section 77 above is almost identical to the wording of section 482. We discuss this in more detail in Chapter 8.

NOTES

1 See Pagan and Wilkie (1993, ch. 9), Turro (1994d).
2 The full text, as of 1992, can be found in Dunning (1993, 588–96) and in Preston and Windsor (1992, 249–67).

PART II: MULTINATIONALS AND INTRAFIRM TRADE