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**Taxing Multinationals:
Transfer Pricing and
Corporate Income
Taxation in North America**

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I would like to dedicate this book to Carl Sumner Shoup, McVickar Professor Emeritus of Political Economy at Columbia University, who introduced me to multinational enterprises and transfer pricing over twenty years ago, encouraged me to take a multidisciplinary and policy-oriented approach to the problem, and has continued to provide me with guidance and the benefits of his knowledge in this complex area of international taxation.

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Preface

In September 1974, I started a Ph.D. in economics, specializing in public finance, at Dalhousie University under the supervision of professors John Head, Carl Shoup, Cliff Walsh, and John Graham. It was an exciting, intense two years. Carl Shoup had offered to supervise my dissertation if I wrote on transfer pricing. (He had just retired from Columbia, was coming to Dalhousie as a visiting professor, and was working, as part of a United Nations Eminent Persons group, on a report on transfer pricing.) So I wrote my dissertation on transfer prices,¹ and have been working in the area since that time. On such small things is one's career path determined!

After graduation, I spent the next few years writing theoretical journal articles about transfer pricing, taxes, and tariffs, using the standard microeconomic models developed by Tom Horst, Larry Copithorne, myself, and others. In these models, the multinational enterprise (MNE) generally consisted of a parent firm and a wholly owned foreign affiliate. The MNE's goal was to maximize its after-tax global profits. The enterprise was faced with different tax rates, trade taxes, and exchange rates, and had to decide the direction, price, and volume of intrafirm trade. These choices determined how much each firm produced and sold in each country and where its profits were earned. In more sophisticated models, the MNE had an array of additional choices, such as the level of repatriated dividends, royalty payments, and share of head office expenses.

These analyses were exercises in *comparative statics*; that is, in each case, the researcher modelled small changes from existing tax levels and determined the theoretical impact on variables such as output, sales, prices, taxes paid, trade volumes, and so on. Corporate income taxes were generally treated as taxes on the MNE's pure profits, which implicitly meant either that the firm had no equity capital or that all corporate income taxes were shifted, either forward to consumers or onto other factors of production, so that none of the tax was borne

by shareholders. Models of how the home and host country taxed the MNE's profits populated journals in the 1980s. Tax the parent or foreign affiliate or both? Tax deferral or taxation as accrued? Foreign tax credit or deduction? The theoretical models have become more sophisticated over time (e.g., principal-agent models under uncertainty), but the general format has not changed.

In 1983, I helped Alan Rugman organize a conference on transfer pricing that led to our jointly edited book on transfer pricing,² now unfortunately out of print. The book looked at the theoretical, empirical, and public policy aspects of transfer prices. The messiness of empirical work on transfer pricing (e.g., difficulty in getting data, problems with databases and questionnaires, interpreting results) is evident in the empirical chapters. The last part of the book clearly demonstrates the difficulties in domestic regulation and the need for international cooperation (for example, Carl Shoup proposes international arbitration of transfer pricing disputes). One useful outcome of this exercise was that I learned that while I knew a fair amount about microeconomic modelling of transfer prices, I did not know very much about strategic decision-making processes within MNEs, and that useful work hinged on bringing these two together.

My solution was to develop and teach a course on multinationals, starting first as an undergraduate economics course at Brock University in 1985, and then, from 1988 on, as a graduate course in the School of International Affairs at Carleton University. The Reading Economics Department (John Dunning, Mark Casson, Peter Buckley, John Cantwell, Alan Rugman) and the Harvard Business School (Ray Vernon, Michael Porter, Oliver Williamson, David Teece, Charles Kindleberger, Stephen Hymer) dominated the field.³ The Reading school was most closely identified with the OLI paradigm⁴ developed by John Dunning; the Harvard school followed the business strategy approach⁵ developed by Ray Vernon and Michael Porter. Only in the past few years have the two schools begun to merge.⁶

The more I read and learned and taught about multinationals, the less enamoured I became with the existing microeconomic models of transfer pricing. At the time, I saw them as sterile exercises in calculus, with little contribution to make to the real world of regulating MNEs. This realization became even clearer to me when, in 1990, Jack Calderwood and Wayne Voegelé in the International Audits Division at Revenue Canada Taxation asked me to put together a week-long course on 'Multinationals and Transfer Pricing' for their senior tax auditors and lawyers. The course has now been taught several times under the auspices of Carol Gouin, Jack Calderwood's successor at Revenue Canada. It has been an important building block in this manuscript.

I was fortunate that the course participants were tolerant of my ignorance and

mistakes. From them I learned of the legal and accounting work that has been done on transfer price regulation, the real difficulties with putting the arm's length standard into practice, and the gap between the academic economists and the practitioners in their understanding of transfer pricing. I have also been fortunate to work with and learn from several well-known transfer pricing experts in these Revenue Canada courses, including Charles Berry, Nathan Boidman, Donald Brean, David Quirin, and Alan Rugman. Each has taught with me at one time or another.

I owe a special debt to three internationally renowned individuals who have influenced my own thinking in this book. Carl Shoup, my dissertation supervisor and mentor, has shaped my views on the need for an interdisciplinary approach to this topic. His ability to successfully blend public finance and law, bringing the insights of academic economists together with the needs of real-world policy-makers and multinational managers, sparked my own desire to attempt the same bridging of disciplines and functions. Charles Berry, a Princeton University economist and expert witness in several U.S. transfer pricing court cases, in his own work on transfer pricing shows how economists can play an important and necessary role in this area. For Berry, the economic concepts of opportunity cost and imperfect competition are critical to transfer price regulation, both in writing tax legislation and in solving disputes through the court system. The third individual is Nathan Boidman, an international tax lawyer at Phillips and Vineberg in Montreal and the Canadian representative in the International Fiscal Association. Boidman's writings on the Canadian and OECD regulation of transfer pricing are prolific and insightful. He has been most helpful in providing me with large numbers of transfer pricing documents that I found difficult to obtain elsewhere. Charles Berry and Nathan Boidman also have the unusual gift of being able to make complicated tax court cases vivid and understandable.

These three transfer pricing experts have inspired much of my own recent thinking on the theory of tax transfer pricing. However, I am sure there are sections in the text where we have honest disagreements, so I hasten to add that they bear no responsibility for any of the views expressed in *Taxing Multinationals*. I take full responsibility for the book and for any errors or omissions that may be present.

When Allan Maslove, Research Director at the Ontario Fair Tax Commission, first approached me about writing a monograph on MNEs, taxation, and transfer pricing, I eagerly agreed. My goal was to write a more integrated, interdisciplinary study, one that brought the perspectives of the different disciplines together to examine the transfer pricing issue. The monograph, in attempting to do so much, took much longer to write than anticipated, and eventually grew to

a full-fledged book. I owe a debt to the Ontario Fair Tax Commission for funding the beginning of the project.

Initially I had intended to look at only the Canadian and U.S. transfer pricing regulations. However, as my work progressed, it became obvious that the OECD Committee on Fiscal Affairs has been instrumental in moulding an international consensus around the arm's length standard. The OECD, in my opinion, has successfully established an international regime (in the political science sense of having coherent principles, norms, rules, and procedures) in tax transfer pricing, at least among its 25 member states. The book therefore has been written from the perspective of an international regime approach to taxing multinationals, with detailed discussions of the role of the OECD through its model tax treaties and various transfer pricing reports, the draft transfer pricing guidelines issued in piecemeal fashion over the 1994–6 period. Chapters 2, 5, 12, and 13, in particular, deal with the international regulation of tax transfer pricing, focusing on the OECD's transfer pricing reports. Thus, while *Taxing Multinationals* deals primarily with the history, economics, and regulation of transfer pricing in Canada and the United States, the analysis is placed more generally in the context of the international situation; this should make the book more useful for a wider audience.

Two other key events occurred while the book was in progress. The North American Free Trade Agreement came into force in January 1994. I had also been doing some work for Industry Canada on the organizational and locational decisions of multinationals within the context of regional integration (NAFTA) and technological change (the shift from mass to lean production). These insights turned out to be quite relevant for an analysis of MNE responses to transfer price regulation and corporate income tax changes. They are discussed in some detail in chapters 3 and 4. While I have not specifically devoted a chapter to Mexican tax law in this area, discussions of Mexico in regard to NAFTA can be found throughout the book, especially in chapters 2 and 7.

At the same time, the U.S. Treasury was engaged in a major overhaul of the Treasury regulations that accompany section 482 (the transfer pricing section) of the Internal Revenue Code. The final version of the 482 regulations was released in late June 1994, and the final version of the penalty regulations for valuation misstatements (section 6662) in 1996. The book reviews in detail the nearly ten-year development of the new regulations, starting with the 1986 addition of the 'commensurate with income' standard to section 482, and provides a critical analysis of these changes in chapters 8 and 9.

Taxing Multinationals was written in and carried between Ottawa, Ontario; Cambridge, Massachusetts; Columbus, Ohio; and College Station, Texas, over a four-year period. During part of the period (July 1992 through August 1993),

I was on sabbatical leave from Carleton University on a U.S.–Canada Fulbright award as Visiting Professor and Fellow in the Center for Business and Government at the Kennedy School of Government, Harvard University, and as Visiting Professor, Department of Finance, College of Business, The Ohio State University. The Finance Department at Ohio State continued to provide me with office space and departmental support while I was on research leave from Carleton in the fall of 1994. In the summer of 1995, I left Carleton (remaining on staff as an Adjunct Research Professor in the Paterson School) and moved to join the Department of Management at Texas A&M University, where the final revisions for the book were completed. I would like to thank Carleton, Harvard, Ohio State, and Texas A&M for providing me with the research facilities and colleagues that enabled me to complete this project. I would also like to thank Virgil Duff at the University of Toronto Press for his continuing support and encouragement as the manuscript and I moved from place to place over this period.

Helpful comments and assistance on various parts of the manuscript were received from Brian Arnold, Charles Berry, Nathan Boidman, Harry Grubert, Chuck Hermann, Allan Maslove, Christopher Maule, Maureen Molot, Kingsley Olibe, David Quirin, Subi Rangan, Alan Rugman, Carl Shoup, Ray Vernon, Wayne Voege, and from individuals within Revenue Canada, the Department of Justice, and Industry Canada. I am especially indebted to Don Brean for reading and offering detailed comments on the first full draft of the manuscript, and to two anonymous external referees for their detailed comments on the penultimate version of the manuscript. Various parts of the manuscript have been used in several of my Revenue Canada executive training courses on multinationals and transfer pricing, and I thank the course organizer Bill Blair and the participants for their excellent suggestions. Sections of the manuscript have also been given in several university seminars. Cindy Murray has been a superb research assistant, both during the Revenue Canada courses and in helping prepare this manuscript. Usha Viswanathan, Nanette Tello, and Reinhard Hinterreither have been most helpful in finishing the final version. Lastly, I would also like to thank my family, friends, and colleagues – particularly Jessica Eden and Chuck Hermann – for their understanding and support while I was writing and rewriting this book. I am sure they are as grateful as I am that it is finally done.

Taxing Multinationals should be useful to a wide variety of individuals: graduate students and academics, legal and accounting professionals, business economists, government policy-makers, and managers of multinational enterprises. Transfer pricing is a subject in many different university and executive training courses: business policy, cost accounting, corporate law, the economics of multinationals, international finance, and international taxation. The reasons are not

hard to find. University academics are interested in predicting and measuring the impacts of different taxes and transfer pricing rules applied to multinationals. Legal and accounting professionals and business economists advise multinationals as to acceptable transfer prices, critique government proposals, and are involved in tax court cases. Government policy-makers, tax auditors, and lawyers are responsible for writing and enforcing transfer pricing laws and regulations. Business professionals, particularly in accounting and finance departments, are responsible for developing MNE transfer pricing policies that meet both internal and external objectives. All these groups need to understand transfer pricing regulation.

This is the background that has led me to write this book. It is my firm belief that to study transfer pricing and the taxation of intrafirm trade it is essential to bring together the disciplines of economics, law, accounting, political science, and international business. Each in its own way has focused on transfer pricing, but each is seeing only one piece of the puzzle – transfer pricing requires an interdisciplinary set of lenses.

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