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From Avoiding ‘Double Taxation’ Yesterday to Avoiding ‘Double Non-Taxation’ Today: The Urgent Need for an International Tax Regime Based on Unitary Tax Principles

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From Avoiding ‘Double Taxation’ Yesterday to Avoiding ‘Double Non-Taxation’ Today: The Urgent Need for an International Tax Regime Based on Unitary Tax Principles

A Study of Unitary Taxation as a Solution to the Ills of the Current System of Taxing MNEs, and as a Remedy for Developing Countries’ Tax Struggles

Zachée Pouga Tinhaga, Esq.

Ann Arbor, Michigan, USA, October 28, 2016
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Dissertation Submitted to Satisfy the Requirements of the S.J.D.
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Ann Arbor, Michigan, USA, October 28, 2016
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Abstract

The purpose of this Dissertation is to analyze the current ills of the international tax system with a special focus on developing countries, and to structure and present a Unitary Taxation System (“UT”) as a solution to the legitimate and multifaceted complaints about current international taxation of multinational companies (“MNEs”). The research aims at presenting a UT that would restore credibility in the international tax arena by providing fiscal predictability and certainty to MNEs, and ensuring appropriate taxation by all countries (specifically developing nations) of all “real” economic activity within their borders. Although this issue has been previously explored, there is currently a vacuum to be filled concerning a coherent and complete UT as an alternative to the current taxation of MNEs from a developing countries’ perspective. Specifically, there is a need for a major research and elaboration of a specific UT that would satisfy the legitimate concerns of developing countries while not alienating the developed world and MNEs. That is the goal of this Dissertation.

The international tax regime was created in an effort to avoid situations where the same income was subject to double taxation due to the exclusive fact that it had a cross border character. However, sovereign tax laws and tax regimes have grown so different, and international economic activity has grown so large that the debate ought to shift from the exclusive legitimate need to avoid double taxation to the urgent imperative to prevent double non-taxation and other undue tax arbitrage schemes\(^1\) that are threatening the very existence and credibility of the international tax regime. The current debate\(^2\) in the international tax world about the

inappropriateness of arm’s length standards and its disservice to tax authorities across the globe is opening a tremendous opportunity to reflect and design an international tax system that is fair to MNEs by providing them with fiscal certainty, and fair to all countries, particularly developing countries, by allowing them adequate taxation of economic activity through independent and sovereign tax policies.

This research is a response to the current global outcry about the misfortunes of the international tax treatment of MNEs, largely based on the separate accounting arm’s length standard (“ALS”). Currently MNEs that operate in different countries have very complex and burdensome tax rules applicable to them. The economic realities of MNEs’ operations have shown completely irrelevant in the design of the applicable tax rules. MNEs have therefore proven extreme creativity in using tax rules to their advantage since these rules are not inspired and usually have no real impact on the economics of their transactions. The need to conduct a business in a foreign country in the form of a Permanent Establishment (“PE”) for example is very comparable, on a strict economic standpoint, to the regime of conducting the same business in the form of a Controlled Foreign Corporation (“CFC”). However, in the view of tax law, the not so economically relevant fact of choosing a PE or a CFC has tremendous fiscal consequences. The debate over “check the box” regime in the U.S. and its use abroad by U.S. MNEs is a telling example.³

The main focus of this research is twofold: on the one hand I intend to analyze the current ills of taxation of MNEs, their negative impact on tax authorities in developing countries specifically,

³ Steven Dean, Attractive Complexity: Tax Deregulation, the Check the Box Election, and the Future of Tax Simplification, 34 Hofstra L. Rev. 405 (2005).
and the urgent need for a different approach. On the other hand, I intend to design and structure a proposal for a better way of taxing MNEs. Through this structure, I intend to align international tax rules to economic realities. The UT proposed in this research would provide for equitable taxation of MNEs in every jurisdiction they operate in, specifically, in the developing world. The research therefore aims at providing an in-depth study and explanation of the current unsustainable international tax regime, its weaknesses and unfairness in taxing MNEs; then the construction of a new and better structure to approaching and taxing MNEs: the UT. First, the discussion of the ills of the current system, focusing specifically on the developing countries, would require empirical research of current specific international tax policies in selected sample countries. Also, the design of a new structure would require answering several questions including: what is a UT (an agreement on definitions of Unitary Business, Combined Reporting and Formulary Apportionment)? What can be learned from previous experiences of application of various forms of UT (a look at UT within U.S. States, as well as the European experience with the Common Consolidated Tax Base “CCTB”)? How does UT compare with the present system, in terms of ease of operation and outcomes, for MNEs and for tax authorities? What would be the administrative implications for tax assessments? What changes (ideally the least disruptive) to the legal framework would be necessary for a transition to UT? What would be the administrative cost of such transition, specifically for developing countries?

The answers to the questions raised in this research are utterly important and relevant because they will fill the vacuum by providing a concrete proposal on how to tax MNEs in a way that is fair to developing countries and would address the current shouts and cries of MNEs and governmental authorities about the global fiscal uncertainty.
Introduction

The International tax regime is at a crossroads and the path to be chosen is yet to be determined. Many solutions have been attempted none of which has totally satisfied the needs of the different actors in the international arena. The current system, largely based on a solid network of bilateral tax treaties and other Advance Pricing Agreements (“APA”), has been designed in order to assure that the same income earned should not be subject to multiple instances of taxation due to the simple fact that it has a cross border character. In fact, early tax treaties were denominated “convention for prevention of double taxation”. The international community and the international tax regime have more successfully than not achieved this goal. In fact, the burden of preventing double taxation has been taken on by national tax authorities directly and unilaterally to the point where some have argued that bilateral tax treaties are no longer necessary to avoid double taxation. This sentiment is echoed in the current environment of tax treaty negotiation and drafting to the point where most modern tax treaties do not enunciate the need to avoid double taxation in their titles. The need to avoid double taxation was made necessary as economic activity grew beyond single nations. Today, economic activity has grown so large and the world has become so interconnected that if concerns about double taxation seem diminished, the emerging trend is the legitimate concerns about tax arbitrage and double non taxation. The internationalization of economic activity is demonstrated by a large and very powerful conglomerate of MNEs. The biggest and most impactful companies today operate in

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6 See for example, U.S. Canada tax treaty of 1980, as revised in 2007.
8 See for example, Richard Barnet and Ronald Muller, Global Reach: the Power of the Multinational Corporations, 26 Catholic University Law Review 2 (1977); See also, Brian Roach, Corporate Power in a Global Economy, Tufts University (2007).
several sovereign countries and their taxation has animated many debates. Today, even though these MNEs are very connected and coordinate their global activities very closely, international tax laws, accentuated by the tax treaties network, have chosen to ignore the economic reality and rather to treat those companies as separate entities dealing independently with each other.\(^9\) This has created an opportunity for MNEs to basically choose where to pay taxes, if at all. There is a growing perception that governments lose substantial corporate tax revenue because of corporate designs solely aimed at shifting profits in ways that erode the taxable base from alleged high tax jurisdictions to the so called tax havens\(^10\) notwithstanding the fact that economic activity is located in the former jurisdictions.\(^11\) There currently is a growing realization by some that taxes are only paid by the naïve.\(^12\) Tax revenues are particularly critical in developing countries and such countries have been feeling the full weight of tax evasion by MNEs.\(^13\) There is overwhelming admission today that the system of taxation of MNEs is broken.\(^14\) However, nothing is as far from a consensus on how to solve it. The Organization for Economic Cooperation and Development (“OECD”) in an attempt to solve the problem in the mid-2000s regrettably doubled down and made matters worse by bringing more transactions under the failed ALS of transfer pricing.\(^15\) The OECD is back at it again by issuing a report calling for major research on how to solve the problems related to taxation of MNEs and specifically base erosion

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\(^9\) See Article 9 of the U.S., OECD, and U.N. Model Tax Conventions, providing for the separate accounting and arm’s length standard.

\(^10\) A tax haven generally refers to a country or an independent territory where taxes are levied at a low to zero rates. Traditional examples include Bermuda, British Virgin Islands, Cayman Islands, Luxembourg or Switzerland.

\(^11\) See, for example, Bloomberg: “the great corporate tax dodge”; the New York Times: “but nobody pays that”; the Times: “secrets of tax avoiders”; the Guardian: “tax gaps”


and profit shifting ("BEPS").\footnote{10}{See Supra, Note 12.} This begs the central question of this research: can we design a better way of taxing MNEs? Is there a better way of meeting MNEs’ needs for fiscal certainty and the need for countries all across the globe to legitimately exercise their sovereign power to tax economic activities within their borders? And if such a system exists (and I argue it exist and intend to craft it), what is it all about? How is it different from the current system? How is it advantageous for both MNEs and tax authorities globally (specifically in developing countries)? And what would be necessary to implement that new and arguably better system, departing from the current rules?

Although there have been writings on this issue, there is currently a vacuum to be filled concerning a coherent and complete alternative to the current taxation of MNEs based on a UT. Specifically, there is a need for a major research and elaboration of a specific UT that would satisfy the legitimate concerns of developing countries while not alienating the developed world and MNEs. That is the task that this research purports to take on. To achieve this goal, this research is divided into two main parts, comprised of four chapters each. The first part of this paper is a diagnostic on how, and an explanation of why the international tax system is currently broken. In this part, we start with a voyage in the history of taxation in general and international tax specifically because the knowledge of such history is quintessential to understanding the current system. Then we discuss major trends driving international tax rulemaking in the developing world, looking at specific countries as case studies in three different continents. Finally in this part of the research, we present an analysis of the current shortcomings of the systems, specifically for developing counties. The second part of the paper is dedicated to the advocacy of the UT as a viable alternative to the current failed system. In this part, we start by
presenting a UT through its common tenets. Then we elaborate the reasons why UT would be the panacea for the current international tax ills. Finally, we design and structure an international tax reform proposal based on the UT, and present the current international tax treaty network as a potential accelerator of a transition to UT, with which it is compatible.
Part 1

Past and Present of the International Tax System: an Evaluation
Chapter I
Historical Background
Taxation for every country is more than just an expression of a country’s sovereignty; it is a condition of each country’s existence and ability to meet its most basic responsibilities to its people. To take up a serious discussion around taxation, it is necessary to review its historical perspective. It is important to not fall into the tempting and rather common habit of a generation to easily forget the experiences of its predecessors. The history of taxation, even though with parallels globally, is different between the north and the south. This part of the assay analyses, on the one hand, the history of taxation in general (A) through discussion of taxation in Colonial America (1), in Medieval Europe (2), and in colonial and post-colonial Africa (3); and on the other hand, the discussion of the history of international taxation specifically (B).

A. The History of Taxation in General

Dating as far back as the biblical tithing\textsuperscript{18} and even before that, a form of taxation has always existed throughout times and has shown to be necessary.\textsuperscript{19} The struggles and evolutions, mainly from property to personal taxation have marked the history of taxation in America, Europe and Africa.

1. Taxation and Colonial America

Marks of taxation and contributions to the activities of the collectivity existed throughout colonial America.\textsuperscript{20} However, the first general tax law in the American colonies was enacted in Massachusetts Bay in 1634.\textsuperscript{21} The early tax laws relied heavily on property taxation, taxation of things. In fact, the Massachusetts Bay tax law of 1634 was interpreted to mean that the taxes where to be levied only on the property (specifically land) notwithstanding the curious notion of “abilityes” used in the law.\textsuperscript{22}

In the colony of New Plymouth, a revision to the Massachusetts Bay tax law of 1634 was passed in 1643 to define the notion of “ability”. The New Plymouth tax law indicated that assessment for each person would be “according to their estate and faculties, that is, according to the goods, lands, improved faculties and small abilities”.\textsuperscript{23} This New Plymouth tax law is the first in the history of colonial America to use the term “Faculty”. Tax systems and tax laws throughout colonial America relied on property and tangible things for assessment of taxation. The

\textsuperscript{21} See Colonial Research of Massachusetts Bay, shurtleff’s Ed., No1 Pp 120 (1853).
\textsuperscript{22} The 1634 tax law stated that each man was to be assessed “according to his estate and with consideration all other his abilityes whatsoever”.
innovative tax law of the colony of New Plymouth did not, however, detail the notion of faculty, nor outline methods through which assessment of taxation of a person’s faculties, would be accomplished. Nevertheless, the idea of a tax detached from the tangible property was introduced and the embryo of “faculty taxation” was planted. The notion of faculty tax will thereafter make its way in the Massachusetts Bay later tax legislations and enjoy a wide expansion to other American colonies.

The colony of New Heaven relied on land taxation until 1640 at which time it expanded the tax base to include estates by introducing a tax on estates. In 1648, in an effort to increase their revenues, the colony of New Heaven appointed a committee to inquire as to whether the Massachusetts Bay style of taxation would be admissible in New Heaven. As a result of the Committee’s work and recommendations, the colony of New Heaven introduced, in 1649, a law that imposed tax on the profits of laborers, tradespeople and others.

In Connecticut, the tax law closely followed the Massachusetts Bay model. The Connecticut tax law of 1650 stated that “every inhabitant who doth not voluntarily contribute proportionably to his ability … shall be compelled thereunto by assessment and distress”. The law provided for an assessment based on the situs of the land and the dwelling of the person. In Connecticut, non-compliance with tax laws was strongly sanctioned.

Rhode Island introduced the ‘faculty tax’ a little later, in the tax law passed by the Assembly in 1673. The particularity in Rhode Island however was the fact that the colony entrusted enforcement of the faculty tax to its peoples. In fact, each inhabitant was task to assess its

27 Id.
neighbor, and recommend the tax that the neighbor should be liable for based on the person’s assessment of the properties of its neighbor. The final decision on assessment was however reserved to a committee of three locally chosen honest and able men.\(^{28}\)

In New Jersey, the tax law of 1684 ended the system of taxation solely on property, and stipulated that tax would be assessed on profits. In fact, the 1684 law in New Jersey brought into the tax net, in addition to property owners, “all other persons … who are freemen and are artificers or follow any trade or merchandizing, and also all inholders, ordinary keepers and other persons in places of profits”.\(^{29}\) The law granted the assessor wide discretion in administering the new tax provisions.

In Pennsylvania, the faculty tax was not introduced until after the revolution had started. The law of 1782 imposed a poll tax on all freemen.\(^{30}\) Under this law and similar to the Massachusetts Bay model, taxes were assessed on profits, not only property. The law afforded the assessor ample discretion in the assessment of such taxes. In 1785, a revision to the 1782 law was adopted. The revised version of the law diminished the power and discretion of the tax assessor by providing for floors and ceilings in the tax assessments and payments. Unlike Massachusetts Bay, the Pennsylvania tax was a poll tax because it assigned the taxes to be paid based on categories of persons and classes of professions.\(^{31}\)

The Delaware tax law of 1752 which indicated that all persons should be assessed on their estates, clarified that the estate was not merely the visible and tangible property, but it rather also

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\(^{28}\) See Supra at 24 (Seligman).

\(^{29}\) See Laws of New Jersey, 1664-1701, leaming and Spicer Pp494.

\(^{30}\) See the Laws of the Commonwealth of Pennsylvania, Dallas ii, Pp 8.

\(^{31}\) For example, freemen of no profession might be assessed fifty cents to ten dollars, mechanics thirty cents to ten dollars, retailers fifty cents to five dollars, lawyers and physicians one to ten dollars etc.
included “no visible estate”, adopting thereby, the faculty tax model that existed in other colonies and had gained continuous popularity.

The southern state of Maryland had a very primitive tax system. Taxes were levied evenly and equally, without regard to notions of ability to pay, or property worth. In 1777 the primitive tax system and its poll tax were abolished and the state instituted a property tax along with a faculty tax. Maryland raised its taxes in 1779, very soon after their introduction in 1777. Shortly thereafter, in 1780, the whole system was abolished.

The state of South Carolina introduced the faculty tax earlier. The faculty tax model was existent there from the outset and South Carolina did not abolish such system but rather thrived to improve it over time. The tax law of 1701 clearly imposed tax on citizens according to their “estate… and abilities”. The later tax law, after the state constitution was adopted, indicated that tax should be assessed on “the profits of all faculties and professions…”

As seen above, in the colonial America, the question has seldom been whether to tax; the debate and evolution instead has always been about how to tax. The distinction between real and personal property marked the evolution of taxation in the colonial America. Most colonies started their tax systems with exclusive taxation of real property. Due to the palpable nature of real property, it made more sense to assess taxes on the tangible objects and any taxation detached from the tangible was hard to imagine. Authors have usually referred to the property taxation, predominant during that period, as the ‘real tax’. In a quest to expand their tax base

34 See Maryland Laws of 1777, c. 22 Sections 5, 6.
35 See Maryland Laws of 1779, c. 35 Section 48 (which raised the tax to two and a half percent).
36 See Cooper, Statutes at Large of South Carolina, Pp36, 183.
37 The Notion of real tax to describe taxation of real property remains in some fiscal systems to date. In France and Cameroon for example, the term “Fiscalite reelle” (translated as real tax) is still used today to describe taxation of real property as to distinguish it with the taxation of personal property. See also, supra at 24.
and increase their revenues, many colonies adopted the tax on faculties and abilities to capture that portion of the population with income not necessarily in the form of tangible property. The then known as “faculty tax” imposed a tax on the revenue without being a pure income tax of the modern era. The distinctive trait of this tax, compare to the current income tax is that the faculty tax was not levied on an individual’s total income excluding his expenses or liabilities. The tax was assessed on presumed income on certain classes and categories of people. The system resembled a sort of class tax in which different classes within each employment were rated at fixed amounts and assessed accordingly.

After the constitution of the United States and the formation of the Federation, acts of war and threats of totalitarian powers raised the importance yet again, of taxation. The founding fathers clearly understood the importance of taxation in order to achieve important goals such as shaping the national economy, bringing other nations to fair commercial terms, regulating morals or abolishing slavery. The founding document empowered Congress to “lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States”. The US Constitution however, provided many limitations to such otherwise broad taxing powers of Congress. The Constitution clearly indicated that “No… direct tax shall be laid unless in proportion to the census…” Any direct tax therefore was prohibited unless apportioned to the states populations. Many attempts to impose an income tax or other direct taxes during that period failed on constitutional grounds. In addition, any tax legislation was subject Alexander Hamilton’s “necessary and proper” requirements for its validity.

40 See U.S. Const. Art. I, Sec. 8, Cl. 1.
41 See U.S. Const. Art. I, Sec. 9, Cl. 4.
42 See Federalist Papers, essay by Alexander Hamilton, Federalist No 33.
corporate tax was sometimes upheld as an excise tax imposed on the privilege of doing business in corporate form. The first attempt at imposing an income tax was in 1815. In fact in 1815, Secretary Dallas after proposing a tax on inheritance, a tax on wheat and flour, and a tax on bank dividends, suggested that an income tax would be easier in order to raise revenues necessary to pay for the Civil War.\(^43\) However, the conclusion of peace made the tax unnecessary and the whole system of internal revenue was abolished. Many attempts to impose an income tax thereafter fail through as arguments continued to be raised as to the constitutionality of the income tax. In fact, the Supreme Court, in 1895, held that a non-apportioned income tax on interest, dividends, and rents was unconstitutional as a direct tax.\(^{44}\) The necessity of a constitutional amendment was established in order to sustain an income tax and an Internal Revenue Service (“IRS”). In response, the US Treasury proposed the Sixteenth Amendment to do away with the apportionment requirement of direct taxes, and specifically of income taxes.\(^{45}\) Notwithstanding many attempts to block the Sixteenth Amendment on the grounds that it was a dangerous setback in the development of the Union, and many campaigns after its ratification questioning the legitimacy of the ratification process, the Amendment was passed by Congress and ratified by the requisite number of States in 1913.\(^{46}\) Tax laws and statutes passed after ratification of the Sixteenth Amendment are often referred to as modern tax statutes, and there have been several tax statutes since that period; most commonly in the form of the Internal Revenue Code (“IRC”) and amendments thereon. Similar, the IRS was created and has been the

\(^{44}\) See Pollock v. Farmers’ Loan & Trust Co., 157 U.S. 429 (1895)
\(^{45}\) See U.S. Const. Amend. XVI stating in part: “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”
institution in charge of the administration and interpretation of tax laws. The courts have also consistently upheld Congress’ broad power to tax.\textsuperscript{47}

2. Taxation and Medieval Europe

In Medieval Europe, states and empires survived if they possessed sufficient and continuous command over the financial means necessary to defend their territory and citizens against external aggressions, and to meet internal challenges to their authority.\textsuperscript{48} The regularity of wars and aggressions of this period required ever-increasing amounts of revenues. A successful state was distinguished by its capacity to mobilize the resources required to maintain its success.\textsuperscript{49} England is often presented as the prime example, in early Europe, of strong, centralized state with a powerful monarchy, a sophisticated system of government, and a single representative institution claiming to act on behalf of the people.\textsuperscript{50} The process started with the Kings of Wessex who, in late ninth century, started the process of centralization by establishing themselves as rulers of the whole of England and creating local administrations to institutionalize their authority.\textsuperscript{51} Under King Edward I,\textsuperscript{52} the costs of war increased enormously and much of the crown’s expenditures needed financing. Public taxation was the response. In England however, there was a long standing principle that any extraordinary taxes, say to pay for wars, had to be authorized. From 1920s therefore, it became normal practice for the Crown to request approval from the

\textsuperscript{47} See \textit{Commissioner v. Glenshaw Co.}, 384 U.S. 426 (1955) where the court upheld the IRS’s decision to tax punitive damages awards received by the taxpayer. See also, Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978) where the court confirmed that wages, along with other gains are taxable income. See also, \textit{Murphy v. IRS} as well as \textit{Penn Mutual Indemnification Co. v. Commissioner}, 277 F.2d 16 (1960) where the court agreed that the IRS could properly impose the federal income tax on receipts of money regardless of what the receipt of money is called.


\textsuperscript{49} \textit{Id}.

\textsuperscript{50} Lynn Thorndike, \textit{The history of medieval Europe}, Houghton Mifflin (1917).

\textsuperscript{51} For example, King Alfred the Great who died in 899AD.

\textsuperscript{52} King Edward I reigned from 1272 to 1307.
Parliament for any new taxes. Parliament was entrusted with the power to authorize extra
ordinary taxes, granting the Parliament powers and strengthened bargaining position in its
dealings with the Crown. War taxation gave influence to the Parliament and profoundly altered
the basis of English politics thereby planting the early seeds of the balance of powers system.
The change and empowerment of the parliament in England distinguished it from its neighbor
and greatest rival of the time, France. In the French society at the time, there was no
authorization needed from the Parliament to collect taxes, even extraordinary taxes. In 1470s,
John Fortescue drew the distinction of fiscal powers calling the French system the “dominium
regale” while referring to the English system as the “dominium politicum et regale”. The
distinction pointed the fact that in France, the Monarchy was free to impose tax anytime of their
choosing while in England, Parliamentary consent was needed. The English system relied on
land taxation in its early days. The highly sophisticated and remarkably productive land tax
known then as the “danegeld” provided great resources to the Crown. However, this tax
showed ineffective because the Crown, not a taxable subject, was the largest landholder by far in
the territory by 1086. Even attempts at largess to its most remarkable citizens by granting them
land and thereby reducing the percentage ownership of land by the Crown, did not solve the
problem. Another way of raising revenues in late twelfth century was through arbitrary
‘tallages’ on royal estates and towns and on the Jews. For example, King John imposed a very
successful ‘tallage’ for the expansion to Ireland in 1219. In the thirteenth century however, the

53 See Supra, at 48, Pp 20. See also, McKenna, The Myth of Parliamentary Sovereignty in Late Medieval England, 94
English Historical Review 481 (1979).
54 The Danegeld was a national land tax paid by all landholders in England to combat threats of invasion by the
Danes. The tax was assessed in different ways in different parts of the country.
56 A Tallage was an intermittent tax paid either in money or in kind by the direct feudal subjects or rulers, and was
spent at the discretion of the ruler.
57 See Stacey R., Royal Taxation and the Social Structure of Medieval Anglo-Jewry: The Tallages of 1239-1242, 56
Hebrew Union College Annual 175 (1985).
British Empire instituted a tax on the profits, from land and other activities. The main forms of raising revenues in England were land taxes, custom duties, and later taxes on personal property and income. The English Empire adhered to a procedure for imposing new taxes, unlike the French empire of the time.

In France, there were many attempts to attack localities compared to the attempted attacks to the country as a whole. Taxation in Medieval France, like in England, was driven by the need to protect the territory against attacks and to provide minimum social services. Defense needs in France were mostly local and France relied heavily on local taxation. France, unlike England, did not adopt the “tallage” and instead, various local communities instituted local taxes to respond to the various local attacks. For example, Charles VI allowed a 5% tax in 1383 in Perigueux in order to build and repair town defenses.58 In general however, the most important tax in France, before 1380 (year of its termination) was the hearth tax.59 This tax was relatively consensual as it was authorized by the central authorities and voted on by local authorities. Nevertheless, the main point of distinction in early France is the predominance of arbitrary taxation. Taxes in Medieval France were mostly imposed unilaterally by rulers who then spent the revenues as they choose. The predominance of arbitrary taxation in Medieval France is justified by the increase in the powers of rulers, and the prevailing insecurity. In the free deliberations, the King was free to exempt or lessen the tax burdens of individuals or groups. Specifically, in attempt to secure their support and perpetuate its reign, the King exempted the nobility from taxation in 1384, right after the internal revolts of 1380-82. Taxation in Medieval Europe ultimately spurred the major


59 The Hearth tax was a tax on fixed property, also known as the Chimney tax because collected from each household, each Chimney. The collectors of the tax, known as the ‘Chimney men’ were specifically appointed to these duties and had considerable powers.
revolutions and civil unrest that led not to the abolition of taxation, but rather to a more
democratization of taxation and arguably, more overall levels of taxation in cities and states
across Europe.

### 3. Taxation and Colonial Africa

In Africa, similar to other societies, a form of taxation has always existed as a way of meeting
common challenges and satisfying the needs of the greater group. The history of taxation in
Africa can be analyzed through the lenses of three main periods, before the colonization (pre-
colonial era), during colonization (colonial era) and after the decolonization (post-colonial era).
First, the pre-colonial era in Africa is marked by unique models of societal organization and a
form of centralized powers through notions of ‘chiefhood’. The early traits of taxation in pre-
colonial Africa can be traced to Ancient Egypt. Under the reign of Pharaoh, the Scribes were
responsible for raising funds for the dynasty. The Pharaoh afforded the Scribes large powers and
ample discretion in their revenue raising (tax collection) activities. For example and even though
the most important tax of that period was the grain tax, the Scribes instituted a tax on cooking oil
for every household. The cooking oil tax was very hard to enforce and many in Ancient Egypt
attempted to avoid and/or minimize the tax by recycling their oil, and using the same portion of
the cooking oil several times. In response, the Scribes instituted an audit procedure whereby they

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60 Pharaoh was the common name of Kings in ancient Egypt. The Kings reigned over the territory and the ruling system was a dynasty. A succession of Pharaohs reigned in Egypt from about 3200 years B.C. to about 30 years B.C. Ptolemy, infant son of Cleopatra VII is reportedly the last known Pharaoh who ruled until about 30 years B.C. when Rome took over Egypt thereby ending his reign.

61 In Ancient Egypt, the Scribes were the people who had received special education, learned to read and write, and were special members of society. Most of what is known of Ancient Egypt today is because of the work of Scribes. Even though some evidence suggests that there existed female Scribes, most Scribes were males, who descended from families of Scribes, and who had gone through about five years of learning how to read and write. The Scribes were usually tasked by the King, to collect revenues for the dynasty.
inspected households to make sure that cooking oil was not being recycled.\textsuperscript{62} In their discretion, the Scribal tax collectors often used coercion to raise revenues for the Pharaohs. Like most of precolonial Africa, the Ancient Egyptian society had a predominantly barter economy. As a consequence, the simplest way to exact the taxes was the ceasing of the actual produces, the merchandise or property involved in the exchanges. Farmers and the agricultural sector in general were the highest and most consistently taxed: their fields could be measured, their produces observable, and their yield calculated regularly by the Scribal tax collectors. Scribal tax collectors had more difficulties taxing other peoples’ means of livelihood. The ease with which taxation was assessed to farmers was not possible for other professions and ways of earning livelihoods. Nevertheless, the risk of not paying or reducing one’s tax liability was highly punishable and very discouraged. In fact, the law of the Amasis established that anyone who did not honestly declare the source of his livelihood was punishable by death.\textsuperscript{63} The large powers afforded to tax collectors created massive corruption and to protect taxpayers, the Pharaoh instituted a system of tax receipts and strong punishment to corrupt tax collectors.\textsuperscript{64} Ancient Egypt also adopted tax breaks and exemptions. When a farmer was struggling with his production and was not able to meet his tax obligations, the practice was to offer the farmer a tax break, and when such farmer returned to prosperity, he was immediately reinstated in the tax net. Also, some Egyptians were not subject to tax either because the positions they held in society were too influential for tax collection, or because the state needed their services.\textsuperscript{65} The pre-


\textsuperscript{63} Amasis (Ahmose II) was the Pharaoh from 569 to 526 B.C. Amasis was known as a strong leader as is credited as the last great King of Egypt as the kingdom is reported to have enjoyed great prosperity under his reign. Amasis established the voluntary declaration system whereby each Egyptian was required to honestly report the source of his livelihood for tax assessment purposes. Failure to do so accurately, under Amasis law, was punished by death.

\textsuperscript{64} The condemned tax collectors would usually be tied to polls and publicly beaten by servants of the Pharaoh.

colonial era in Egypt is not unlike other African early societies. Early Sub Saharan African towns began as fortified villages which grew into larger communities that served several purposes. People who lived in the same villages generally claimed lineage to the same ancestor. The extended family, made out parents, grandparents, children and other family members even living in separate homes or separate villages, comprised a lineage group. The lineage groups were the basic building blocks of early Sub Saharan African societies. Members of the same lineage group claimed relation to the common ancestor and the leading members of the group had powers over others. The lineage group provided support to its members, each member taking care of the other. The villages and towns in early Sub Saharan African societies were centers of government, entertained markets with goods for trade, artist who made pottery tools and other crafts, and farmers trading their crops for goods. In these early societies, the king was the ruler of the community. The king held audiences to settle disputes, granted favors to distinguished members of the group, allowed merchants to practice their trade, maintained law and order, and levied taxes. Similar to Egypt, merchants and other craftsmen used their produces and goods to pay their taxes to the King and contribute to the larger community. In most of early African societies, the taxes collected by the King were used to provide for the community and to some extent for the King’s comfort and prestige. As colonization started and foreign powers started entering the African territory, the nature and purpose of taxes changed. Second, during colonization, taxes collected by the Kings in early African societies were destined to the colonial powers, until the colonial powers started directly exercising their powers to directly tax their subjects and territories. Colonial officers were instructed to make Africans pay something in tax, “however poor they may appear to be.” Colonial taxation was not simply

a fiscal measure ensuring revenue and balanced books; it was conceptualized as a moralizing force, transforming the primitive and barbaric into good, industrious and governable colonial subjects.67 Many colonial powers started relying on duties to raise revenues in their territories; however, direct taxes quickly became the main instrument. Frederick Lugard,68 showed his preference for direct taxes and was one of the early pioneers of direct taxation in the colonies.69 The two main colonial powers that were active in Africa are France and England.70 Across colonial Africa, taxation was usually imposed by requiring payment of cash. African economies and peoples at the time, however, relied on barter economy and did not possess the cash. Colonial powers often imposed tax settlement in cash as a way to compel Africans to sell their goods, or as a way to create a labor force whereby African would be compelled to work for the colonial power to obtain the cash needed to pay their taxes.71 The review of taxation in colonial Africa ought therefore to be seen from the lens of Colonial English Africa and Colonial French Africa as the two systems presented noticeable differences. Colonial powers in Colonial English Africa applied generally a colonial system through indirect administration advocated by Lugard.72 The colonial government chose local representatives and built upon the local tribal structure to administer their territories. Under these systems, local chiefs and kings were in

68 Frederick Dealtry Lugard (1858–1945) began his career in the army on the Northwest Frontier of India. He spent some time in East Africa, where he was involved in conflicts in Uganda, and in the Kalahari, before gaining prestige at home for beating the French in the race to sign a treaty with the rulers of Northern Nigeria at Nikki. Lugard’s achievements were rewarded in 1900 when he was made High Commissioner of the newly-acquired Northern Nigeria. He held this post until 1906; having spent the intervening years as Governor of Hong Kong, he returned to Nigeria in 1912, whereas Governor General he presided over the amalgamation of the Northern and Southern provinces until his retirement from the colonial service in 1919.
69 See Supra at 56, Pp 14.
70 Each of France and England has more than 10 colonies in Africa, deeply influencing culture and society.
72 Id., at 57.
charge of collecting revenues that they thereafter, remitted to the colonial power representatives. Taxes were collected in the form of goods like Ivory, copper, slaves, salt and labor. It was well established in these societies that a portion of each inhabitant’s possessions should go to the king and the king was in charge of remitting most if not all, to the colonial power.\textsuperscript{73} As indicated by Leigh Garber, the revenues raised by England in its colonies contributed tremendously to fund the British Empire costs.\textsuperscript{74} The British government required each colony to be self-sufficient and any excess was reverse to England.\textsuperscript{75} Nevertheless, empirical data shows that taxes collected in English colonial Africa were much lower than the taxes in French colonial Africa. In addition the English colonial Africa was unique in that they admitted the principle of “no taxation without representation” early on. In its 1920, the first meeting of the newly formed National Congress of British West Africa\textsuperscript{76} adopted a resolution establishing the principle of “no taxation without representation” and advocated a more pronounced African control over public revenues of the colonies.\textsuperscript{77} French colonies used a direct system of administration of their colonies. The central French government sent a representative in the colonies and such representatives were in charge of directly administering the colonies and levying taxes. Taxes collected in French colonies were comparatively higher and the coercive means used to collect the taxes were reported more brutal. People in French colonial Africa paid their taxes with the goods they produced and their labor. The resistance to taxation started in the early days of colonial Africa. Many movements were formed to protest the imposition of taxes by a foreign power, but such movements were quickly

\textsuperscript{74} Leigh Gardner, Taxing Colonial Africa, the Political Economy of British Imperialism (2012).
\textsuperscript{75} Id.
\textsuperscript{76} The Congress of British West Africa comprised, in 1920, Sierra Leone, Gambia, Gold Coast, and Nigeria).
silenced with the brutality and coercion of the conquering power. Notions of Kings and ‘Chiefhood’ were diminished and their prestige among the population tarnished. In some instances, the Kings and Chiefs were used by the colonial powers to raise the revenues and enforce punishment against the people attempting any protest of the exercise of the taxing power of the colonial authorities. The taxes collected were generally brought to the central governmental power and many accounts indicate the necessity of the revenues to fund the central powers’ governmental obligations to their citizens in the west. Many authors have argued that tax systems imposed in colonial Africa have many consequences in the view of taxation today. African early population were introduced to taxation as a means of funding an oppressor, and such image, some argue, has shaped the view of taxation by many African population today and their rebellion to tax compliance. The compliance rebellion, however, is not the only trait of taxation of in post-colonial Africa.

Finally, taxation in post-colonial Africa is a constant struggle of how to tax the unwilling and how to access the hard to tax. As indicated by Fjeldstad et al., taxation in sub Saharan Africa faces a “trilema”: first, an urgent need for increased revenues and ensuing pressure on taxation to provide it; then, the strong resistance of the very few with capacity to actually pay the taxes; and finally, the majority of the people with nearly nothing to tax, show similar strong feelings against taxation. To this list, it is important to add, following Tadesse and Gunther, the impotence of African post-colonial tax administrations as well as the ever growing underground economy, the hard to tax. After the independence era, many African countries faced the reality of providing for their people, the very basics in terms of social services and defense. The weak social structures

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78 See Kasara Kimuli, Tax me if you can: Ethnic geography, democracy, and the taxation of agriculture in Africa, American Political Science Review 101.01 (2007).
81 Id.
that had emerged from the colonization needed special attention and many areas required considerable investments. The new independent countries faced a high need for revenues and the obvious form of obtaining those was through taxation. Governments must be able to ensure sustainable funding for social programs and public investments for development. The struggles to raise revenues internally have sometimes been compensated by outside aid and assistance. However, as aid became more and more questionable or insufficient, African governments were faced with a choice to either reduce/eliminate expenditures, and/or raise revenues in order to avoid unsustainable balances in their economies. Many governments reduced their expenditures to the simplest minimum and still fail to provide a sense of balance to their economies. The taxation became quickly the royal means of solving the economic and budgetary threat.83 The need for revenue and many attempts at raising states intakes have collided with the refusal and rebellion of the peoples subject to taxation. Taxation is not a popular idea in many places but African reluctance is unique in many regards and many tax administrations have resolved to accessing the accessible and taxing the easily available while acknowledging their inability to reach the hard to tax.84 Many specialists have attributed Africans deep feeling against taxation and their reluctance to tax compliance to the colonial era.85 During that period and as seen above, African were required to pay something in tax, however poor they were, and at the same time they were not allowed to “spend a penny” without express authorization of the colonial power. Taxes were seen as a reward to their oppressor, and many African have continued to view taxation through those lenses and would do whatever necessary to escape the tax net.86 Many newly independent African countries continued to rely heavily on direct taxes and duties post-independence. The tax systems grew to rely primarily on the big industries and big companies that existed. Corporate taxation of the bigger companies, even though challenging, yielded more revenues as those businesses were regulated and could not easily hide their existence. As a consequence of concentration on main big businesses, the major part of the economy fell out of the tax net. Many attempts to regulate the so called under-ground economy have proven ineffective.87 Personal income taxes are difficult to collect either because of phenomenon of

84 Id.
85 See Supra, Note 79.
86 Id.
87 See Supra, at 71.
under reporting or because many people are poor and have close to nothing to be taxed on.\textsuperscript{88} Business taxes, primarily on big business, have been unable to reach small business and lose tremendously on income from small operations. Collection from large businesses, usually subsidiaries of multinational companies (“MNEs”) became more difficult as these businesses started using more sophisticated tax planning techniques beyond the expertise of the newly formed African countries and their tax administrations.\textsuperscript{89} After colonization and to date, African countries have remained at the cross roads of their people despising tax and political price to be paid for any pressure otherwise, and large established businesses using complex tax planning strategies that African tax administration have neither the physical capacities nor the intellectual expertise to respond to and levy the appropriate taxes. Many governments, including in the developed world, have been outsmarted and outpaced by big MNEs in the development of creative ways to minimize if not evade taxation. Tax administrations have usually played “catch up” in these circumstances and have reacted to counter MNEs strategies. The reaction has always required seasoned expertise to match the creativity in the private sector. The reaction of tax administrations in Africa, if at all, has come late and has shown very slow to curve the patterns and, more often than not, ineffective. The ineffective taxation in post-colonial Africa, and the various barriers to expanding the tax base have led government to focus on getting their revenues mostly from specific industry sectors, such as natural resources industry sectors. Some authors have argued that the incompetence to tax citizens has also been a major impediment to the establishment and expansion of democracy. Governments, because they get their revenues mostly from a restricted sector of industry, do not feel accountable to the nations as a whole, instead deal with the stakeholders in the specific industries and feel accountable to them.\textsuperscript{90} A more aggressive tax collection and tax participation from the regular citizens could participate in more involvement in the affairs of the nation. Additionally, the collection of the revenues from their inhabitants could lead the leaders to feel and express more political accountability toward their people.\textsuperscript{91}

\textsuperscript{88} According to the World Bank, the poverty rate in Africa is slightly below 50% (based on a 2012 study). Available at \url{http://povertydata.worldbank.org/poverty/region/SSA} (last retrieved 09/15/2016).
\textsuperscript{91} \textit{Id}. 

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4. Common Denominator in Global Tax History: Tax Disdain

The existence and collection of taxes has grown hand in hand with the revolts against taxes and tax payment. Because taxation has often been onerous, and sometimes excessive and cruel, reaction to its enforcement has been consistent, heated and usually violent. Tax revolts date at least as far back as the Later Han Dynasty in Asia, the Hammurabi era in Babylon, and the Roman Empire in Europe. Many major events in world history, including the Magna Carta, the American Revolution, and the French Revolution, had their roots as tax protests. Taxation simply provides an ostensible cause for protest and insurrection because they represent an easily identifiable and detested target. Most people understand and deal with taxes at the very personal level. Taxes are tangible and almost everyone pays them, whether in moneys or goods; therefore, the objections to taxes are easily popularized and the disgruntlement comes immediately. As seen above, there has always been a form of taxation. The ancient states of Persia, Greece, Egypt, and Rome all relied heavily on a form of taxation to meet their revenue needs. Early forms of taxation included real property, sales and inheritance taxes, as well as various custom duties. The introduction of these taxes as well as their maintenance sparked various revolts and protest throughout history. Nevertheless, and as stated by Benjamin Franklin, only taxes and death are certain this world; indeed, many people share the opinion that of the certitudes throughout history, it has become easier to avoid death than taxes. Rebellions and riots protesting imposition of taxes and the activities of tax collectors exist across centuries. Below, we will analyze some major historical events, in diverse geographical areas to underscore the

93 The Later Han Dynasty in Asia went from AD 25 to AD 220.
94 The Hammurabi era in Babylon went from 1792 to 1750 BC.
95 The Roman Empire went from 27 BC to AD 337.
96 See Supra, at 93.
point that the common global trend in the history of taxation is its permanent coexistence with revolt and protest.

In the Roman Empire, in year 6, Augustus Caesar introduced a 5% tax levy on inheritance. The tax sparked general protest and was widely unpopular. The furious revolt, known as the Senate Tax Opposition forced Caesar to consider alternative levies. However, the alternatives considered were less attractive and Caesar used oppression to successfully implement his inheritance tax proposal.

In addition, in year 400, the Roman Empire experienced the so called Garlic Trader’s Tax Avoidance movement in Gaul. Badly affected by the tax, many traders in Gaul fled to avoid taxation. The legislation of year 400 revealed that the City of Gaul was losing members who fled to anonymity of the countryside, preferring to live under the shelter of a wealthy rural patron rather than paying the proper taxes.

In the Byzantine Empire, in year 722, taxes brought to light a deep dislike between the emperor and the clergy. After suffering a defeat against the Arab forces in Armenia in 720, the forces of the Empire regained momentum by defeating the Arab forces in Isauria in 721. The ongoing Arab assault and the response increased the military expenditures of the Empire and the Emperor needed further revenues. In an effort to raise the needed revenues to fund the Arab war, Emperor Leo III\(^97\) levied greatly increased taxes on Rome and Italy in 721 and 722. However, Pope Gregory II\(^98\) publicly and forcefully rejected the increased taxes. The Pope specifically denounced the poll tax. Leo III in fact ordered that the Pope be assassinated and replaced in order

\(^{97}\) Leo was the Emperor of the Byzantine Empire from 717 to 741.

\(^{98}\) Pope Gregory II was Pope from 715 to his death in 731. His defiance of the Byzantine emperor Leo III as a result of the iconoclastic controversy in the Eastern Empire prepared the way for a long series of revolts, schisms and civil wars that eventually led to the establishment of the temporal power of the popes.
to do away with the opposition to his taxes. The Pope sent out communications to the people of Rome and Italians, instructing them to oppose Leo III’s decrees. The Italian took up arms to defend the Pope against the Emperor, and to protect their own liberties. Italians also endeavored to choose their own Emperor instead and in replacement of Leo III. Unable to control Rome, Leo III was obligated to back down, abolishing the increased taxes. Many commentators attribute the independence of the church from governmental power as well as the tax free status of churches to this early fight and resistance by Pope Gregory II which remained known as the Papal Tax Rejection of 722.

The struggles between the papacy and the kingdom continued late in the 13th Century. In 1297, Monarch Edward I of England, declared war to King Philip IV of France. Both kingdoms were already engaged in war, and this new military adventure stretched their military budgets. In a search for new revenues to cover the war, Edward I and Philip IV instituted a tax on the Clergy and the church. However, these measures were put in place at the time where Cannon Law explicitly prohibited taxation of the church by the state. In fact, Pope Boniface VIII had declared the Prohibition of taxation of Clergy. The Pope saw taxation as an assault to clerical right and took a hard stand against it. In 1296 the Pope denounced Edward and Philip’s levies in a Bull titled Clericis Laicos whereby he indicated the prohibition of any taxation without prior and express papal approval. The Pope instructed excommunication of anyone who levies the

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100 Id., Pp 64.
101 King Edward I also known as Edward Longshanks was King of England from 1272 to 1307.
102 Philip IV also known as Philip the Fair or the Iron King was King of France from 1285 until his death in 1314.
103 Pope Boniface VIII was Pope from 1294 to his death in 1303. He declared that both spiritual and temporal power were under the pope’s jurisdiction, and that kings were subordinate to the power of the Roman pontiff.
104 Clerics laicos was a Papal bull issued on February 5, 1296 by Pope Boniface VIII in an attempt to prevent the secular states of Europe, in particular France and England, from appropriating church revenues without the express prior permission of the Pope.
taxes or pays them without the required papal approval. In the bull, Boniface stated "they exact and demand from the same the half, tithe, or twentieth, or any other portion or proportion of their revenues or goods; and in many ways, they try to bring them into slavery, and subject them to their authority. And also whatsoever emperors, kings, or princes, dukes, earls or barons...presume to take possession of things anywhere deposited in holy buildings...should incur sentence of excommunication." Nevertheless, the emperors of both France and England had a very strong response to the Papal tax opposition. In France, Philip IV prohibited the expatriation of property outside of France thereby preventing the transfer of the church’s revenues from France to Rome. In England, Edward I denied all judicial protections to the church; the church and its members could not bring cases to the royal courts, but every case brought against the church and its members was to be heard. With these restrictions, Pope Boniface had his hands tied and was obliged to agree to the taxation of the church and the clergy. France and England therefore instituted clergy taxation. Pope Boniface’s initial opposition to taxation in fact led to the diminution of the papacy and the expansion of the monarchal power. In fact, Pope Boniface was ultimately removed and succeeded by Pope Clement V, who moved the papacy to France and basically subordinated himself to the monarchical power by repealing the acts posed by Pope Boniface to establish Church’s supremacy. Further, Pope Clement V basically endorsed most policies and demands of the French Monarchy whether as regards to tax increases or supremacy of the state over the church.

106 See Supra, at 93, Pp 95.
107 Id., Pp 97.
108 Pope Clement V was Pope from 1305 to his death in 1314. He is infamous for moving the Curia from Rome to Avignon, ushering in the period known as the Avignon Papacy.
In England in June 1215, King John signed the Magna Carta, the Great Chart, in Runnymede, as a symbol of the victory of the English nobility against the King’s tax proposal. King John attempted an unsuccessful military campaign to regain control of Normandy, creating an increased need for revenues for the Kingdom. To raise the revenues, the unpopular King John imposed, in May 1214, a new Scutage, a tax paid in place of military service, on his baronial tenants. The barons were already subject to a Scutage, already set at 2 marks, which they considered too high. The new Scutage was set at 3 marks, an unacceptable increase for the baronial tenants. Most barons refused to pay the new tax. In an effort to compel them, the King met with a group of nobles; however, the nobles vehemently rejected the tax and failed to reach any agreement with the King. Instead, the barons swore to withdraw their allegiance to the King unless he restored their rightful laws and liberties (including the old Scutage tax). The barons gathered an armed force to pressure the king and enforce their demands, if needed. The barons marched and presented their demands to the King, which the king rejected, forcing the barons to officially withdraw their allegiance to the King and march to London. Under growing pressure, the King agreed to meet with the insurgents near Windsor. After about a week of discussions and negotiations, the conclave produced a document that became the basis of the Magna Carta. Although intended to secure a variety of liberties, the Great Chart was largely an outgrowth of the barons’ resistance to taxes. Two chapters in the Great Chart were dedicated to taxation. Chapter twelve posed the requirement that any new Scutage tax or aid or tallages in the city of London be approved by the Common Council of the Kingdom.\(^\text{110}\) Chapter fourteen on the other hand required the assembling of the Common Council of the Kingdom whenever its approval is necessary for new taxes, and indicated procedures for notifying the nobles of the assembling of

\(^{110}\) *Magna Carta*, Chapter 12.
the Council.\footnote{Magna Carta, Chapter 14.} The Magna Carta therefore posed the basis of the principle of ‘no taxation without representation’. However, the representation prescribed therein was that of the nobility, the most influential and powerful, not the people as a whole.

The power of representation in taxation, even when afforded to the people in later English years, would not go unchallenged. In 1736, a general protest known as the Gin Act Protest of 1736 would demonstrate the power of the people to protest against an assembly attempting to restrict consumption of spirit (specifically Gin) through taxation. In 1727, the annual consumption of spirits was 3.5 million gallons; by 1735, the annual consumption had increased to about 5.5 million gallons. In 1735, the London area alone accounted for more than 7,000 Gin shops offering quick and easy access to drinks. By 1736, the plethora of spirits and Gin shops presented a concern of drunkenness especially amongst apprentices and servants. The Parliament responded with the Gin Act of 1736. The Act aimed at making the consumption of spirits more expensive by levying taxes on them. Under the Act, a duty of 20 shillings per gallon had to be imposed on spirits and all spirit retailers had to pay a yearly license fee.\footnote{See Supra at 92, Pp 238.} The Act, along with other frustrations sparked massive riots starting in July 1736 displaying over 2000 protesters. Also, reports emerged of plans to assassinate the drafters of the Gin Act in the Parliament; and many others protested by massive distribution of free Gin to the people. Nevertheless, the revolt was not successful at repealing the Gin Act, and its revisions, first in 1743 and then in 1751 continued the taxation of the spirits and eventually slowed and controlled Gin consumption within the kingdom.

In France, in 1548, the King imposed a tax on salt known as the “Gabelle” and a direct tax on land known as the “Taille”. The introduction of these taxes provided the catalyst for revolt.
People opposing the taxes formed a rebellion, known as the Guyenne Revolt, in Guyenne and its neighboring provinces. The rebellion was one of the biggest agrarian rebellions of that century. The taxes were widely unpopular and parishes and the church joined in to organize protests against the taxes. In August of 1548, protesters slaughtered the King’s Lieutenant General and seven supposed tax officials. Many local representatives of the King refrained from taking action against the revolt, and some shared the non-fiscal purpose of the protests. King Henry II, in 1549, rescinded the salt tax forever in Guyenne and its neighboring provinces by pledging that neither him, nor his successor in perpetuity would again impose that tax.

Yet, in 1643, the Taille (the direct tax) is one of attempted tax proposals that met strong protests known as the Tax Risings of 1643, a yearlong series of tax revolts across France. In May 1643, a five-year-old, Louis XIV succeeded to power, after his father’s death. At that time, France was at war with the Habsburgs and more revenues were needed to finance the war. As always, the kingdom imposed new taxes which in turn, provoked several revolts. During the year 1643, rebellions were recorded against the Taille across France including in Guyenne, Rouergue, Tours, Alencon, Gascony, and Clermont. There were regular attacks against tax collectors including protest in Valence where the resident rose up and drove the tax collectors out of town. Tax collectors were killed in Toulouse, and a mob of several thousands in Ile-de-France attacked a troop of soldiers dispatched to enforce the collection of taxes.

Even the second great revolution in Western civilization during the 18th Century, the French Revolution, originated to a large extent, in discontent against taxes. Even though the Revolution tackled many issues, taxes ranked high on the agenda. In fact, tax troubles were palpable. No laws, including tax laws of the national government applied uniformly throughout

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113 The French Revolution lasted from 1789 to 1802.
France. Taxes in the northern and central districts were notoriously more burdensome than taxes in the south of France. Taxpayers in Paris paid more taxes per head than any other person in Europe; similarly, French people as a whole, in proportion to their wealth, were more heavily taxed than the people of any other nation in Europe. Further, the inequity of the national mishmash and the regional comparative burden were worsened by the various tax exemptions granted to nobilities including exemptions to Taille,\textsuperscript{114} Gabelle\textsuperscript{115} and Corvee.\textsuperscript{116} As a consequence, the ensuing multi-year and generalized revolution drew its inspiration and passions from the crucial inequities in the taxation system. The social inequalities were seen as encouraged by the tax system, and the drive to abolish classes was fueled by the need to establish a tax system uniformly and non-discriminatorily applicable to all throughout France. Following the 1789 uprising, marking the beginning of the French Revolution, citizens stopped paying taxes and threatened officials who tried to collect them. In years 1790 and 1791, local taxes on commerce and consumption including tax on tobacco and salt, were abolished. The Deputies of the revolution naively proposed a tax system with direct taxes, no exemptions, no enforcement mechanisms with an expectation that citizens would voluntarily pay the taxes since the proposed systems met the egalitarian requirements voiced in the 1789 uprising. The policy quickly showed to be a mistake.

In Guatemala in 1659, Guatemalan indigo producers and merchants, the richest and most powerful section of that society, designed a system allowing them to evade taxes when they lost control of the tax system. Until 1667, indigo merchants controlled the tax system and as a consequence no taxes were collected from them. However, when they lost control of the tax

\textsuperscript{114} Taille was a direct tax imposed on French Citizens.  
\textsuperscript{115} Gabelle was a tax on salt, imposed on the French.  
\textsuperscript{116} Corvee was a form of tax payment through forced labor.
system, and to respond to the state’s efforts to collect taxes on the merchants, taxpayers designed a strategy with the then tax exempt church, strategy known as the Indigo Tax Evasion. In fact, the merchants sold the indigo to church officials who thereafter, and free of any taxation, sold the indigo to the Mexican and the Spanish purchasers.

Later, in 1763, a series of reforms including increase in taxes initiated by the Spanish crown led to generalized protests in Guatemala. The protest was known as the Bourbon Fiscal Reform Resistance. In an attempt to reform the Guatemalan tax system which was dominated by the indigo merchants and derived most of its revenues from the tributes paid by the Indians, the Spanish Crown delegated The Visitador from Mexico into Guatemala. The Visitador abolished the Indian Tributes by ending the farming tax system, took control of the tax system from the merchants, instituted a sales tax, and doubled the existing Barlovento, a tax originally intended to support the Caribbean fleet. The Visitador also levied tax on goods that had never been taxed, and added new import and export duties. Under mounting pressure and continuous complaint sent to the Crown in Spain, and various threats of massive popular uprising, the Spanish Crown agreed to reinstitute pre-existing taxes to their previous levels. Additionally, and to diffuse the threat, the Guatemalan president suspended the collection of the tax on resale and distributed grains to the poor areas of the city.

In the 1880s in Egypt, many revolts and resistances were recorded specifically against the salt tax. In 1883 for example, as the epidemic of cholera ravaged the people of Cairo, officials in charge of tax collection were given absolute powers. Tax collectors had the ‘right to use violence in order to enforce respect of the law,’ here, the tax law. The salt tax was widely unpopular and many tax collectors suffered fatal experience with the protesters. In 1886 in Faiyum, peasants rose up and murdered a salt tax collector. Similarly, a tax collector was assassinated by the
people of Wadi Natrum. There were widespread hostilities against tax collectors, which resulted in significant loss of revenues in Egypt in the 1880s.

In the neighboring Ethiopia, taxation and failure to pay taxes led to the so called Bale Rebellion starting in 1963. The Ethiopian central government and its corrupt local tax officials used land expropriations to sanction any non-payment of taxes. The residents of Bale, a southern province of Ethiopia and bordering Somalia took refuge into Somalia when expropriated from their lands for non-payment of taxes. With Somalian expansion plans, the anger in Bale presented an opportunity. The residents of Bale organized a rebellion against corrupt tax systems and protested against their expropriation. Somalia encouraged and supported the rebellion. Ultimately, the Ethiopian central government intervened, quelled the rebellion, and offered a cancellation of all tax liability and arrears for land owners. Additionally, the government allowed a reclaiming of the land by the formerly expropriated owner with no previous tax liability attached.

Tax protests were just as common, albeit non-violent, in India. In 1921, the Guntur district organized a tax resistance movement forcing many government officers to resign their posts succumbing to intimidation. Rejecting advice from Mahatman Ganghi, resisters initiated their non-cooperative campaign centered on the refusal to pay taxes. The campaign continued throughout January 1921, causing a big drop in government revenues. The tax resistance movement in India along with other contemporaneous revolts had wider political ambitions of doing away with the British rule.

In Japan in 1770, the Fukuyama rising marked the third in a series of tax rebellions in the Fukuyama during the eighteenth century. After his accession to power in 1769, Lord Mosatomo was presented with a series of nineteen demands. The peasants, authors of the demands, specifically requested their Lord reduced the enterprise taxes on cotton. Mosatomo resisted the
demands and the peasants organized a movement to protest against Mosatomo. In 1772, Mosatomo responded forcefully by ordering the execution of the Leaders of the rising.
B. History of International Taxation Specifically

As seen above, taxation has been throughout history, the omnipresent tool to raise revenues to provide for the community. Throughout history, taxation was justified by the need to provide for the defense of the territories and sometimes for the basic social services or a way of honoring royalties.\textsuperscript{117} At national levels therefore, the need to tax was established and taxation was commonly applied for transactions within the state. In the United State for example, the passage of the Sixteenth Amendment in 1913 legitimized Congress’s constitutional power to tax residents of the U.S. in very broad terms.\textsuperscript{118} The consensus to tax at national level raised questions when cross border activities became involved. With growing need for bilateral and multilateral cooperation, taxation of cross border and international transactions became a concern. Very early on, as economic activity grew and evolved beyond the frontiers of one country, there were questions regarding the application of sovereign taxing powers of several countries on the same income. Each state, aiming at taxing economic activity within its borders and/or income of its citizens, targeted all kinds of income. It therefore became obvious that double taxation would exist and would interfere with cross border transactions and transnational economic activities.\textsuperscript{119}

This concern was very important in the early twentieth century, specifically after World War I, when most countries engaged in behaviors of protectionism and retrieval from global cooperation.\textsuperscript{120} Possible double taxation was seen as added threat for countries growing further apart from each other. When income is earned in one country by a citizen or resident of another

\textsuperscript{118} See U.S. Const. Amend. XVI.
\textsuperscript{120} Increase in global Protectionism following World War 1.
country, both the country where income is earned (the source country) and the country where the
investor or earner resides (the residence country) have legitimate claims to tax the income. The
basic task of international tax rules was to resolve the competing claims of residence and source
nations in order to avoid the double taxation that results when both fully exercise their taxing
powers.

Facing this situation, the League of Nations, newly created after World War I and aiming at
promoting international cooperation between countries looked to find a solution to double
taxation as a way of promoting international economic cooperation. In early 1920s, the League of
Nations appointed a Commission\textsuperscript{121} and charged it with the task of finding a solution to the threat
of international double taxation. The Commission composed of four prominent economists
representing both capital importing and capital exporting countries had to design a solution that
would allow cross border cash flow to be subject to a single instance of taxation. Members of the
commission had different perspectives on the issue. View from the side of capital exporting
countries and led by Professor Seligman\textsuperscript{122} of the United States on the Commission, the argument
was that all taxation has to be by the country of residence. Professor Seligman used arguments of
ability to pay to declare that any source based taxation was “illegitimate” in that view.\textsuperscript{123} Under
his view, the residence country has an exclusive right to levy tax and the source country has the
obligation to assure that there is no double taxation. On the other end of the spectrum, capital

\textsuperscript{121} The Commission was composed of: Professor Edwin R.A. Seligman of the United States, Sir Josiah Stamp of
Great Britain, Professor G.W.J. Bruins of the economists, Netherlands, and Professor Luigi Einaudi of Italy.
\textsuperscript{122} Professor Edwin Seligman (1861-1939) was an American economist who spent his entire academic career at
Columbia University in New York City. Seligman is best remembered for his work involving taxation and public
finance.
\textsuperscript{123} Edwin Sligman, \textit{Essays in Taxation}, 98 (1900).
importing countries represented on the Commission by Professor Luigi Einaudi\textsuperscript{124} of Italy argued that taxation shall be exclusive to the country of source. Under this view, the connection to the source country and the ability of the country to levy the tax gives exclusive taxing power to the source country and the residence country has the obligation to assure that there is no double taxation. The debate was framed in terms of rich versus poor countries. In fact, rich countries exporting capitals needed to ensure that their investment was not subject to taxation locally and that taxation should only occur where the investors reside, thereby giving such rich countries, the exclusive power to tax. Poor countries on the other hand maintained that economic activity was within their borders, and income earned within their borders; consequently they were sole qualify to exercise taxing power.\textsuperscript{125}

After intensive debate, the Commission came out with a solution, labeled the “great compromise of the 20s.”\textsuperscript{126} The Commission submitted its report in 1923 representing the compromise reached by the four economists in eliminating double taxation. The League of Nations adopted the report and it was publicized in 1923. Under the Compromise, income was divided into two main categories: active income,\textsuperscript{127} and passive income.\textsuperscript{128} The solution was to allow source countries the privilege of taxing active income, and residence countries, passive income. This translated into capital export countries taxing income from return of capital and other passive income, while capital import countries tax income from business activities and other active

\begin{itemize}
  \item \textsuperscript{124} Professor Luigi Einaudi (1874-1961) was an Italian politician and economist who served as the second President of the Italian Republic between 1948 and 1955.
  \item \textsuperscript{125} See Seligman, Supra note 123; but see T.S. Adams, \textit{Federal Taxes Upon Income and Excess Profits}, 3 AM. ECON. REV. 19 (1918).
  \item \textsuperscript{127} Generally, active income is income for which services have been performed. This includes wages, tips, salaries, commissions and income from businesses in which there is material participation.
  \item \textsuperscript{128} Generally, passive income is made of earnings a person derives from an enterprise in which the person is not materially involved.
\end{itemize}
income within their borders. This Compromise shaped the international tax regime for a century and has its marks on all tax legislations throughout the globe to this day.  

In fact, in late 1920s, the League of Nations published the Model International Tax Treaty founded on the Great Compromise which continues to serve as the basis for countries international tax policy to date. Even before the Great Compromise, many countries endeavored unilaterally to solve the threat of double taxation. In the US for example, the Foreign Tax Credit (“FTC”) legislation was passed in 1918 to allow for tax credit to US persons for any taxes paid outside of the US. The FTC system created in the US quickly enjoyed popularity globally as many countries quickly adopted it. The need to avoid double taxation of the same income was therefore reduced and serious plans and strategies were designed globally to eliminate it. The ensuing national laws and international tax treaties followed the same basic compromise in allocating the power to tax. To the question of whether the same income should be taxed multiple times only due to the fact that it has a cross border character, the answer was unanimously, no. To the question of what country had the power to tax, the Compromise divided this power according to the nature of the income. The risk of double taxation was therefore, at the very least, mitigated.

However, the four economists at the negotiating table in the 1920s could not have foreseen the intensity in which international economic activity and international taxation would expand. They could not imagine that the world would mainly function through cross border transactions and that transnational economic activity would dominate the landscape. The compromise which has continued to shape the international tax policy a century later shows inadaptable to the current realities. The advent of multinational companies has changed the entire landscape and the global

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129 See Graetz, Supra Note 119.  
130 Revenue Act of 1918, ch. 18, 40 Stat. 1057.
fiscal response has been, at the very least, disappointing. The solutions designed are inappropriate, and have proven suicidal to developing countries which often do possess neither the material nor the human resources necessary to implement mind-boggling complex mechanisms designed by the developed world to avoid, or at least, reduce illegitimate erosion of tax base.

In the US, specifically, the development of international tax has aligned, and to some extent has shaped the development of international taxation globally. As presented by Professor Reuven Avi Yonah, the evolution of international taxation in the US can be analyzed under four major periods representing each the major policies that drove reform.  

The first period was dominated by the right to tax and largely resulted in an emphasis on source-based taxation. The legislative act consecrating this period was the FTC Act of 1918. Under this period which lasted until about 1960, the dominant argument was that taxing jurisdiction should be based on the benefits conferred by the taxing state. Most US international taxation architects of the time recognized source taxation as the convenient and more efficient way of addressing issues of double taxation. The enactment of the FTC act of 1918 legitimized Professor Thomas Adam’s argument of a predominance of source based taxation while not allowing for opportunities for double non taxation. The Great Compromise of 1923 gave

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132 See Supra, note 130.
133 See Avi-Yonah, Supra note 131; Professor Reuven Avi-Yonah calls this period The Age of Benefits.
134 The emphasis can be seen on the works of the main US international tax figures of the time including Thomas Adams, the Yale economics professor and the principal international tax adviser to the US Treasury of the 1910s and 1920s; Professor Edwin Seligman, the Columbia economics professor who was the US representative and the guiding spirit of the Great Compromise of the League of Nations in 1923; and Mitchell Carroll, a Lawyer and founder of the International Fiscal Association who was involved on the League of Nations’ early Model Tax Treaties.
135 See Graetz, Supra Note 119.
credibility to Professor Seligman’s view of the idealistic nature of pure residence taxation. The Permanent Establishment ("PE") limitations on source based taxation are in recognition of the incidence of PE on taxation, developed by Mitchell Carroll.

The second period saw an increased attention to the notion of residence based taxation based on the dominant concept of capital export neutrality at the time. This period which lasted from about 1961 to 1980 is referred to as the “Age of Neutrality.” Under the Kennedy administration there was a profound shift in the principles underlying US international tax policy. The long standing principle of benefits afforded by the state as well as fairness were abandoned and gave way to the notion of efficiency which in taxation, translated to neutrality. The main architect of this switch was Stanley Surrey who advocated for neutrality and whose marks on US international tax policy remain apparent today. Surrey was the main driver of the Subpart F rules in the 1960s allowing the US to currently tax some incomes earned outside of the US. The debate centered on neutrality and the choice, highlighted by then Secretary Dillon in his 1961 address to the House Ways and Means Committee, was between Capital Export Neutrality ("CEN") and Capital Import Neutrality ("CIN"). As a matter of fact, Stanley Surrey who prepared the remarks for Secretary Dillon indicated the choice was about designing an international tax policy that either encourages investments in the US or investments abroad.

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136 See Report, Supra note 126.
137 Capital export neutrality has generally been associated with worldwide taxation coupled with a credit for foreign income taxes.
138 See Avi-Yonah, Supra note 131.
139 Id.
140 Professor Stanley Surrey was a Harvard Law professor and the First Assistant Secretary for Tax Policy from 1961 to 1969.
143 Id.
The US treasury at the time which expressed its preference for CEN ushered an era of prioritization of residence based taxation over source based taxation.\textsuperscript{144} Surrey went on to influence tax policy enactments such as the 1966 Foreign Investors Tax Act that invented the notion of “effectively connected” income;\textsuperscript{145} and the 1968 transfer pricing regulations.\textsuperscript{146} The concept of neutrality was at the heart of any tax policy discussions during this period and any tax policy enactment was viewed from the lenses of their impact on tax neutrality, whether import or export neutrality.

The third period which lasted from about 1981 to 1997 focused the attention of US tax policy making on competitiveness and competition.\textsuperscript{147} Professor Avi-Yonah refers to this period as the “Age of Competition”.\textsuperscript{148} The new emphasis on competitiveness encouraged unilateralism in tax enactments. Many legislative and regulatory actions taken during this period endeavored, unilaterally, to level the playing field for MNEs. Legislative action of this era included the Foreign Investment Real Property Act (“FIRPTA”),\textsuperscript{149} the Branch Profits Tax rules of 1986,\textsuperscript{150} the earning stripping limitations and interest deductibility rules of 1989,\textsuperscript{151} the portfolio interest exemptions of 1984,\textsuperscript{152} or the reduction in the scope of the Subpart F rules between 1994 and

\textsuperscript{144} See, e.g., The President’s Tax Proposals to Congress for Fairness, Growth, and Simplicity, 383 (1985) (“The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions.”).


\textsuperscript{148} See Avi-Yonah, Supra note 131.


\textsuperscript{150} I.R.C. § 884.

\textsuperscript{151} I.R.C. § 163(j).

\textsuperscript{152} I.R.C. § 871(h).
As a result, this period saw a reduced emphasis on US residence based taxation and growing criticism of the CEN as well as growing unilateral action for the sake competition.

The fourth period started in the late 1990s and is still prevalent today. Under this period, US tax policy makers understand the need for coordinated action to achieve both competitiveness and avoid double taxation and ideally double non-taxation. Professor Avi-Yonah refers to this period as the Age of Cooperation. Long urged to cooperate by their European counterparts, it is only under this period that US tax policy actors engage in cooperation and accept to meet international tax challenges in cooperation with at least the US major trading partners. The US took the lead in international organizations such as the OECD to define a coordinated tax policy with and for the member states. The OECD’s initiative on harmful tax competition was mostly driven by Professor Hugh Ault, and main figure in US international tax policy. The US negotiated/renegotiated and concluded many tax treaties during this period all of which contained measure of cooperation including the exchange of information with major partners. Most recently, the US has led in the OECD’s effort to combat Base Erosion and Profit Shifting (“BEPS”). With US cooperation, the BEPS project has developed a number of Action Items understood as needed to combat the phenomenon. Even though the US has not signed on to and does not agree with some of the action items proposed, the US has been involved in the process throughout as a testament of its activism in the international tax arena in this era of cooperation.

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153 See generally McClure & Bouma, Supra note 149.  
154 See Avi-Yonah, Supra note 131.  
The salient point in the review of the history of the US international taxation historical shifting from source to residence taxation and back, as well as motive of competitiveness or cooperation have still not answered the question of how to prevent both double taxation and double non taxation at the same time. Adams struggled with the question in 1918 and the US and International Tax policy actors and spectators continue to struggle with it today.
Chapter 2

The formation of international taxation rules in the developing world has to contend with various philosophies and structures of the respective nations. The design and adoption of rules, including international tax rules is motivated by various underlying economic positions and philosophies. Ideas, interests, and institutions play a central role in shaping tax policy. As indicated by Vito and Zee in their 2001 piece entitled Tax Policy for Developing Countries: “In developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal.” Even though, as will be shown, the specificities of each system may differ, there are general philosophies that underlie the design, adoption and implementation of international tax rules in developing countries. Most developing countries aim to (A) attract investments, (B) encourage exports, (C) deal with the hard to tax, (D) provide simplicity, and (E) set special rules for their vital industries, usually extractive industries.

159 Vito Tanzi and Howell Zee, Tax policy for developing countries, 27 International Monetary Fund (2001).
A. Attracting Investments: the Phenomenon of Tax Incentives

Many countries in the developing world have sought to attract investments and ignite more business activities within their borders. Attempt to convince investors to intervene have touched many areas of the local laws. However, not many areas have been used as often as tax law design and implementation for purposes of attracting business investments. The decisions to adopt a tax rule and incorporate it into the country’s legislation, as well as the decision to implement those rules that were already incorporated in the local laws have had to contend with the idea of whether those decisions contribute to attract investments. The concern is even more vividly expressed in recent years as global completion grew and many countries battle to be home of the major multinational companies. In this context, developing countries which are already shorthanded by their very many other impediments to business investments have had recourse to heavy and ever controversial tax incentive constructs.\textsuperscript{160}

A tax incentive is defined as any measure that provides for a more favorable tax treatment of certain activities or sectors compared to what is available to general industry. The very existence of tax incentives was largely sparked by tax completion. Many countries, both in developing and the developed world, endeavored to attract capital by reducing taxes on capital and other creative fiscal strategies. Typical tax incentives include tax holidays, special zones, investment tax credits and other investment tax allowances, accelerated depreciation, targeted reduced tax rates, targeted tax exemptions, exemptions or deferrals of customs taxes on imports, and tax incentives on financing.

Tax holidays are very popular in developing and developed countries alike. A tax holiday is a temporary reduction or elimination of a tax. Examples of tax holidays have included all areas of taxation including income taxes, indirect taxes, or property taxes. Tax holidays may be granted to particular activities or to particular taxpayers. In developing countries specifically, tax holidays are used to attract Foreign Direct Investment (“FDI”), to stimulate growth in selected industries, or to develop specific business sectors. Tax holidays can however be particularly harmful. The fact that tax holidays are temporary in nature make them most attractive to short term footloose and rapidly profitable investment. The absence of a long term view and structure leads to opportunistic investor behavior, establishing a short term investment to benefit from the tax holiday and planning on winding the investment down when the holiday ends. Nevertheless, most economic data indicate that tax holidays, more often than not, serve their purpose by boosting a business sector, albeit short term.

Special zone, originally with labor and trade undertone, are now frequently used in the tax debate as a tax incentives. Special zones traditionally have many objectives including increased trade, optimal taxation, increased investment, or lenient labor requirements. In developing countries, special zones are used to allow fiscal benefits. The zones can be determined geographically or based on the business sectors. Special zones are still used as tax incentives even though many commentators doubt their ability to attract investments.\(^{161}\)

Investment allowances which have the same effects as investment tax credits are another common form of tax incentives. Under the investment allowance, the investor can deduct a percentage of its capital cost, including depreciation, from its taxable income. Whereas, under the investment credits, the investor is allowed to deduct the investment cost directly from their

tax liability. Many developed countries experimented both investment allowances and investment credits before generally abolishing those systems.\textsuperscript{162} The investment incentives are directly related to the investment. In fact, investment incentives are contingent on the investment. Many commentators argue that investment incentives are only useful to profitable businesses and as such may not be as valuable to those already highly profitable corporate entities.\textsuperscript{163} Investment incentives remain largely used however, specifically in the developing world.
A tax incentive seen as much in the developing and developed world alike is the accelerated depreciation. Accelerated depreciations are mechanisms through which a tax system allows for a business to depreciate some assets faster disregarding their regular useful life. The particularity of this incentive is that it is simply a timing advantage afforded to the investor. Investors are allowed to frontload their depreciation deductions, reducing their taxable income in the early years of acquisition of the depreciable asset.\textsuperscript{164} The accelerated depreciation incentive is effective as it allows the investors to enjoy the time value of money and pay tax later. On the other hand, the government does not indefinitely forgo the revenue; it simply delays the time the revenue is collected. This incentive has particularly shown effective and helpful for cash-constrained, but highly profitable businesses.
Even though tax incentives have expanded globally, the question remains as to whether they are fit for purpose. Are tax incentives effective in attracting investment or boosting growth? The general answer to that question seems to be that tax incentives are ineffective. In fact, many commentators have argued that there is no link between tax incentives and business development generally; and in the case of developing countries, that there is no evidence that tax incentives

\textsuperscript{162} The U.S. adopted investment allowances in 1962 to protect domestic corporations against foreign competition, but then abolished the system in the 1969 Tax Reform Act.


\textsuperscript{164} Davidson Sidney, \textit{Accelerated depreciation and the allocation of income taxes}, Accounting Review 173 (1958).
lead to increased FDI.\textsuperscript{165} There is however broad understanding and acceptance that tax incentives are used for tax competition. Many countries have adopted some tax incentives in order to mimic behavior seen elsewhere, to compete for mobile tax base, or to align their tax policies with other jurisdictions. Within developing countries, tax incentives continue to be adopted despite overwhelming evidence of their infectivity. Many commentators have endeavored to demonstrate how and why tax incentives are ineffective; however, there has been no concrete proposal of what they should be replace with. In the developing world the need to attract investments is so profound that it leads to countries being pushed to do something, and in the absence of a viable alternative, tax incentives continue to be introduced in tax legislation. The debate therefore is not whether tax incentives should be adopted, but rather which types of tax incentives are less harmful and can be put in place in situations where they are most likely to work. Understandably the trend in many countries has been to replace tax holidays with for example accelerated depreciation.\textsuperscript{166} The need to attract investment continues therefore, through tax incentives or otherwise, to dictate international tax policy design and debate in most developing countries. Another philosophy that influences international tax rule making is the developing countries exports encouragement philosophies.

\textsuperscript{165} Agostini Claudio and Soraphol Tulayasathien, \textit{Tax Incentives and Foreign Direct Investment}, (2006).
\textsuperscript{166} See for example US rules on accelerated depreciation.
B. Encouraging Exports and Markets Openness

Major policy design in the developing world has to contend with the need to encourage exports from those countries as a way to grow local economies. Dating as far back as in the writings of Adam Smith, it has been generally accepted that international trade is the engine of growth. Many protectionists policies experienced with, specifically in the twentieth century, were short lived and the general consensus today remains that international trade and countries openness lead to major economic benefits and growth.\textsuperscript{167} In fact, major international organizations such as the World Bank and the International Monetary Fund (“IMF”) have made market openness and reduction in trade barriers, a condition for financial assistance in developing countries.\textsuperscript{168} The success of the World Trade Organization (“WTO”) in increasing international trade including in developing countries is another proof of the general belief that more trade is good for the economy.\textsuperscript{169} In the current era of globalization, many developing countries are encouraged and expected to ‘bring something’ to the international market. International trade has opened global markets and presents an opportunity for developing countries to access major trading centers and sell their goods and services. The design of the rule of law in general and of taxation law particularly including international taxation, must therefore satisfy the need to promote exports as many developing countries measure their economic success by how many goods and services they are able to offer in the international markets.

In the tax arena, the promotion of exports and the openness of markets generally translate into national tax rules that allow for incentives and sometimes international tax rules that struggle to

balance source based versus residency based taxation. As will be shown in the case studies below, sometimes, there are contradictory tax policy goals and design of contradictory tax rules that aim to attract investment into the local jurisdiction while promoting local exports from that jurisdiction. Many countries have adopted tax holidays for companies investing into products exclusively destined for exports. Encouragement of exports is not a concern for developing countries alone. In fact, many developed countries continue to design rules that would boost their capacity to export goods to foreign markets. In the US for example, it was a central promise of then presidential candidate Barack Obama to double US exports by the end of his first term in office, a promise that he argued he was on his way to achieving and even doubled down on it during his second run for president in 2012.\textsuperscript{170} The goal to promote exports, while noble from a local country perspective, is not always in line with the rules of some international organizations. The design of rules, including taxation rules that promote local countries exports have usually faced obstacles regarding their compliance with rules of international organization such as the WTO. As an example, the US as well as China, in their endeavor to promote local exports, have been engaged in litigation regarding violation of WTO rules.\textsuperscript{171} Any design of tax rules, and international tax rules specifically should satisfy the need of developing countries to encourage exports but at the same time should not put compliance with international tax provisions of international organizations in jeopardy.

C. Inability to Reach the Hard to Tax and Heavy Reliance on Corporate Taxation

Exercising the taxing power is one of the most daunting tasks that countries face globally. In fact, one of the quintessential issues facing tax administrations around the world is how to deal with tax evasion, both on the large and most publicized scale, and on the smaller, less headline grabbing scale.\textsuperscript{172} The issues varying from the “hard to levy”\textsuperscript{173} to the “hard to tax”\textsuperscript{174} pose specific challenges to developing countries. The proliferation of small businesses, the engine of any economy, has created a quasi fiscal nightmare for developing countries tax administrations. The question remains how to deal with the hard to tax, how to reach the underground economy. In the developed world, tax administrations are relatively well resourced and have the expertise to track the otherwise hard to tax. In the developed world, government allocate necessary resources to form robust and ever increasingly skillful tax administration with the time and the man power to go after tax evasion, on a large as well as small scale. In these systems, tax administrations are organized around voluntary assessment by taxpayers, with regular and robust audits by the tax administrations to correct any irregularities or sanction fraud. In developing countries, challenges are different and more fatal. In developing countries, skillful personnel are scarce and the necessary manpower is unsustainable.\textsuperscript{175} In these countries, most of the economy is underground and out of the tax authorities reach and the infrastructure needed to reach such underground economy is inexistent. As a consequence, many tax authorities in developing countries have focused on relatively bigger businesses that are within the tax net, slamming them

\textsuperscript{172} Tax Justice Network and Mike Lewis, Global tax evasion, (2006).
\textsuperscript{173} The expression hard to levy has generally been used to describe a pool of income the base of which is not determinable for assessment for tax purposes.
\textsuperscript{174} The expression hard to tax has generally been used to describe a pool of income difficult to locate and account for, for tax purposes.
with high taxes and relentless audits. The phenomenon, described as that of ‘milking the cow already in the barn’ has led any effort to develop tax rules laser focused on big companies as the only source of the ever-increasing need for government revenues. The reality of the developing countries is that self-assessment of tax is not trusted and tax administrations have neither the resources nor the time to enforce notoriously complex tax structures. The design of tax rules, and international tax rules specifically in developing countries have to face the reality of weak tax administration infrastructures and the resulting heavy reliance on relatively big companies already in the tax net, for most of the tax revenues.
D. Need for Simplicity and Simplification Concerns

Legal simplicity in general and tax simplicity specifically have always been a goal of legislators globally.\textsuperscript{176} In the developing world in fact, tax simplicity is not only an ideal, it is a necessity for optimal tax administration.\textsuperscript{177} The definition of simplicity itself has animated many debates.\textsuperscript{178} Many commentators have defined simplicity solely from its economic perspective while others have looked at simplicity solely from a legal standpoint. Even though the debates have merits, we will limit ourselves to the notion of legal simplicity in our discussion of tax simplicity in developing countries because we believe legal simplicity is not totally separate from economic simplicity and a well-rounded legal simplicity will lead to the economic simplicity in tax. The commonly accepted definition of legal simplicity of taxation is the ease by which a body of a tax law can be read and correctly understood and applied to practical situations.\textsuperscript{179} Legal simplicity of taxation therefore requires clarity, consistency and certainty.\textsuperscript{180}

Clarity in tax simplicity refers not only to the linguistic expression of the legislation, but also to the organizational scheme by the drafters. The notion of consistency refers to both internal and external consistency. Internal consistency requires coordination, harmonization and linkage between all the parts of the legislation. External consistency requires the laws at large\textsuperscript{181} to not contradict with any other adopted tax legislations in the jurisdiction.\textsuperscript{182} The requirement of certainty is arguably the most important in the concept of simplicity. Certainty means that the

\textsuperscript{176}See Adam Smith, An Inquiry Into the Nature and Causes of the Wealth of Nations, Book Five, Chapter II (1776).
\textsuperscript{177}See Supra, at 89.
\textsuperscript{179}Id., at 241.
\textsuperscript{180}Id.
\textsuperscript{181}Laws at large refer to law passed by the legislative body but also regulations and other official pronouncements of the tax administration agency.
taxpayers ‘true’ tax liability can be uniquely determined from a minimal supply of relevant data with reasonable efforts.\textsuperscript{183} Tax simplicity can therefore be measure by answering a number of questions including: how simply is the tax legislation written? How simple is the content of the tax legislation? How taxpayers respond to the tax law? How tax administrations respond to the tax law? How expensive is it to operate the tax? This last question factors in the economic simplicity as the economic simplicity looks at the interaction between the tax law and the economy. The economic simplicity shifts the focus from comprehensibility to applicability, but a well-rounded legal simplicity takes applicability into account.

Changes in tax legislations in general and international tax rules specifically in developing countries have been preoccupied with the need to achieve simplicity. Any proposal to change international tax rules in developing countries needs to be simple, in both the legal and economic sense in order to achieve optimum tax administration. The need for simple tax rules is very pronounced in developing countries because, as indicated, those countries usually lack the expertise and resources to apply complex rules. The current rejection of the transfer pricing regulations adopted by the Organization of Economic Cooperation and Development (“OECD”) by developing countries is rooted in the fact that the regulations are too complex and resources available to developing countries tax administrations do not allow them to apply those regulations.\textsuperscript{184} Developing countries need simple rules, easily applicable, easy for taxpayer to comply with and for tax administration to enforce, and able to be coordinated with rules of external jurisdictions.

\textsuperscript{183} See Tran-Nam Binh \textit{Supra} note 178.
\textsuperscript{184} Neighbour John, \textit{Transfer pricing: Keeping it at arms’ length, Organisation for Economic Cooperation and Development,} 29 The OECD Observer 230 (2002).
E. Special Regimes for Extractive Sectors

In many developing countries, the extractive sector, specifically the oil and gas industry account for the major part of the economy and taxes therefrom constitute the major source of revenues for those governments.\(^{185}\) In Nigeria for example, the largest oil producer in the African continent, statistics show that the country produces approximately 2 million barrels of oil per day, 1.9 million of which were exported.\(^ {186}\) The oil industry is the main sector of the economy representing approximately 95% of the country’s total exports. Oil revenues in Nigeria represent approximately 80% of the government’s total revenues, and the oil and gas sector accounts for approximately 35% of the Gross Domestic Product (“GDP”).\(^ {187}\) Similar to Nigeria, many developing countries have the oil and gas industry at the center of their economies and any tax policy discussion or proposal is bound to give special consideration to the sector.\(^ {188}\) The dilemma in designing tax policy for these countries is to raise enough revenues from the oil and gas sector while not consecrating a tax system that would discourage investments in the sector.\(^ {188}\) The concerns in this area are taken more seriously today as research overwhelmingly shows that countries with high reliance on oil have performed poorly comparatively to their counterparts who are less reliant on oil. The so called “resource curse” obliges any tax policy to aim carefully at solving/mitigating the curse, at least from a fiscal policy perspective.\(^ {189}\) The dependence of revenues on oil proceeds, which are volatile, unpredictable and exhaustible, significantly complicates fiscal design and fiscal management specifically from a short as well as long term...

\(^{185}\) See for example, in the case of Nigeria, Khan Ahmad, *Nigeria: The political economy of oil*, (1994).

\(^{186}\) See the 1998 statistics reported by Amponsah et al (2012).


\(^{189}\) See Shalk and Hemming, providing a survey of fiscal sustainability (2000). See also Alier and Kaufman (1999); Engel and Vlades (2000); Bjerkholt (2002), or Hausmann, Powell and Rigobon (1993).
perspectives.\textsuperscript{190} From a short term point of view, taxation of the central extractive industries must raise enough funds to provide for government expenditures while providing enough incentives for continued investments in the sector. From a long-term perspective, taxation of this central sector must be done in a way that designs non-reliance of governments to those industries alone. As a consequence, and on a long-term basis, governments must utilize tax policy that encourages and boost other forms of investments in other sectors in order to proactively deal with the unpredictability of the extractive sector and its exhaustiveness. It is accepted that fiscal policy is not the only way to deal with the “resource curse” but it is also widely accepted that fiscal policy is a central way to deal with it. The taxation policy and its redistributive underpinning can lay the ground for enhanced government services and enticement to develop alternative industries making the system sustainable for the long run. Also the design of tax policy takes into account the way in which the natural resources sector is operated. In most developing countries, resources are operated through private companies which then pay taxes to the government on their profits.\textsuperscript{191} Taxes are usually high in this industry but often accompanied by many incentives and loopholes that major natural resource companies willingly take advantage of. Most high oil producing companies have grown creative as to how to raise funds through taxation of the industry. It is therefore common to encounter special taxes on the industry for education, or wellbeing of the localities.\textsuperscript{192} On the other hand, in some other countries, the governments directly operate the natural resources, and in that setting tax policy might be less impactful.\textsuperscript{193}

\textsuperscript{190} See Davis Jeffrey, Annalisa Fedelino, and Rolando Ossowski, Fiscal Policy Formulation and Implementation in Oil-Producing Countries, IMF (2003).

\textsuperscript{191} Most oil producing countries have the oil industry operated by private companies.

\textsuperscript{192} In Nigeria or Chad, the Oil industry is subjected to a special tax to fund the education trust fund.

\textsuperscript{193} Some countries directly operate the oil and gas industry, using state owned and operated companies. Examples include Venezuela or Mexico.
Chapter III

Current international Tax Positions in the Developing World, Case Studies
The tax policy philosophies discussed in Chapter II are discernable in the international tax rules and systems that exist currently on the developing world. As details below demonstrate, the struggles to satisfy the major fiscal policy philosophies discussed above are noticeable from Africa to South America and Asia. The analysis below focuses on a few countries, in a sampling manner, to characterize the systems as a whole. As any sampling exercise, the choice of the countries below did not meet an exact and wholly objective standard. Instead, the below case studies were decided based on a number of criteria including whether the countries meet the definition of a developing countries and the pertinence of the potential link between its tax policies and its overall development. Also, the choice of the below countries as case studies was informed by the aspiration of this thesis to bring a novel contribution to the discussion; as a consequence, we intentionally avoided the large yet classified as developing countries but for which ample writing on their tax systems is readily available. Our intention was therefore twofold: first, to study those countries judged, a priori, ‘interesting’ because their tax structures are either strong or weak, and the impact is readily ascertainable on the overall economy. And second, to bring into light in an academic setting, the policies existent in those fiscal jurisdictions\(^\text{194}\) that are not abundantly explored in academic tax research.

A. Current International Tax Positions in Africa

Developing countries in general and African countries specifically face many hurdles when it comes to taxation. The need to raise revenues is urgent in these countries. However, authorities have struggled to use taxation as a means to provide for the optimum operation of the state. In the sub-Saharan Africa context for example, tax authorities have little to no powers and are unable to collect tax from ‘the very few’ who are wealthy and powerful; at the same time the enforcement powers they possess toward ‘the many’ are ineffective because ‘the many’ have next to nothing to be taxed on.  

Countries are diverse and tax systems vary profoundly from one country to another. For instance Mauritius has adopted the worldwide system of taxation, Congo the territorial system of taxation, and Liberia applies a blend of both systems. Nevertheless, there are common concerns across the continent including those related to enforcement of the international tax rules that have been incorporated into most of these systems. The task of choosing two countries in the continent that might provide a relatively acceptable representation of the situation as a whole is bound to be imperfect. The choice of Cameroon and Nigeria for the cases study below was necessary in order to portray the situation as a whole by showing both ends of the spectrum. On the one hand, Cameroon, a smaller country which inherited most of its fiscal policies from its former colonial power, France, is an example of a tax system in a smaller African economy. On the other hand, Nigeria, a larger country whose fiscal policies early influences came from England, shows a tax system in a larger economy.

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196 Cameroon has approximately 23 million inhabitants.
197 Cameroon is a smaller economy, and yet one of the fastest growing countries in the continent and in the world (See statistics from the world economic forum, 2015).
198 Nigeria has approximately 200 million inhabitants.
199 Nigeria was colonized by England.
200 Nigeria is the second largest economy in Africa.
It should be noted that most African countries rely on indirect taxes, specifically Value Added Tax ("VAT") which since its introduction throughout the nineteen nineties, has had it percentage increased many a time.\textsuperscript{201} The case studies below disregard the study of VAT and its specific impact in the selected jurisdictions.

\textsuperscript{201} In Cameroon for example, VAT was introduced in 1996 at a rate of about 17%, ever since, it has drastically increased to stand at 19.25% today.
1) Cameroon Fiscal Environment: a Case Study

Cameroon is a developing country in the Central Region of Africa. Like most countries including industrialized countries, the Cameroonian tax system is separated into individual taxation and entity taxation. Further, taxation should be viewed from an internal as well as an international tax perspective. The focus of this case study is to present, in a topical manner, the international tax aspects of the Cameroonian tax system. The impact of the fiscal policy and tax structure in the overall economy is widely acknowledged by both the government and the private sector. In fact, in 2007, the government initiated an effort to reform the fiscal structure in Cameroon in order to produce a simple yet competitive tax system capable of meeting the then current and ever changing national and international fiscal challenges. The commission for fiscal reform was therefore created to carry that mission through consultation with the various stakeholders and policy recommendations.202

Cameroon adopted the territorial tax system whereby Cameroonian companies that carry out trade outside of Cameroon are not taxed on their foreign sourced profits. Likewise, foreign companies with activities in Cameroon are subject to Cameroonian corporate tax only on their income sourced in Cameroon.203 Further, Cameroon adopted residency requirements similar to those applicable in the US. Thus, a company is classified as a Cameroonian company only if it is registered in Cameroon, and regardless of whether or not it is managed and/or controlled in

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203 See Article 5, Cameroon Internal Revenue Code.
In the event of an entity managed and/or controlled from Cameroon, there is a likelihood of the entity having a permanent establishment in Cameroon thereby subjecting its income sourced in Cameroon to Cameroonian taxation.

The individual income tax system in Cameroon relies on a progressive tax rate. Depending on the income of the individual, the tax rate ranges from 0% to approximately 40%. The Cameroonian tax legislation establishes a number of conditions in order for one to be liable for tax in Cameroon. The conditions include the requirement to have a home or principal place of residence in Cameroon, or to maintain a ‘center of business’ in Cameroon, or be a civil servant. The requirement of one’s principal place of residence is satisfied if one spends 183 days per year in the country. The individual tax allows for both personal and business deduction of expenses where applicable. However, in 2012, the law was amended to preclude deductions where payments are deemed made to a recipient in a ‘tax heaven’. Nevertheless, the tax authorities are unable to clearly construe the notion of tax heaven, and are unable to track and trace those payments that are destined to recipients in the designated tax heavens. This situation is similar to struggles in the corporate international environment.

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204 See OHADA, Droit des Societes (1999); as regularly amended and restated.
205 See Article 21 for companies and 69 for individuals, Cameroon Internal Revenue Code.
206 See Article 21, Cameroon Internal Revenue Code.
Taxes on Income and gain of Corporations

As indicated above, Cameroon applies the territorial tax system whereby Cameroonian corporations are not taxed on their foreign sourced income, and foreign companies are only taxed in Cameroon on their income sourced in Cameroon.\textsuperscript{207} The regular corporate income tax rate is 38.5\% (35\% plus a 10\% council surtax).\textsuperscript{208} Cameroon also adopted a turn over tax to serve as an alternative minimum taxation. Cameroonian companies are tax on the higher of either corresponding corporate tax rate or 1.1\% of their turn over, meaning, their gross annual sales. It should be noted the turn over tax is presumed from the previous year turn over, it varies depending on the kind of industries or sectors of activities, and it should be remitted throughout the current financial year with a credit being allowed at the end of the year.\textsuperscript{209} Profits realized by branches of foreign companies in Cameroon are presumed distributed to the parent companies and are consequently subject to the branch profits withholding tax currently at 16.5\% of the after-tax income.

Capital Gains and Dividends

In Cameroon, capital gains, specifically return on investments, are subject to the regular corporate tax rate of 38.5\%.\textsuperscript{210} Capital gains include gains on the sale of real estate, corporate shares and business assets.\textsuperscript{211} Cameroon has not adopted the preferential tax treatment of capital gains as applied by most other jurisdictions. It should be noted however that the tax can be deferred or eliminated in the event of a merger. Additionally, if a business is wholly or partially

\begin{itemize}
  \item \textsuperscript{207} See Territoriality Supra, note 203
  \item \textsuperscript{208} See Supra at 230.
  \item \textsuperscript{209} The minimum tax payable is higher for companies under the simplified tax regime (3.3\% for non-importing traders, and 5.5\% for producers, service providers and importation traders).
  \item \textsuperscript{210} See Article 44, Cameroon Internal Revenue Code.
  \item \textsuperscript{211} Id.
\end{itemize}
transferred or discontinued, only one half of the capital gains would be taxed if the transfer or termination occurred less than five years after the business started or was acquired, or only one third of the capital gains would be taxed if the business started or was acquired more than five years before the transfer or discontinuation.

A unique characteristic of the Cameroonian system of capital gains taxation derived from its need to promote and encourage investments in the local stock exchange. In fact, any capital gains realized on the Cameroonian (and planned to be regional) stock exchange are exempt from corporate income tax and taxation on movable capital.212 The exception to that generous treatment is however related to capital gains derived from the disposition of the oil and gas related interest when the exploitation of the Cameroonian subsoil is involved. In fact for all oil and gas related capital gains, whether realized inside or outside of Cameroon, the corporate tax rules would apply provided the interest is related to the exploitation of the Cameroonian subsoil.213

Dividends paid to residents in Cameroon are subject to a 16.5% withholding tax (15% plus the 10% council surtax).214 Resident recipients must include the gross dividend in their taxable income, but they receive a corresponding 16.5% tax credit to prevent double taxation.215

Dividends paid to nonresidents are subject to a 16.5% withholding tax, which is a final tax.216 A parent corporation may exclude up to 90% of the dividends received from a 25%-owned subsidiary if the parent company and the subsidiary have their registered office in a Central

212 See Article 56, Cameroon Internal Revenue Code.
214 See Article 11, Cameroon Internal Revenue Code.
215 Id.
216 Id.
African Economic and Monetary Community (CEMAC) country.\textsuperscript{217} In this case, however, no withholding tax credit is allowed. Instead, the tax can be offset against any withholding tax due on its own dividend distributions.

**Tax and Other Investment Incentives**

Cameroon, like many other developing countries has always maintained various incentives to encourage investment and spur economic growth. Tax incentives have usually served as the primary vessel for attracting investments. The recent provisions in Cameroon were laid in the 2013 law to provide for various preferential tax treatments to attract investment. The law of April 18, 2013 establishes two main kinds of incentives. On the one hand, incentives that affect the installation phase of the enterprise. The April 18, 2013 law defines the installation phase of the enterprise as the period of five years from the date of issuance of the approval of the enterprise as pertaining to the special regime.\textsuperscript{218} During the installation period, the April 18, 2013 law offers exemptions from registration duties, transfer duties, custom duties and Value-Added-Tax on certain items.\textsuperscript{219} On the other hand, the April 18, 2014 law establishes incentives that affect the operational phase of the enterprise. The April 18, 2014 law defines the operational phase as the period of ten years from the time the company qualified for the incentive.\textsuperscript{220} Incentives during the operational phase are many and very impactful for the approved enterprises. As a matter of fact, and under the April 18, 2014 law, operational phase incentives include exemption or reduction with respect to the minimum tax, exemption or reduction of the corporate tax, custom...
duties, and other specified taxes and duties. Also, even though the general rule on loss carry
forwards in Cameroon is four years, a company under operational phase of the incentives would
be allowed to carry losses forward into the fifth year.

**Tax Treaty Network**

Even though Cameroon has various investment tax treaties, the country only has a few executed
tax treaties. Currently, Cameroon has eight executed tax treaties, only two of which are with non-
African countries. Each of the tax treaties contains specific provisions and some of the
provisions are now outdated as they provide for a worse fiscal treatment than no treaty. For
example, in the Financial Law of 2014, Cameroon established a 0% withholding tax on interest
payments to non-resident lenders. However, all tax treaties executed by Cameroon provide for at
least 15% tax on interest payments. Some provisions in the treaties reveal the balance of
power when the treaties were negotiated and ought to be revised. The tax treaty between
Cameroon and Canada for example provides for different tax rates for the same income
depending on source of such income. The tax treaty provides that if the dividend, interest or
royalty is paid from sources in the Cameroon, there shall be a 15% withholding tax; however, if
the dividend, interest or royalty is paid from sources in Canada, there shall be a 20% withholding
tax.

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221 Cameroon has Tax Treaties with Canada, Central African Republic, Chad, Congo, Equatorial Guinea, France, Gabon, and Tunisia.
222 Example all the Treaties have a 16.5% tax on interests, except the Treaty with Canada providing for a 15/20% tax, and the treaty with Tunisia providing for 15% tax on interests.
It should be noted however that all the rules discussed above apply only when there is no double tax treaty otherwise applicable. The existence of the tax treaty supplements the above rules and rules under the executed treaty are dispositive.

**Transfer Pricing**

In 2012, Article M19 bis in Book II of the General Tax Code on Manual of Tax Procedures was introduced to increase the regulation and control of transfer pricing. Under the new rules, if in the course of an audit, the administration has evidence that a company indirectly transferred profits, the administration may request that the company provide information and documents regarding relationship between the company and other companies or groups outside of Cameroon, the pricing method utilized and the justification, the tax treatment for the other company or related party in the foreign jurisdiction, and a description of the activities of the other party located outside of Cameroon. The 2012 law allows for a request, in addition to the regular disclosure requirements, of a detailed statement of transactions with the companies which control or are controlled by 25% or more. Specifically, 25% companies must provide a statement of their shareholding in other companies, and a detailed statement of intercompany transactions.

The 2012 amendment was introduced in order for the Cameroonian tax authorities to respond to undue base erosion and profit shifting schemes that are on the rise across the continent. Cameroon, like many other tax administrations across Africa is reacting through an increase in requested information. The issue however is whether the tax authorities in Cameroon possess the

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225 *Id.* But see Law N* 2014/004 (2013) providing for exceptions to the documentation requirement.
necessary human capital to digest the ever-growing list of information requested from MNEs. The Director of the tax collection sub-division at the ministry of revenues indicated that transfer pricing is by far their major challenge around tax administration and tax collection in the country.\footnote{Interview with Makon, under director at the ministry of revenues, conducted 11-14-2014.} The Director specified that the information they are given is abundant and overly confusing; the information does not easily trace the movement funds and the rational. Base erosion and profits shifting seems therefore easily achievable and the potential for redress pursuant to an audit is slim to none. The Cameroonian tax authorities, heavily reliant on corporate taxation, have been outspoken about the need to curve issues of base erosion and profit shifting within Cameroon, regionally, and globally.
2) Nigerian Fiscal Environment: a Case Study

Nigeria is a developing country in West Africa, and one of the largest economies in Africa. Nigeria operates under a fiscal federalism composed of three layers, federal, state and local taxing authorities. Taxation has existed from the pre-colonial era of the Nigerian society but its modern state can be assessed from the post-independence period. Since Nigeria became independent, major political and social needs have dictated tax policy orientations.

Right after independence, the most urgent need of the system was to provide revenues to finance public sector programs. As a consequence, early post-independence tax policy making was driven by the need to provide as much revenues to the government and possible. As Nigeria evolved after independence, the tax policy began to be influenced by the need to develop an internal economy and an internal business sector. Tax policy making therefore shifted from exclusive revenue raising mission to a mission to encourage business venture and national economic development. Tax legislation during this period was evidenced by several measures to encourage national production and slow imports. Government revenues during this period originated primarily from import duties levies. Also, the Nigerian tax policy relied heavily on revenues from the oil and gas industry as major reserves were found in the country.

Later into its independence and more recently, the Nigerian tax policy has been focusing on diversifying tax revenues sources, reducing the dependence in oil revenues, and producing a globally competitive tax system.

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229 *Id.*
Nigeria applies the worldwide system of taxation whereby Nigerian persons are taxed on their worldwide income.\textsuperscript{230} On an individual income tax perspective, Nigerian tax legislation specifies condition for tax liability as well as the taxable amount.

The main condition for individual tax liability in Nigeria is the requirement of Nigerian residency. Under Nigerian law, individuals are considered Nigerian residents if they reside in Nigeria, expatriate employees present in Nigeria for employment purposes, or anyone present in Nigeria for more than 183 days during any 12 months’ period. These rules regarding individual tax liability are preempted in the presence of a tax treaty.

The Nigerian tax legislation subjects various kinds of individual income to taxation in. The individual income tax rate, depending on the income, varies from 0 to approximately 40%.

First individual taxable income includes employment income. Employment income has a wide definition which includes salaries, wages, fees, allowances, pensions, non-cash benefits, bonuses and other premiums or gratuities. Individual partners are taxed on their share of the partnership profits whether the profits are distributed or not. Income from self-employment is subject to individual taxation. Individuals are also subject to taxation on their investment income.

Nigeria imposes a 10\% tax rate on payments of interest, dividends or royalties. Further, the Nigerian tax legislation subject individuals to a 10\% tax rate on their capital gains including the sale of land and/or buildings located in Nigeria. Finally, the Nigerian tax legislation imposes various taxes on individuals including the inheritance tax, the gift tax, the social security tax, or the national housing find tax.

\textsuperscript{230} See Section 14 of the Nigerian Companies Income Tax Act (2004), as amended from time to time.
Contrary to individual taxation that is relatively easy to grasp, corporate taxation in Nigeria and international taxation specifically have a more complex structure.

Taxes on Income and gain of Corporations

As indicated above, Nigeria operates a system of worldwide taxation whereby companies resident in Nigeria are subject to tax on their worldwide profits. Similarly, non-resident Nigerian companies are only subject to tax on their Nigerian sourced profits. A company is resident of Nigeria if it is incorporated in the country. Any foreign company that intends to carry on a trade or business in Nigeria is required to incorporate a company in the Country.231

The general corporate tax rate in Nigeria is 30%, and the rate can be reduced in various circumstances. However, all companies are subject to a minimum tax representing the greater of either 0.25% of turnover, 0.25% of paid in capital, 0.5% of net assets, or 0.5% of gross profits. Companies are subject to a 10% withholding tax on payments of interest, dividends and royalty to all recipients in non-treaty jurisdictions.

Nigeria has no specific thin capitalization rules. Thus, generally speaking, there are no ratios which may limit the amount of debt that may be applied to fund a company. However, companies that intend to engage in banking or insurance business are required to have specified minimum paid-up capital, capital adequacy ratios and/or solvency margins.

Capital Gains and Dividends

In Nigeria capital gains arising from the disposal of capital assets are taxable at a 10% rate.

Generally, capital gains arise from disposal of assets such as land and buildings, options and

231 See the Companies and Allied Matters Act, Chapter 59 (1990), available at http://www.nigeria-law.org/CompaniesAndAlliedMattersAct.htm (last retrieved 11-25-2014).
other property rights, currency exchange gains, or movable assets. The general rule is applied to assets situated in Nigeria. For residents, disposal of those assets are subject to taxation even if the assets are located outside of Nigeria.

Dividends are generally subject to 10% withholding tax rate. The rate is reduced or eliminated in cases involving treaty jurisdiction. The Nigerian tax legislation also provides various instances of tax exemption on dividend payments, as part of general tax incentives.

Tax and Other Investment Incentives

In an attempt to make its tax regime more modern and more competitive in the globalization era, the Nigerian government has enacted various tax and other investment incentives.

First, even though as indicated above the general corporate tax rate is 30%, Nigerian tax law allows a reduction to 20% tax rate during the first five years of a company’s existence if the company is engaged in agricultural or mining production. Similarly, companies are exempt from the minimum tax requirement in their first five years of existence.

Second, Nigeria has implemented various tax holidays. For example, if a limited liability company is operating in an industry that the government recognizes as vital to Nigeria’s economic development; such company would be granted a general tax holiday of up to five years. Any such company would have no tax liability in Nigeria during up to five years from starting its operations in the country.

Third, Nigeria has instituted free-trade zones to encourage exports of Nigerian products.²³² Any approved Nigerian company operating in an export free-trade zone is exempt from all federal,

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state, and local government taxes, levies and fees. Additionally, any new export oriented companies, even if located outside of the free-trade zones maybe eligible for the preferred tax treatment.233

Fourth, new companies engaged in mining in Nigeria are eligible for a general tax holiday for up to five years from their start of business.234 Similarly, companies engaged in downstream operations in the oil and gas industry are eligible for a general tax holiday of up to five years. Generally, at the end of the specified tax holiday period, the Nigerian tax legislation offers the selected companies accelerated capital allowances.

Finally, Nigeria offers tax exemptions to interest payments on foreign loans. The exemption from withholding is dependent on the time for repayment of the loan, and generally the exemption is limited in time.235 The presence of a tax treaty might however make the exemption permanent.

**Tax Treaty Network**

Nigeria has a relatively expansive tax treaty network, compared to other African countries. Nigeria has entered into such treaties with Belgium (effective January 1, 1990), Canada (effective January 1, 1993), China (effective January 1, 2010), Czech Republic (effective January 1, 1991), France (effective January 1, 1991), Netherlands (effective January 1, 1994), Pakistan (effective January 1, 1990), Romania (effective January 1, 1993), South Africa (effective January

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233 *Id.*


235 Foreign Loan Interest Tax exemption: If more than 7 years for repayment of loan, not less than 2 years of 100% exemption. If 5 to 7 years for repayment of loan, not less than 18 months of 70% exemption. If 2 to 4 years for repayment of loan, not less than 12 months of 40% exemption. If less than 2 years for repayment of loan, no exemption.
1, 2009), and the United Kingdom (effective January 1, 1988). In addition, Nigeria has signed double tax treaties with Bulgaria, Mauritius, the Philippines, Spain, Sweden, or Poland. Those treaties have yet to be ratified. Nigeria is also engaged in many treaty negotiations including with Algeria, Denmark or Tunisia.

In all tax treaties concluded by Nigeria, passive income, namely income from dividends, interests, and royalties is subject to a 7.5% withholding tax rate. This is a preferential rate compared to the regular rate of 10% on such incomes in transactions involving non-treaty jurisdictions. It should be noted however that even though the treaties with China and South Africa have not been updated to reflect the 7.5% rate, the Nigerian authorities apply that reduce rate in those situations since the reduced rate was introduced in the budget pronouncement of 1999.

Transfer Pricing

For a long time, there were no special transfer pricing rules in Nigeria. There were general anti-avoidance provisions in the tax laws that empowered the tax authorities to adjust the tax liability of a company where they believed the company’s transactions were not conducted at arm’s length. Transactions between a company and related entities were usually scrutinized by the tax authorities, to ensure that they were conducted on competitive terms. Certain expenses (such as management fees and offshore expenses), for which relevant regulatory approval was not obtained, may also be disallowed for corporate income tax purpose.

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236 See Articles 10, 11, and 12 of the tax treaties executed by Nigeria.
On August 4, 2012, transfer pricing regulations took effect in Nigeria.\textsuperscript{237} The regulations apply to transactions between connected taxable persons.\textsuperscript{238} Under the regulations, the notion of connected taxable persons refers to related parties as specifically defined in the regulations. Related parties entering into transactions to which the regulations apply must determine the taxable profits resulting from such transactions in a manner that is consistent with the arm’s length principles. Further, for purposes of the regulations, a permanent establishment is treated as a separate entity. Transactions between the permanent establishment and its head office or other related persons are subject to the regulations.\textsuperscript{239}

The transfer pricing regulations of 2012 in Nigeria incorporated the international norms of ALS advocated in Article 9 of both the United Nations (“UN”) and the OECD Model tax treaties.\textsuperscript{240} The Nigerian regulations require that related parties transactions satisfy the arm’s length principle and that the parties produce documentation to establish that the transactions are at arm’s length. Nigerian tax authorities will receive information regarding the covered transactions, however, the question remains as to whether the authorities would always be able to determine what arm’s length should be, and adequately evaluate the methods used to arrive at the company’s claimed arm’s length price.


\textsuperscript{238} Related persons under the regulations refer to entities that meet a certain threshold of ownership interest, companies that own or are owned by others in the transaction.

\textsuperscript{239} \textit{id}.

\textsuperscript{240} Article 9 in both the UN and the OECD Model Tax Conventions discuss tax treatment of related enterprises transactions based on arm’s length principles.
B. Current International Tax Positions in Latin America

Any regional study on South America has to refrain from any generalization because even though the countries might be in close geographical proximity, their divergence is very profound. South American countries differ largely including in their economic structure, their dimension, their historical heritage, their wealth, and their administrative and political institutions. The challenges posed by diversity are even more pronounced when it comes to the study of taxation in South America. The region has known two major influences both from Europe and from the United States that have shaped many of its cultural background and other political philosophies. The northern part of the region was more exposed to American influence, while the southern part was more impacted by forces from Europe. The selection of two countries with a hope they would provide a general sense of taxation in the region was therefore a task bound to be imperfect. However, similar to the approach adopted in the case study on Africa above, we have selected two countries approximately at both ends of the spectrum. In fact, Argentina will offer a view of taxation in the context of a south American large and heavily populated country while Panama would offer a perspective of a smaller south American country and its experiences with taxation in general, and international taxation specifically.

It should be noted that most African countries rely on indirect taxes, specifically Value Added Tax (“VAT”) which since its introduction has usually followed an increased trend. The case studies below disregard the study of VAT and its specific impact in the selected jurisdictions.
1) Argentinian Fiscal Environment: A Case Study

The Argentine Republic ("Argentina") is a country located in the southeastern part of South America.\textsuperscript{241} Argentina became independent from Spain in 1816 following a fight for independence that lasted for almost a decade.\textsuperscript{242} With approximately one million square miles of territory, Argentina is the eighth largest country in the world, and the second largest in South America. Argentina is classified as a middle emerging economy with historically high ratings on the human development index.\textsuperscript{243} The country is organized as a federation of provinces with Buenos Aires as the capital and largest city. The population of Argentina is estimated at approximately 43 million inhabitants.\textsuperscript{244} The country has known a tumultuous modern history. In fact, Argentina is classified as an emerging market today despite being the 7\textsuperscript{th} wealthiest country in the world in early 20\textsuperscript{th} century. Political and social instability in the last few decades have impacted the Argentinian economy. Today Argentinian leadership endeavors to deal with the many economic challenges of the country through economic and tax policy philosophies that encourage local production, attract foreign investment, encourage exports, and promote local employment. Taxation, and international taxation policy plays a central role in the struggles for Argentina for remain globally competitive while providing enough revenues for the optimum functioning of the government.

\textsuperscript{243} It should be noted however that Argentina’s rating has decreased in recent years, ranking 49th in the 2014 Report of the Human Development Index.
\textsuperscript{244} Per the latest census, in 2014, the population is estimated at 42,669,500 inhabitants.
The government of Argentina is the sole entity in charge of national tax policy and tax collection. Fiscal responsibilities are entrusted to a government agency known as the ‘Administracion Federal de Ingressos Publicos’ (“AFIP”) which is in charge of administering the income tax system. Argentina has adopted a worldwide system of taxation. The tax system, like many others, is divided both into individual and corporate tax, and into internal and international taxation.

From an individual tax perspective, residents of Argentina are subject to tax on their worldwide income while non-residents are only taxed on their income that is sourced in Argentina. To be a resident of Argentina, one must satisfy either of three conditions: be a native or naturalized citizen of Argentina; be a foreign individual who is granted permanent residence in Argentina; or be a foreign individual who remain in Argentina under temporary authorization for a period of 12 months or longer.245

Argentina adopted a progressive individual tax system. Individual tax rates range from 0 to approximately 40%. Argentina taxes various kinds of incomes including: employment and self-employment income; education allowances; investment income; interests and royalties; directors’ fees; capital gains; and employer provided stock options. Argentina, in an attempt to encourage investment and development of its local stock exchanges, exempts from taxes, capital gains from the sale of stock on national exchanges. Sales of real estate are subject to a transfer tax at a rate of 1.5% of the sale price.

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245 It should be noted however that, under Argentinian tax law, individuals under temporary authorization who have not been granted permanent residence are deemed non-residents if they can prove that they do not intend to stay permanently in Argentina.
From a corporate tax perspective and as indicated above, resident companies are taxed on a worldwide basis. As a consequence, any profits, including capital gains of Argentinian companies are taxable in Argentina whether earned in the country or not. Businesses in Argentina as well as branches of foreign companies are considered residents of Argentina and are subject to taxation in the country.

**Taxes on Income and gain of Corporations**

The statutory corporate tax rate in Argentina is 35% of companies’ profits. Additionally, Argentina adopted the Tax on Minimum Presumed Income (“TMPI”). This tax is imposed on resident companies in Argentina and is applied instead of the regular corporate income tax if the regular corporate income tax rate leads to a tax liability that is lower that the TMPI. The TMPI is similar to the notion of Alternative Minimum Tax in other jurisdictions; however, the TMPI is calculated on the basis of the company’s assets. TMPI is imposed at a rate of 1% of the company’s qualifying worldwide assets which constitute its tax base. In an effort to encourage certain industry sectors, Argentina tax legislation provided for a special rate of TMPI (generally lower rate) for certain industries.

Generally, Argentinian tax legislation provides that a tax year for a company is its accounting year. AFIP, the Argentinian tax administration, requires that resident companies make advanced tax payments each month, on the basis of the previous tax liability. In certain circumstances, advance payments of TMPI may be required to be made by certain companies. At the end of the

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246 See The Federal Administration of Public Revenue.
247 TMPI is calculated on the basis of the resident company’s or branch’s worldwide assets at the end of the year. However, some assets are excluded from these tax base computations.
year, companies must file their tax returns, and make payments of any balances due. The payments are generally due within five months of the end of the accounting year and Argentinian tax legislation has adopted a system of interest and penalties for late tax payments.

**Capital Gains and Dividends**

Capital gains derived by Argentinian tax residents companies are included into their normal taxable income and are taxed at the regular corporate income tax rate of 35%. However, capital gains derived by Argentinian non-resident companies are taxed at a rate of 15%, which can be decreased to 13.5% in certain circumstances, and generally, in the case of presumed income. The capital gains arise generally from the transfer of shares, bonds and other securities. It should be noted that capital gains tax is not applicable for the transfer of government bonds. Traditionally, Argentina had maintained a tax exemption for transfer of stock by non-residents. In fact, Section 78 of the Decree N*2,284/1991 of 1991 established an exemption from tax for foreign beneficiaries on income derived from Argentinian share transfer.\(^{248}\) In 2013, in an effort to mitigate an expected decrease in tax revenues, the Argentinian tax legislator repealed the non-resident capital gains tax exemption and replaced it with a 15% or 13.5% tax rate. The transferee, in these instances, is liable for the tax that applies to the transferor. This tax does not, however, applies to indirect transfers which could produce the same result while remaining out of the Argentinian tax net.

Dividends distributions from Argentinian companies are subject to a 10% tax rate. The tax is administered through withholding mechanism whereby the distributing entity is required to

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withhold the tax and remit to the Argentinian tax authorities. Similarly, branch profits remittance is subject to the 10% withholding tax rate if a branch located in Argentina distributes its profits to its parent. Argentina has adopted the Argentine Equalization Tax currently imposed at a rate of 35% through withholding. Under this tax, if any distribution or any branch profits remittance exceeds the accumulated tax earnings of the distributing or remitting entity, then such excess distribution or remittance is subject to the 35% withholding tax rate. The 10% withholding tax rate is administered simultaneously with the 35% withholding tax rate, the latter being applicable only to the excess distribution.

Argentina imposes a withholding tax on interest and royalty payments. The general rate for interest payments is a 35% imposed through withholding. However, under certain circumstances, the rate is reduced to 15%; such circumstances include interest payments on loans granted by financial institutions not located in tax heavens, or interest on loans for the importation of movable assets. The general rate for royalty payments is 31%. The royalty tax rate can be reduced to 21% if certain conditions are met. The royalty tax is enforced through withholding tax mechanisms.

**Tax and Other Investment Incentives**

Like many other developing nations and middle economies, Argentina relies on tax and other investment incentives to boost its economic growth. Argentina introduced and maintains a tax incentive to attract energy investment in the country. Introduced in 2013 and extended thereafter, the tax incentive allows energy companies who invest $250 million over five years, to sell 20% of their energy production in international markets without Argentinian export taxes. Additionally, those energy companies are able, tax free, to keep some of the export revenues
outside of the country. Tax incentives further exist for certain activities such as mining, software production, biotechnology, and biofuel production. In addition, Argentina maintains tax-free zones (“Tierra del Fuego”) with special incentives for certain activities. The appurtenance in a tax-free zone, for qualifying industries results in an exemption from taxation on the activities and production of such entities.

**Tax Treaty Network**

Tax treaties negotiations in South America in general, unlike other regions of the developing world, have been very aggressive in the past decades. Argentina maintains one of the oldest and most established tax treaty networks in South America. Countries that have signed bilateral tax treaties with Argentina include: Australia (1999), Austria (1979), Belgium (1996), Bolivia (1976), Brazil (1980), Canada (1993), Chile (1976), Denmark (1995), Finland (1994), France (1979), Germany (1996), Italy (1979), Netherlands (1996), Norway (1997), Russia (2001), Spain (1992), Sweden (1995), Switzerland (2000), United Kingdom (1996), or United States (1981). Most Argentinian tax treaties have been drafted along the lines of the UN Model Convention with general bias toward protecting source based taxation.

In general, the treaties above provide for preferential tax treatment compared to rules that apply in the absence of treaties. For example, in the absence of a treaty, dividends income is subject to a tax rate ranging from 10% to 35%. In most treaties signed by Argentina however, dividend payments in a treaty situation are subject to a tax rate that ranges from 10% to 15%. Similarly, interest payments in the absence of a treaty are subject to a tax rate ranging from 15.05% to 35%. Whereas, in a treaty context, interest payments are subject to withholding tax rate ranging from

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250 See for example, Article 10 of the United Kingdom and Argentina double tax convention.
Further royalty payments in the absence of a treaty are subject to a withholding tax rate ranging from 21% to 31.5%, but in the event a treaty is applicable, the withholding tax rate for royalties can be reduced down to 3%. It should be noted however that certain requirements must be satisfied for application of the preferential treatment provided for by the bilateral income tax treaties.

**Transfer Pricing**

The law in Argentina includes transfer pricing rules generally applicable to transactions between related parties. The law also applies to transactions that do not involve related parties if the tax authorities believe or have reasons to believe that such transactions were not carried under the ALS principles. A regulatory decree in Argentina contains a list of countries that are qualified as low tax jurisdictions and any transactions with entities located in such jurisdictions are ipso facto considered not carried on under the ALS principles and therefore, subject to transfer pricing rules.

Argentina generally accepts five methods of transfer pricing analysis: the comparable uncontrolled price method; the resale price method; the cost plus method; the profit split method; and the transactional net margin method. However, in 2003 and under the General Anti-Avoidance Rules (“GAAR”), Argentina introduced a law that in fact provided for a new method of transfer pricing for the agricultural sector. The commonly known as the sixth method of transfer pricing, is still pending litigation as to its constitutionality in Argentina. Under such de facto sixth transfer pricing method, if exports of agricultural products with publicly quoted price are made to related parties and if an international intermediary who is not the effective purchaser

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251 See for example, Article 11 of the United Kingdom and Argentina double tax convention.
252 See for example, Article 12 of the United Kingdom and Argentina double tax convention.
of the products is involved in the transaction, the appropriate transfer price is deemed the higher of either the market quote on the day the products are delivered, or the transaction price.

To justify the use of any transfer pricing method, Argentinian tax authorities require that each taxpayer submit specific documents that are part and based on their mandatory transfer pricing study. The required documents include: special tax returns and other reports signed by independent certified public accountants.

Argentina has adopted debt-to-equity rules. Under general rules and as indicated above, transactions must be carried under the ALS principles. The debt-to-equity ratio in Argentina is generally 2:1. As a consequence, interests paid on liabilities in excess of the debt-to-equity ratio are non-deductible. Further, the disallowed interests’ deductions because of the debt-to-equity ratio limitations are treated as dividend distribution and may not be deducted in future years.
2) Panama Fiscal Environment: A Case Study

The Republic of Panama, as it is officially known, is a country in the most southern part of Central America, at the junction of North and South America. Along with Colombia, Panama was colonized by Spain and acceded to independence as part of Colombia. In 1903 however, Panama separated from Colombia to become its own country. According to the World Economic Forum’s for Global Competitiveness Index, Panama is the second most competitive economy in Latin America. With only over six million inhabitants, Panama is one of the fastest growing countries in Latin America. The relatively small size of the country makes it more realistic to analyze the impact, if any, of tax policy on the economy as a whole. Panama is known for its relatively clement tax system.

On an individual tax perspective, Panama taxes income of all those who qualify as residents, regardless of their country of citizenship. To qualify as a resident and be subject to tax in Panama, one must reside in Panama or must have remained in Panama, continuously or not, for a period of more than 183 days in a calendar year. Panama adopted a territorial system of taxation whereby all residents and non-residents are taxed only on their Panama sourced income. Panama taxes individuals on various types of income including employment income, self-employment income, investment income, dividend income, income from stock option plans, or education allowances. The individual income tax structure in Panama is the progressive income tax system with rates ranging from 0% to 25%. Panama draws no distinction in taxing Panama sourced income whether the person entitled to the income is resident of non-resident. All

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253 The World Economic Forum (“WEF”) is a Swiss non-profit organization based in Geneva. The organization is independent and dedicated to shaping regional and global industry agenda by engaging world leaders.
255 Id.
256 See Garay Eduardo González, The Panama trust in international tax planning, 17.5 Trusts & Trustees 401 (2011).
257 See Supra, at 254.
income sourced in Panama is subject to taxation in Panama, a principle that constitutes a basic foundation of the corporate tax system in Panama.

From a corporate income tax perspective, taxation in Panama is based on the territorial system of taxation. Therefore, any person whether individuals or entities are subject to taxation in Panama on any and all income derived or sourced in Panama. Resident branches and legal entities are all considered Panama residents. However, for entities, it is relevant whether they are incorporated in Panama or not; they will be subject to tax provided that they receive (and from wherever they receive it) taxable income produced within Panama.

**Taxes on Income and gain of Corporations**

As indicated above, corporations, partnerships, branches, and any other entity considered as a legal entity are subject to tax in Panama provided that they derive income from sources within Panama. As a consequence, businesses in Panama organized for the purpose of generating income outside of Panama and those companies would not be subject to taxation in Panama. Further, Panama has designated some income as not arising from Panama even when the activities are carried on Panama in order to encourage some activities. The sectors exempted include income from managing outside of a Panama office, activities that take place abroad, as well as certain invoicing and re-invoicing activities.

The general business income tax rate in Panama is 25%. The tax rate is applied on the all the entity’s income derived from sources within Panama, and after deducting exempt income and deductible expenses and costs. The income tax system is based on an accrual method whereby revenues have to be recognized in the year in which they are earned. Panama enacted the equivalent of a minimum tax regime for certain entities. In fact, entities with income exceeding a
certain threshold specify by law, the higher of either the liability arising from application of the regular corporate tax rate of 25%, or 4.67% of their total income taxable in Panama.  

**Capital Gains and Dividends**

Panama tax system designed a special treatment to capital gains income. Pursuant to a policy of encouraging investments and promoting economic growth, Panama allows for special tax treatment of various kinds of capital gain income. In Panama, capital gains derived from the transfers of shares or quotas are subject to capital gains tax if the shares or quotas were issued by a company with operations or assets in Panama. In 2006, Panama passed a tax legislation to regulate and provide more details on the taxation of various kinds of capital gains incomes. Under the 2006 tax law, taxable transfers of shares in Panama are subject to a 10% tax rate. The 2006 law required that the transforee of the shares withhold 5% tax on the transfer amount and remit it to the tax authorities within 10 days of the share transfer. The transferor is responsible for the remainder of the tax, if any, on the transfer. It should be noted that the 5% withholding tax upon the transfer operates as a credit toward the 10% capital gains tax required overall upon the transfer of the shares. The provisions of the 2006 law also apply to the indirect transfer of shares deemed economically invested in Panama.

Similar to the transfer of shares, capital gains derived from the transfer of movable assets as well as the sale of real estate are subject to income tax in Panama, at a rate of 10%. However, under

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258 In fiscal year 2014, the threshold amount was PAB 1,500,000. Therefore, any Panama taxable entity with taxable income over PAB 1,500,000 shall pay the higher of either the liability derived from the application of the 25% tax rate, or 4.67% of the entity’s total taxable income.

259 See Section 701(e) of the Panama Tax Code.

260 See Panama Tax Law N*18, June 19, 2016.
Section 1 of Law N*6 of 2005, a transfer tax is imposed on all transfers of real estate in Panama. The real estate transfer tax rate of determined at 2% of the higher of either the amount provided in the signed public transfer deed, or the cadastral value of the real estate in Panama. Transfers of real estate in Panama must be execute by a public notary for their validity, and the notary is required to obtain proof of payment of both the capital gains and the real estate transfer tax before they can execute the transfer deed.

Distributions of profits, by corporations, in the form of dividends, are subject to taxation in Panama. A newly formed company in Panama obtains a Notice of Operations upon incorporation. All companies that have the Notice of Operations or that generate income in Panama must pay a tax on dividends, at a rate of 10%. Panama recognizes the notion of Bearer Shares whereby the shares and therefore the interest in the company is owned by whoever possess the physical share certificates. Share certificates of bearer shares do not have names of the owners and transfer tax or other fees are applicable upon their transfer. In the event of distribution of dividend to holder of bearer shares, Panama requires a dividend withholding tax of 20%. It should be noted that Panama imposes a reduced and final withholding tax rate of 5% on dividend distribution from foreign source income, income from export activities, and certain types of exempt income. Dividends distributed by entities in free-trade zones are also subject to a reduced and final withholding tax rate of 5%. Many exceptions apply this general rule, including exceptions stemming from tax incentives.

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261 The Notice of Operations was formerly known as the Commercial License. The Panama Tax Law N*5 of January 11, 2007 streamlined incorporation in Panama, and specifically, the process of obtaining the Notice of Operations.
Tax and Other Investment Incentives

Similar to many other developing countries and small economies, Panama has enacted many forms of tax and other investment incentives to attract investment and promote economic growth. Tax incentives make Panama very appealing to investments and the economy has seen various forms of direct investments in recent years. The main incentives are the company headquarters law and the free trade zones.

The regulation of MNEs’ headquarters has the main purpose of attracting MNEs to Panama and encouraging them to maintain their headquarters there for their regional or global operations. The headquarters law created a special incentive for MNEs that establish their headquarters in Panama. The law indicates that headquarters of a company are entities engaged in activities such as management and services. Headquarters services which must be part of the entity ordinary course of business, include technical assistance, financial and accounting services, marketing and publicity, or logistic and warehousing. Also, to qualify under the law, the entity must have regional or global operations.

Qualified companies under the headquarters law receive a License to that end from the Ministry of Commerce and Industry. Licensed MNEs are exempt from income tax for services rendered to the entities domiciled abroad that do not generate taxable income in Panama. Licensed MNEs are also exempt from VAT on their export of services. The tax benefits are in addition to the non-tax advantage of a special immigration regime for management visas.

Panama has also adopted free-trade zones allowing special benefits to companies established therein. The main special free-trade zones include the Colon Free Zone, and Panama Pacifico Special Economic Zone. From a tax perspective, companies established in the special free-trade

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262 The Colon Free Zone is located on the Atlantic side of Panama.
zones are exempt from taxation in Panama. In some instances, such companies benefit instead of a reduced tax rate.\textsuperscript{263}

**Tax Treaty Network**

The territorial nature of the tax system in Panama and the fact that the country does not tax foreign income has led the country to not engage in tax treaty negotiations and to deem income tax treaties irrelevant to its circumstances. Until recently therefore, Panama had not engaged and had not signed many double tax agreements. In 2009, the OECD placed Panama on the “grey list” due to its unwillingness to cooperate internationally through tax treaties.\textsuperscript{264} In an attempt to be removed from the ‘grey list’ Panama engaged in a series of tax treaties negotiations culminating in its removal from the list in July 2011. Panama has executed bilateral tax treaties and exchange of information agreements with many countries including with France (2012), Portugal (2012), Singapore (2011), South Korea (2012), US (2011), Finland (2014), UK (2013), Canada (2013), Czech Republic (2013), Israel (2012), or Ireland (2012).

Panama Tax Treaty negotiations are largely based on the OECD’s Model Tax Convention and tend to favor residence based taxation. The Tax Treaties executed by Panama provide preferential tax treatment when a Treaty jurisdiction is involved as compared to non-treaty jurisdictions. In the absence of a Tax Treaty, Panama subjects interests, dividends, and royalties to the 12.5% withholding tax rate. However, in the presence of a Tax Treaty the withholding tax rate for the same interests, dividends, or royalties would be subject to withholding tax ranging from 0% to a rare maximum of 10%.

\textsuperscript{263} For example, companies located in the Colon Free Zone are exempt from corporate income tax; however, dividends distributions from those companies are subject to 5% tax rate.

\textsuperscript{264} See G20 Summit in London in April 2009 where the resolution was to put Panama on a “grey list” as a country that is committed but has not substantially implemented the internationally agreed standards of transparency.
**Transfer Pricing**

In Panama, transfer pricing is regulated by Law N*33, and the transfer pricing regulations apply solely to transactions between related parties. Article 762-C of Law N*33 provides a definition of related parties, including both horizontal and vertical relationship situations. Article 762-A of Law N*33 requires that all transactions between related parties satisfy the ALS principles. In fact, the law requires that such transactions be tested in comparison with similar but independent and unrelated transactions. Panama has adopted the following transfer pricing methods: the Comparable and Uncontrolled Price method, the Resale Price method, the Cost Plus method, the Profit Split method, and the Cost Plus method.

Law N* 33 does not however, provide guidance on how to search for comparables and the use of foreign comparables. The Tax Authority in Panama, the ‘Direcccion General de Ingresos’ (‘AGI’) reports transfer pricing provisions as the most difficult for them to administer and apply. Nevertheless, Article 762-D of Law N* 33 establishes the application of the OECD Transfer Pricing Guidelines to any transfer pricing matter that is not expressly addressed in the local law in Panama.

Panama tax authorities are allowed to require extensive documentation in the event of transactions within the transfer pricing regulations. Documentation may related to group ownership information, description of the transfer pricing policy of the group, identification of the related parties, description of the nature, amounts and characteristics of the payments involved in the transactions, detailed comparability analysis, or transfer pricing method used and the reasons for its use. The taxpayer has the burden of proving that the information provided is accurate and the AGI has the ultimate decision on the validity of the transaction from a transfer pricing perspective.
The transfer pricing regulations in Panama were limited to related parties in jurisdictions having executed a Tax Treaty with Panama. However, in 2012, Panama amended its transfer pricing rules to expand their application to all related parties’ transactions, regardless of whether the related parties are located in treaty or non-treaty jurisdictions.
C. Current International Tax Positions in Asia

Similar to Africa or South America, any regional study of Asia is bound to be imperfect. Countries in Asia, similar to North America or Western Europe are highly integrated from an economic point of view. Nevertheless, and similar to South America, or Africa, there is a lesser degree of homogeneity amongst Asian countries.\textsuperscript{265} In fact, there are large variations in policies across Asian countries. Countries across Asia differentiate on their size, their level of development, the political priorities, or their geographical situation. These major differences have an impact on major tax policies adopted by the various countries in Asia. When compared to other regional studies therefore, the case of Asia is particular, the many differences make improbable to get a general and harmonized picture as a whole. An analysis that aims to provide a general and complete picture of the tax atmosphere based on two sample countries is therefore futile. The differences and variations are too profound and their implication too consequential. Still, and in conformity with our previous approach, our choice of two countries aims at providing at least two aspects of those many differences, aspects that many countries in Asia would easily associate with. For our case study, we have selected two countries on the opposite end, a priori, to provide a closer look at the current Asian tax systems. At first, we will focus on Malaysia, a smaller country in terms of population\textsuperscript{266} and a relatively smaller economy. At a further end of the spectrum, we will look at Indonesia, a more densely populated country,\textsuperscript{267} with tax policies that carries a heavier impact on the economy, a priori.

It should be noted that most African countries rely on indirect taxes, specifically Value Added Tax (“VAT”) which since its introduction has usually followed an increased trend. The case studies below disregard the study of VAT and it specific impact in the selected jurisdictions.


\textsuperscript{266} The estimated population of Malaysia as of 2014 was of approximately 30 million inhabitants.

\textsuperscript{267} The estimated population of Indonesia as of 2014 was of approximately 250 million inhabitants.
1) Malaysian Fiscal Environment: A Case Study

Malaysia is a country located in Southeast Asia bordering Thailand, Singapore, Vietnam, and Indonesia. As a former colony of England, Malaysia is politically organized as an elective monarchy with executive powers resting on the Prime Minister. Malaysia became independent in 1957 and for decades after independence, the country enjoyed unique economic prosperity. Early from its independence and until the 1970s, the Malaysian economy relied heavily on natural resources, the mining sector specifically. However, deep in its independence years, Malaysia adopted politics to encourage and expand other sectors of the economy and other business sectors. In the 1980s, the country’s growth was mostly driven by the industrial sector, with large investments. A specific focus was on business sectors related to tourism, Commerce, and Science. The economic diversification policies contributed to a stronger Malaysian economy, ranking third in the Southeast Asia, and 29th largest economy in the world. Today, Malaysia is an open economy, oriented toward the industrialized and global market economy. The government aims to develop Malaysia as a developed country, and many economic and financial experts are optimistic about Malaysia becoming a developed country in a near future. In Malaysia, the state defines macro-economic policies and plans, and there is a notable state participation in the economy through various state owned enterprises.

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268 From its independence and up until approximately 2005, Malaysia enjoyed at least a 5% GDP growth per year. Sachs Jeffrey, and Andrew Warner, The curse of natural resources, 45.4 European economic review 827 (2001).
270 See Statements from Credit Suisse Managing Director Wong Wei-Shen, as reported in The Star (7 May 2012), "Malaysia got what it takes to be developed nation".
271 See for example, Malaysian Airline, Patronas, or Agrobank Malaysia.
The tax system present in Malaysia today has its roots from the country’s British colonial period. In fact, there was no unified tax law applicable all across Malaysia until 1967, with the passage of the Income Tax Act, which consolidated the various tax laws and created a unified federal income tax legislation. The Malaysian Inland Revenue Board (“MIRB”) is responsible of tax administration across the country, and is under the supervision of the Ministry of Finance. The MIRB is highly decentralized with considerable powers and discretion of the administration of the tax legislation. The dynamism of the Malaysian economy has led to an expanded tax base and ever increasing need for uniquely designed internal as well as international tax policies.

From and individual income taxation perspective, Malaysia has adopted a territorial system of taxation. Residents and non-residents of Malaysia are subject to taxation in Malaysia on all their Malaysian sourced income only. One is treated as a resident of Malaysia if they are physically present in Malaysia for a period of 182 days or more within a 365-consecutive day period. Malaysian tax legislation taxes individuals on various kinds of income including employment income, business profits, investment income, pensions and annuities, royalties and interest income, or stock options. Individual income tax rates are structured in a progressive structure depending on the amount of total taxable income of each individual. Malaysian individual income tax rates range from approximately 0 to 26%. Individual income tax rates can be affected by the very expansive tax treaty network subscribed by Malaysia, and such treaty network has a significant impact on corporate tax system.

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Taxes on Income and gain of Corporations

From a corporate tax perspective, Malaysia applies a territorial tax system. The Tax legislation of 1967 provides that corporations, residents and non-residents, are subject to tax on income accrued in or derived from sources within Malaysia. Income from sources outside of Malaysia is generally not subject to Malaysian taxation. Under Malaysian tax legislation, place of incorporation is irrelevant in determining the residence of a company. A company is a Malaysian resident if and only if its place of management and control is Malaysia.\(^\text{274}\)

Corporate tax rates in Malaysia are based on a set of circumstances and range from 0% to 38%. In general, corporations are taxed at a rate of 25% in Malaysia. For specific kinds of income the rate may vary significantly from the 25% general corporate tax rate. In fact, in Malaysia, income from interest, and royalties is subject to a 15% reduced tax rate.\(^\text{275}\) As we will see below, such rate is subject to further reduction if an income tax treaty applies. Further, income from use of movable assets, as well as certain other services in Malaysia is subject to a 10% reduced tax rate.\(^\text{276}\) For businesses the general rate of 25% is reduced to 20% if the paid in capital is less than MYR 2,500,000.\(^\text{277}\) However, for residents and non-residents companies carrying on petroleum operations, petroleum income is taxed at the higher rate of 38%.\(^\text{278}\)


\(^{275}\) Id.

\(^{276}\) See taxation of rental income from ships made by Malaysian Companies; or taxation of commissions and guarantee fees.

\(^{277}\) In general, companies with a paid up capital MYR 2,200,000 or less benefit from the 20% tax rate. However, such reduction is not applicable when the company with such paid up capital is owned by a company with a higher paid up capital amount.

\(^{278}\) See the Malaysian Petroleum Income Tax Act of 1967, as amended from time to time, imposing a general rate of 38% tax on oil and gas income.
The general tax year in Malaysia is the calendar year, however, companies may adopt their accounting year as their tax year and as a basis for assessment. Tax administration is based on the self-assessment methodology and concept. Companies may provide an estimate of their income and tax liability before entering their tax year, and shall make tax prepayments throughout the year with any balance due to be settled and paid at the end of the fiscal year.

**Capital Gains and Dividends**

Historically, Malaysia has applied an imputation system for taxing dividends. Under this historical system, the ability of a company to pay taxes was dependent on the availability of distributive reserves and any cost incurred in production or distribution of the dividend was deductible. The distributive capacity, known as the availability of “franking credits” or the “section 108 credits” made the distribution of any amounts above the available credits to be taxable at the ordinary corporate income tax rate in Malaysia.

However, in 2008, Malaysia introduced the single tier tax system, effective January 1, 2008. Under the single tier system of taxation of dividends in Malaysia, any distributions to shareholders as dividends are not subject to taxation in the hands of the shareholders. Income properly distributed to shareholders as dividends is exempt income for tax purposes. As a consequence, shareholders cannot deduct any expenses incurred in deriving the dividends and situations whereby a shareholder may claim a refund no longer exist.

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280 Under the imputation system, the money distributed as dividend was deemed to already have sustained a regular corporate tax rate. However, imputation allowed a shareholder to deduct any further expenses incurred in deriving the dividend. As a consequence, some shareholders were entitled to receive a refund upon distribution of dividends to them. The new legislation installing the single tier system of taxation for dividends makes the finds in the hands of the shareholder exempt income. All tax effects having been accounted for at the corporate level.
Under Malaysian tax legislation, dividends paid by resident companies are not subject to withholding taxation at source. The absence of withholding tax on dividends paid by Malaysian companies are a consequence of the single tier taxation and is in furtherance of Malaysian goals of facilitating and encouraging investments in the country.

In general, Malaysia has no capital gains tax. Gains from sale or exchange of stock for example are not subject to taxation as Malaysia does not provide rules for taxation of capital gains as a general principle. Nevertheless, Malaysia maintains a real property gains tax. The tax is levied on capital gains from the sale of real property located in Malaysia or the disposition of stock in closely held corporations with substantial interest is real estate. Depending on the holding period in the real property, the tax rate ranges from 0% to 15%. Under Malaysian law, purchasers of real property located in Malaysia must withhold a rate of 2% on the sale price of the real property. The legislation allows for losses incurred in the disposition of real property to be carried forward indefinitely to offset future real property gains. In 2014, Malaysia proposed a rate increase for taxation of gains from disposition of real property. Under the new proposal, gains from the sale of real property maybe taxed at a rate of up to 30%. The proposal was seen as an attempt by the Malaysian government to curb what they saw as an abuse of the real property preferential tax rates. The changes would also apply to the sale of stocks in company having a majority of their interest in real property.

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281 If the real property is held for two years or less, the tax rate on the gains from its disposition is 15%. If the real property was held for more than two years but less than six years, the tax rate on the gains from its disposition is 10%. And if the real property was held for six years or more, Malaysian tax law provides for a 0% tax rate on the gains, if any, from the disposition of the property.

282 See Malpezzi Stephen and Stephen Mayo, Getting housing incentives right: a case study of the effects of regulation, taxes, and subsidies on housing supply in Malaysia, Land economics 372 (1997).
**Tax and Other Investment Incentives**

As a developing country, Malaysia does not constitute an exception to the general urge by developing economies to implement tax incentives. Malaysia has a wide range of tax incentives aim at positioning the country as a regional hub for MNEs, and a hub for research and development.\(^{283}\) Malaysia also uses tax incentives to encourage activity in some sectors that the country deems desirable to its economy and its society. Throughout history, Malaysia has enacted various tax incentives including tax holidays, investment allowances, or reduced tax rates for selected industries or sectors.

The main incentive dates from 1990 when the Malaysian government enacted legislation that created a business center on the Island of Labuan with its distinct tax and regulatory regime.\(^{284}\) The legislation created a very friendly fiscal atmosphere for conducting business in Lubuan. In fact and with the exception of companies in the financial sector, companies need no government approval to operate in Lubuan. Companies in Lubuan are subject to a reduced tax rate of 3% on their business profits from their trading activities, and are authorized to transact business with other companies in Malaysia. Further, companies in Lubuan are exempt from the obligation to withhold on their payments to non-resident recipients. Lubian companies may also open and maintain, in Malaysia or abroad, bank accounts in foreign currency with no restrictions imposed on the movement of funds through these accounts. However, companies in Lubuan are free to make an election to taxed under the provisions of the Malaysian main tax law of 1967.

The other notable incentive is the Operational Headquarters Companies provisions. To attract more MNEs to locate their regional headquarters in Malaysia, the Operational Headquarters


\(^{284}\) See the Lubuan Island Act (1990) in Malaysia creating a separate tax and regulatory environment in Lubuan.
Company provisions were introduced in 2005 and amended in 2007 to provide for a ten year exemption from taxation for income derived from selected activities.\textsuperscript{285}

Finally, Malaysia provides for research and development ("R&D") incentives which many commentators have argued not sufficiently attractive. In fact Section 34(7) of the Income Tax Act of 1967 provides for a single deduction on scientific research. The government regularly distributes generous research grants, as well as double deduction for approved R&D,\textsuperscript{286} or an exemption of income for capital expenditures.

**Tax Treaty Network**

Malaysia has one of the most expansive tax treaty networks in Southeast Asia. With more than sixty bilateral tax treaties executed, Malaysia bases its treaty negotiations on the OECD Model Tax Convention. National tax legislations and provisions are preempted when a tax treaty is applicable. However, the national law will preempt application of a treaty of the national law provides for a more favorable treatment. Tax Treaties executed by Malaysia offer preferential tax rates on various kinds of income. For example, all dividends involving a treaty jurisdiction are not subject to taxation in Malaysia.\textsuperscript{287} Also, interest income under the treaty is subject to a tax rate as low as 5\%.\textsuperscript{288} Finally royalty income under the treaty is subject to a tax rate as low as 5\%.\textsuperscript{289}

\textsuperscript{285} See Malaysia PU(A) 307 of 2005 as Amended by PU(A)260 of 2007.
\textsuperscript{286} See Section s34A of the Income Tax Act of 1967. The R&D must be approved by the Minister of Finance.
\textsuperscript{287} See for example, Article 10 the Double Tax Convention between the United Kingdom and Malaysia (1998), as amended from time to time.
\textsuperscript{288} See for example, Article 11 the Double Tax Convention between the United Kingdom and Malaysia (1998), as amended from time to time.
\textsuperscript{289} See for example, the Double Tax Conventions concluded by Malaysia including with South Africa, Singapore, Spain, the UK, Namibia, or Sweeden.
Malaysia as a state incorporates the island of Lubian. Lubian has adopted several tax policies that have prompted some countries to consider qualify the Island as a tax haven. Some tax treaties executed by Malaysia explicitly prohibit their application to Lubian Island. In recent treaties, Malaysia has agreed to the exchange of information provisions, including for Lubuan companies. The signing of the exchange of information is seen as a step toward non qualification of the Lubuan Island as a tax haven for international tax dealings.

It should be noted however that the majority of tax treaties executed by Malaysia do not include treaty anti shopping provisions that are necessary to curb various forms of treaty abuse.

**Transfer Pricing**

Transfer pricing in Malaysia, like in many other parts of the world, is a constantly evolving story and structure. The transfer pricing legislation is largely based on the separate accounting and arm’s length standard principles. In 2003, Malaysia adopted the Transfer Pricing Guidelines that closely mirrored the guidelines among the OECD countries. In January 2009, Malaysia adopted specific Arm’s length and Advanced Pricing Agreements (“APA”) provisions to strengthen its transfer pricing environment. In May 2012, Malaysia enacted transfer pricing rules and APA rules to coordinate in transfer pricing regulations. In July 2012, Malaysia proceeded with a revision of its transfer pricing guidelines and enacted new APA guidelines.

The rules of 2012 placed a greater responsibility on the taxpayer regarding transfer pricing compliance. The rules expressed the need to prepare contemporaneous transfer pricing documentation to substantiate that transactions involving related parties are carried under the arm’s length standard. The guidelines provide a detailed list of information, documentation and records that need to be compiled regarding intercompany transactions. The taxpayer, however, is
not obligated to submit the above substantiating documentation with its tax return. In fact the documentation is only provided to the tax authorities upon request.

Malaysia enacted thin capitalization rules as well as other anti-base erosion and profit shifting measures.

In August 2010, the first and to date the only transfer pricing case was heard on an appeal to the Special Commissioner of Income Tax (“SCIT”).290 The issue posed was in regard to application of the arm’s length standard and use of comparables. The SCIT found for the taxpayer and the case is currently pending before the Malaysian high court.

Since enactment of the 2012 rules, companies have seen a spike in transfer pricing audits by Malaysian authorities and the difficulties to implement the complexities of arm’s length standards have led to various disagreements among taxpayers and tax authorities. There is reason to expect even more judicial controversies as the 2012 rules continue to be implemented.

Indonesia share border with New Guinea, Timor, and Malaysia.

2) Indonesian Fiscal Environment: A Case Study

Indonesia is a country in Southeast Asia officially known as the Republic of Indonesia, and comprising a multitude of Islands. With over 250 million inhabitants, Indonesia is the fourth most populated country in the world.291 Indonesia is one of the most diverse countries in the world, with more than 300 ethnic group and approximately 700 languages spoken on the territory.

Indonesia has a dynamic economy fueled by both public and private investment. Indonesia is the largest economy in Southeast Asia, largely based on the industry and services sectors, along with

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290 See the August 2010 first transfer pricing case heard by the Malaysian Special Commission on Income Tax (“SCIT”) witnessed by KPMG.

a non-negligible agricultural sector. The World Trade Organization also ranks Indonesia as one of the biggest exporting countries in the world with the major partners being Japan, Singapore, US, and China. Indonesia has various natural resources including oil, natural gas, copper and gold. The diverse profile of the country has made taxation in Indonesia an intricate issue of concern, with permanent struggles to strike a balance of a tax system that encourages investment while supplying enough revenues for the functioning of the government and the provision of basic public services to citizens.

The power to taxation in Indonesia is derived from Article 23A of the country’s Constitution of 1945. The legislative foundation in the area of taxation in Indonesia was further developed by the General Provisions and Taxation Procedures of 1983, and the Income tax law of 1983. Indonesian tax law adopted the worldwide system of taxation. Indonesian residents are taxed on all their income, wherever earned, whereas non-residents are only taxed on their income sourced in Indonesia. Indonesia adopts the calendar as the fiscal year, and taxes returns must be settled at the end of the year, after, generally, advances are made throughout the year.

From an individual tax perspective, all residents individual of Indonesia are subject to taxation on all their income. Under Indonesian tax law, an individual is a resident of Indonesia if they are present in the country for more than 183 days within any 12-month period, or if they resided in Indonesia within the calendar year, with intention to stay in Indonesia. The country subjects various kinds of income from individuals to taxation including income from employment, from

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292 The world bank estimated, in 2012, that 48% of GDP was based on the industry sector, 38% on the services sector, and 22% on the Agricultural sector. See World Bank: Indonesia World’s 10th Largest Economy, Jakarta Globe (May 2014).
293 Undang-Undang Dasar Republik Indonesia 1945, UUD ’45.
other business, or from investment. The individual tax rate structure follows a progressive tax rate system. Depending on the income, the tax rates range from 5% to 30%. The progressive individual income tax rate structure is unlike the corporate income tax rate flat structure.

**Taxes on Income and gain of Corporations**

Companies, residents on Indonesia are subject to income tax there, on their worldwide income, A company is a resident of Indonesia if it is incorporated or is domiciled there. In the event of corporate branches situated in Indonesia, they are only taxed on the amount of income derived in the country. In addition, Indonesia has adopted the force of attraction rule whereby income accruing from Indonesia to a foreign company having a PE in Indonesia is taxed as income of the PE if the business generating the income is of a similar nature to the business of the PE. Indonesian resident companies and companies operating in Indonesia through PE are subject to a corporate income tax flat rate of 25%. The income tax rate is reduced to 20% for all companies with at least 40% of their equity listed on and traded on an Indonesian stock exchange. Small and medium size companies (companies with gross turn over not exceeding IDR50 billion) are even entitled to a 50% reduction on tax rate. Indonesia imposes a branch profit tax of 20%. The branch profit tax is administered through withholding and it is payable regardless of whether the profits are actually distributed to parent companies of not. Indonesian tax law provides for an exemption to the branch profit tax if the income is reinvested in Indonesia.
Capital Gains and Dividends

Indonesia applies a tax on capital gains. For residents, capital gains are included on their ordinary taxable income and are subject to the regular income tax rate. Capital gains derived by non-residents in Indonesia are subject to a withholding tax determined at 20% of an amount of deemed income.\(^{296}\) The Minister of Finance established that the deemed income for sales of unlisted shares, on which the 20% withholding tax should be applied, is the equivalent of 25% of the gross sale proceeds. All sales or transfer of shares listed on an Indonesia stock market are subject to a 0.1% final withholding tax rate. An additional 0.5% tax rate is added in the event of a sale or transfer of shares by a founder shareholder. Sellers or transferors of the right to use land or buildings are subject to a tax at the rate of 5%.\(^{297}\)

In general, dividends paid to non-residents of Indonesia are subject to a final 20% withholding tax rate.\(^{298}\) Dividends paid to an Indonesian resident company are subject to a 15% withholding tax rate, which represents an advance payment on the dividend recipient’s tax liability. However, if the recipient of the dividend is resident of Indonesia, and owns at least 25% of the equity in the distributing entity, the dividend payment is exempt from taxation. If an individual resident of Indonesia receives dividends locally, the individual recipient of the dividend is subject to a final withholding tax rate, the maximum of which is set at 10%.

As indicated above, Indonesia adopts as a fiscal year, the calendar year. As a consequence, annual corporate income tax returns must be filed by the end of the fourth month following the fiscal year end. The government can extend the filing deadline by 2 months. It should be noted

\(^{296}\) Id.
\(^{297}\) The 5% rate is applied on the higher of either the transfer price or the government estimated value of the real property.
\(^{298}\) The 20% withholding overseas tax rate can be reduced if a tax treaty applies.
that companies are required to make monthly installment payments, throughout the fiscal year, of their tax liability and the balance is settled in the annual tax return.

**Tax and Other Investment Incentives**

Boosting investments and enhancing productivity are the main drivers of Indonesian tax and other investment incentive policies. The country aims to meet the competitiveness of the current global markets while reducing unemployment and poverty within its borders.

Indonesia has a long history of tax incentives. Early from the change of a nationalist government to an open market economy, Indonesia instituted a New Order in 1967, granting a five years tax holiday on foreign investments in the country.\(^{299}\) Very soon, in 1968, the incentive and five year tax holiday was expanded to apply to domestic investors as well. However, due to lack of concrete empirical evidence of the need for the generous tax incentives for increased investment, the whole tax holiday system put in place in 1967 and 1967 was abolished in 1984.\(^{300}\)

Upon termination of the tax holidays in 1984, many pressures amount on the Indonesian government to reintroduce the tax incentives or enact new attractive regimes to promote investments in the country. The government eventually caved to the pressures in 1994 by providing special regimes on oil and gas operations,\(^{301}\) and in 1996, by introducing new tax holidays with a different system of administration. In fact, the new tax holiday law was more discretionary and the tax holiday was set to apply on a case by case basis and to be administered by an intergovernmental organism chaired by the Minister in charge of economic affairs.

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\(^{299}\) The tax holiday covered, for 5 years, income tax as well as dividend withholding tax.


\(^{301}\) Exxon Mobile was awarded a special fiscal regime and was no longer subjected to general taxation in Indonesia.
The current tax incentives regimes available in Indonesia are largely based on the laws crafted in the late 1990s. First, the Tax Allowance Incentive, granted to qualifying resident companies provide them with accelerated depreciation and amortization; 10 year extension of tax losses carry forwards, a reduced tax rate of 10%, or a reduction of the net income tax by 30%. The above incentives only apply to new investments, or expansion of already existing investments in Indonesia. Second, Indonesia adopted incentives for certain taxpayers engaged in pioneer industry. The pioneer industry law, enacted in 2011, allows the government of Indonesia to determine what industries are pioneer for the country. If admitted, the investor in pioneer industry benefits from a 5 to 10 years corporate income tax exemption, followed by a 50% reduction in corporate income tax for 2 years renewable. The Indonesian government has explained the pioneer industries to include those that introduce new technology, provide high value added, or have strategic value for the nationwide economy. Third and finally, the Indonesian tax law provides for special tax rates as incentives in certain industries. For example, the oil and gas industry in generally subjected to a 20% tax rate; foreign drilling companies subject to 3.75% corporate income tax rate from their gross drilling income; or construction companies subject to a tax rate ranging from 2% to 6% of their contract value.

**Tax Treaty Network**

Indonesia has a wide tax treaty network with a number of countries both in the developed and developing world. The tax treaties generally provide for a more favorable tax treatment than the general tax law in Indonesia. From an individual tax perspective, tax treaties signed by Indonesia provide for relief of double taxation for individuals of treaty countries, deriving income in Indonesia. The model generally followed in Indonesian tax treaty negotiations follows
the 1920s consensus whereby active income is taxed at source and passive income taxed at residence.

From a corporate income tax perspective, tax treaties signed by Indonesia provide for reduced tax rates for the various forms of income earned in Indonesia by residents of treaty countries. Therefore, in the absence of a tax treaty and as seen above, dividend payments to non-residents are subject to a final 20% withholding tax rate. However, if a treaty country is involved, the tax is reduced, and under the current treaties signed by Indonesia, the tax rate ranges from 5% to a maximum of 15%. Similarly interest and royalty incomes under the treaties signed by Indonesia are subject to a tax rate ranging from 0% to 15%, compared to the 20% final withholding tax rate applicable from interest in the absence of a tax treaty.

Indonesia has adopted rigorous anti-treaty abuse rules and has granted the tax administration wide powers in the enforcement of tax rules related to treaties. It is therefore not uncommon for the Indonesian tax authorities to question and sometimes ignore the provisions of a tax treaty if the anti-abuse rules are not satisfied. Such expanded powers are also granted in the area of transfer pricing enforcement in Indonesia.

**Transfer Pricing**

Until recently, Indonesia was known as lagging in the area of transfer pricing. Compared to its neighbors including India and China, Indonesia was known not to be aggressive in its transfer pricing regulations and enforcement. In fact, since the tax law of 1984, the Indonesian tax authorities were granted power to review transfer pricing but rarely did so in practice. By the

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302 See Article 10, Income Tax Treaty between Indonesia and Hong Kong (Signed March 2010), available at file:///C:/Users/pougaza/Downloads/ASEAN_Indonesia_Hong%20Kong_DTA.pdf (last retrieved 2/2/2015).
year 2010 however, Indonesia was emerging as a mature transfer pricing jurisdiction with robust regulations comparable to those in the developed world. To date, Indonesia has contemporaneous transfer pricing documentation rules as well as Mutual Agreements Procedures and Advanced Pricing Agreements.

Indonesian tax law provides for the use of five traditional methods in determining the arm’s length pricing: the Comparable Uncontrolled Price method; the Resale Price method; the Cost-Plus method; the Profit Split method; and the Transactional Net Margin method.

Indonesian tax legislation requires that related parties transactions be carried at arm’s length and in a commercially justifiable way. The tax authorities require that the taxpayer maintain documentation to prove arm’s length character of related parties’ transaction for at least 10 years, and the burden is on the taxpayer to prove that the transaction was carried at arm’s length. Transfer pricing scrutiny has increased in recent years as the government and tax authorities aim to counter phenomena of base erosion and profit shifting. Transfer pricing audits have increased, and the government is more proactive in issuing Advance Pricing Agreement in transactions between related parties in order to mitigate ex post transfer pricing disputes.304

The analysis above of the current international tax structures in various developing countries jurisdictions provide a basis for the argument that most countries, including in the developing world, are struggling the question of how to best approach taxation of international income. As they deal with the question, developing counties are continuously encountering various problems and many tax systems globally, suffer deep ills in their attempts at international income taxation.

Chapter IV

Current Ills of the International Tax System
Most academics do not like to talk about an “international tax system” because, they argue, it really is a set of rules adopted by domestic jurisdictions so they constitute in fact national tax systems. A look, in this part of the research of the international tax system does not suggest that there is an overarching tax structure, above countries, and that govern all countries. In fact, the analysis of the international tax system here refers to the way in which different countries and some international organizations provide for the taxation of international income. The international tax system is therefore the framework put in place, sometimes similar and other times dissimilar, amongst the various countries to deal with issues on taxation of international income. International tax system will thus refer to the taxation by a country of the income of those persons who earned income there without claiming residency, and those persons who are residents in said countries but earn income abroad.

At the outset, it is important to note that the international tax system, as it currently stands, lives and dies with the arm’s length principle. As indicated above, the international tax system was created to eliminate instances of double taxation. The mechanics proposed aroused much debate but the consensus of taxation of active income as the source jurisdiction and passive income at the residence jurisdiction quickly became the universal norm and most countries subscribed to it. As the economic activity grew and companies became bigger in an international stage, the international tax structure faced significant issues posed by related operations and related companies transactions. The question was how to access the true economics of a transaction when the parties involved are related and do not possess divergent interests. The solution painfully designed and widely accepted was to require the related parties to deal at arm’s length. The ALS was adopted as a means to look at the transaction, disregarded its related parties character and assure that the true economics of the deal, the arm’s length price, are achieved. ALS is the current cornerstone and the relatively beloved bedrock of the international tax system.

306 Id.
The success, now admittedly outdated, of the international tax system was because of the successes and merits of the ALS. 308 The failures, more contemporaneous, of the international tax system are because of the shortcomings of the ALS. 309 The ills of the current system can therefore directly be traced to the shortcomings of the ALS. We will look at the current international tax ills on a global scale (A), and then will focus on the specific struggles of developing countries with the current system (B), before looking at the current OECD BEPS project as a case study of global failure of the current system (C).

A. International Tax Ills Globally

It is important to clarify at the outset that the distinction between tax avoidance and tax evasion bears a significant merit when it comes to tax enforcement.\textsuperscript{310} Tax avoidance is legal and consists of the use of available laws to minimize one’s tax liability and exposure. Tax evasion however, is illegal and consists of the non-application or misapplication of the tax legislation. As deserving of attention that the distinction is, our research looks critically at both tax evasion and tax avoidance for it has been shown in practice that the line is not that easily drawn.\textsuperscript{311} Further, any attempt to influence policy, we believe, ought to critically look at the legal tax avoidance schemes that lead to the discredit of the tax system as a whole. Our analysis shows how broken the current international tax system is also through how many and how easily achievable tax avoidance schemes are available.

The outcry is currently global regarding the failures of the international tax system. Developed and developing countries, large and small business, civil society, the media, international organizations, specialized groups, and various tax observers seem all to agree on one proposition: the current system is broken. The system does not seem to work neither for governments, nor business. In the meantime, the view in civil society is that taxes are only paid by the naïve; world citizens increasingly express their feelings that wealthy individuals are corporations not only choose what taxes to pay, if any, they also seem to easily decide where to pay the tax.\textsuperscript{312} The president of the American Chamber of Commerce vociferously lamented that

\begin{footnotesize}
\textsuperscript{312} See Houston Jodie and Alfred Tran, \textit{A survey of tax evasion using the randomized response technique}, 13 Advances in taxation 69 (2001).
\end{footnotesize}
US international tax rules were rigged against US MNEs and at the same time, Congress indicated that a number of companies, on a global scale paid an effective tax rate shy of 10%. In the UK, the company Starbucks was reported to have accumulated about $700 million in sales in 2012 and paid no taxes. Similarly, the company Amazon was reported to have realized approximately $4 billion in sales in 2011 in the UK and paid just about $2 million in taxes. For its part, the company Google accumulated about $500 million and paid approximately $7 million in taxes. There is overwhelming amount of evidence that profits appear in countries inconsistent with economic motivation. As indicated in Table1, a study in location of US MNEs profits as of 2005 suggested very little about their economic operations and a lot more about their tax rate shopping. Table2 indicates the percentage of Fortune 500 companies with subsidiaries in tax heavens.

315 Id.
### Table 1: Top 6 countries where profits of US MNEs are located and tax rates (2005)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Countries</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Netherlands</td>
<td>5.10%</td>
</tr>
<tr>
<td>2</td>
<td>Luxembourg</td>
<td>0.90%</td>
</tr>
<tr>
<td>3</td>
<td>UK</td>
<td>28.90%</td>
</tr>
<tr>
<td>4</td>
<td>Bermuda</td>
<td>0.90%</td>
</tr>
<tr>
<td>5</td>
<td>Ireland</td>
<td>5.90%</td>
</tr>
<tr>
<td>6</td>
<td>Switzerland</td>
<td>3.50%</td>
</tr>
</tbody>
</table>
Table 2: Top tax heavens with US Subsidiaries from Fortune 500 companies (2013)
The question is how are companies able to achieve that? How is the current international tax system unfit? What are the main areas of weakness within the system? How can one locate profits in a jurisdiction in which they have minimum to no operations? Several schemes and methods are used by companies and their explanation goes a long way to showing the flawed character of the current international tax system.
1. The Transfer Pricing Global Dysfunction

Transfer pricing is one of the most challenging issues in international taxation for MNEs, tax administrators and tax policy makers. The basic transfer pricing situation can exist in the example below: imagine a scenario where a US MNE that manufactures Phones in the US, owns valuable intangibles related to the know-how and the marketing of the phones. US MNE would like to expand its business to Cameroon where intellectual property rights are not properly protected. In order to avoid the intellectual property being compromised, US MNE to create a wholly owned subsidiary in Cameroon (“Cam Sub”), responsible for selling the US manufactured phones to the Cameroonian market. The decision allows US MNE to expand its business to Cameroon while avoiding the independent local distributors and minimizing the risk of compromising its intellectual property rights. However, the relationship between US MNE and Cam Sub is an intra-group relationship and US MNE has large discretion on the prices it sales to phones to Cam Sub for resale to final customers.

In fact US MNE can easily use such pricing discretion in its interaction with Cam Sub to implement various international tax planning technics. 318 For example if we assume US MNE incurs a cost of $25 to manufacture a phone, and Cam Sub incurs $25 to distribute the phone in Cameroon. The phone is sold to the final customer for $100. If US and Cameroon were the same tax jurisdiction, there would be no issue as US MNE and Cam Sub would file consolidated returns showing a net gain of $50 ($100 - $25 - $25). However, since US and Cameroon are two separate tax jurisdictions with presumably different tax rates, the allocation of the income between the two jurisdictions will

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be dependent on the price charged to Cam Sub by US MNE in the their intra group transaction. Assuming neither party wants to operate at a loss, the minimum price acceptable by US MNE is $25 (equivalent to the amount it incurs to manufacture the phone) and the maximum price acceptable by Cam Sub is $75 (representing $25 of its cost and the $50 maximum profit he can get from the final consumer). There is therefore, a continuum of possible prices at which US MNE can charge the manufactured phone to Cam Sub.

If we assume that the US has a higher tax rate than Cameroon, US MNE and Cam Sub would structure the transaction so as to charge for the phone as low a price as possible. Under this scenario, US MNE would be inclined to charge Cam Sub $25 (the minimum US MNE can accept) for the manufactured phone. As a consequence and after incurring an additional $25 for distribution, Cam Sub would sale the phone to the final customers in Cameroon for $100 realizing a profit of $50. Because of the intra-group price, the MNE has managed to locate all its profits from the manufacture of the phone to Cameroon, the lower tax jurisdiction.

If conversely, we assume Cameroon has a higher tax rate than the US, US MNE and Cam Sub would structure the transaction so as to charge for the phone, as high a price as possible. Under this scenario, US MNE would be inclined to charge Cam Sub $75 (the maximum Cam Sub can accept) for the manufactured phone. As a consequence, and after incurring an additional $25 for distribution, Cam Sub would sale the phone to the final customers in Cameroon for $100 realizing no profit. Because of the intra-group price, the MNE has managed to locate all its profits from the manufacture of the phone to the US, the lower tax jurisdiction.

As seen in the illustration above, the flexibility to determine the price in the related party context is unavailable in the circumstance of unrelated independent parties involved in a transaction. The
determination of intra-groups prices known as transfer pricing, cause two major problems: first and as illustrated above, transfer pricing allows for manipulations on the location of profits and defeats the purposes of taxation. In addition, transfer pricing harms competition as it is only available to big MNEs and provides a flexibility that local small companies do not possess. The net effect of transfer pricing in to increase the after-tax profits of the MNEs as a group. The profits, wherever located, belong ultimately to the same shareholders of the group.

Since the implementation of the first regulations in this area in the UK in 1915, tax legislations continue to struggle in their attempts to find ways to police transfer pricing and curb its abuses. From these attempts, a regulation emerged, that now enjoys international recognition: the ALS. As a basic principle, the ALS attempts to impose to intra-group transactions, the realities of similar transactions but amongst unrelated parties. As such, the ALS was conceived a system that requires related parties to set the prices of their transaction in similar manner independent parties would set the prices in comparable transactions. ALS therefore consists of comparing intra-group transactions to open market transactions and taxing them accordingly. Transfer pricing leads to various adjustments in the event the intra-group pricing does not agree with the independent parties’ open market transactions. At its inception transfer pricing regulations remained unclear as to how to assure a reasonable and comparable price leaving courts to use their best judgment as to what transfer price was at arm’s length. In 1968, the US adopted regulations that provided for methods of enforcing arm’s length. Originally, there were three methods (known as the traditional methods) to access the reasonableness of intra-group pricing. The OECD quickly incorporated the traditional methods in its transfer pricing guidelines of 1977. However, due to the various limitations of the traditional methods observed in practice, policy makers adopted two additional methods. We will review the methods consecutively.
The first transfer pricing method (one of three the traditional methods) is the Comparable Uncontrolled Price ("CUP"). Under this method, the transaction between the related parties is compared to a transaction in the same good or service, in the same market, under similar conditions, but between unrelated parties. The CUP method is only useful is the goods or services are standard enough that they can be found in the open market. There is a requirement that the comparable be close to the actual transaction if not identical to the actual transaction except that it is occurring between unrelated parties unlike the actual transaction which is between related parties. If such comparable is found, the transfer price is adjusted to the price in the comparable transaction and taxed accordingly. The main issue with this method is that it is very hard if not impossible nowadays to find transactions as close to the intra-group transactions. It is hard, if not impossible to find comparables. MNEs today have grown so large and continue to grow very large and distinguish themselves for offering innovative products and services, products that are not available in the markets and have no real comparables. The case of patented products is a telling example where exact comparables required under the CUP method cannot and are not supposed to be found. The CUP method is therefore fundamentally flawed and unfit for current business practices of the MNEs world.

The second transfer pricing method (one of three the traditional methods) is the Cost Plus. The cost-plus method compares gross margins of controlled and uncontrolled transactions. Under this method, the arm’s length price is measured by adding an appropriate gross profit to the controlled taxpayer’s cost of producing the property involved in the controlled transaction. Under Cost Plus, the amount needed to produce is added to the prevalent profit margin (from uncontrolled transactions) to determine the arm’s length transfer price. The main issue with the Cost-Plus method is its limited scope. The method is ordinarily used in cases involving the manufacture,
assembly, or other production of goods that are sold to related parties. Cost plus is only useful, like CUP is there are comparables, and Cost Plus is most appropriate for the manufacturing and assembly industries. Today’s economy is less reliance on brick and mortar and the search for comparables remains a lacking endeavor.

The third transfer pricing method (one of three the traditional methods) is the Resale Price Method (“RPM”). The RPM evaluates whether the amount charged in a controlled transaction is at arm’s length, by reference to the gross margin realized in comparable uncontrolled transactions. Under this method, the arm’s length price is measured by subtracting an appropriate gross profit from the applicable resale price of the property involved in the controlled transaction. RPM uses Comparable profitability, and comparable profitability is determined by calculating the ratio of the initial purchase price of comparable tangible goods to their resale price to an unrelated party. This ratio (expressed as a percentage) is then used to calculate the value of the goods in a related-party transaction. Like the other traditional methods, the RPM relies heavily on the availability of actual comparables; however, as we have seen, exact comparables are very difficult if not impossible to find. Further the workings of this method gives it a relatively limited scope as the RPM is most often used for distributors that resell products without physically altering them or adding substantial value to them. Current economies, as indicated above rely as much on intangibles and alterations in the chain are common practice. All three traditional methods require a high standard of comparability. In practice, however, such comparability has been difficult to establish prompting the OECD to amend its transfer pricing guidelines in 1995 in order to add two new methods, which arguably require a lesser degree of comparability.

The fourth transfer pricing method (one of the two additional methods) is the Comparable Profits Method (“CPM”) which is also known as the Transactional Net Margin Method (“TNMM”). This
method evaluates whether the amount charged in a controlled transaction is at arm’s length by comparing the profitability of one of the parties to the controlled transaction (the “tested party”) to that of companies that are similar to the tested party. The advantage of this method is that it draws not from comparables in the same industry; instead, the method uses reasonably similar industries. The analysis of the reasonably similar industries would provide a range of prices allowing for a curve where the bottom 25% and the top 25% of the curve are excluded. If the profits realized on the controlled transaction fall within the middle 50%, no further analysis is required. However, if the related parties’ transaction does not fall within the middle 50%, then tax authorities are allowed to proceed to adjustments. The main weakness of this method is that it requires a tremendous amount of available information in order to examine a wide range of reasonably similar transactions for a reliable curve. Tax authorities have difficulties assembling this information and big four accounting firms have establish a de facto monopoly for these analysis and charge a considerable amount for their services. CPM is therefore not available to small companies (since they cannot afford the services of the accounting firms) and tax authorities do not have all the necessary information to potentially challenge the position taken by MNEs of a transfer price reasonably comparable to the open market price.

The fifth and last method (the second of the two additional methods) is the Profit Split. This method allocates operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses. Relative contributions must be determined in a manner that reflects the functions performed, risks assumed, resources employed, and costs incurred by each party to the controlled transaction. After the functions of the related parties are analyzed and a standard market based return is assigned to them based on publicly available data, the residual, if any, is to be assigned and there is disagreement as to who
gets assigned any residual of profits. Under US law, the residual, if any, should be assigned to the developer of the group’s intangibles due to the presumption that intellectual property is responsible for the residual. This view is not shared by the OECD which is yet to determine how the residual should be assigned. Many countries, specifically developing countries, are left to guess if and when they are skilled enough to get to that point.

The various transfer pricing methods reveal their imperfect nature and the continued effort to designed better technics to curb abusive use of transfer pricing. The global and relentless litigation on the issue is testament that transfer pricing is an existential threat to the integrity of the international tax regime and might support an extreme view of the complete elimination of its necessity, as argued in this dissertation, through the use of Unitary Principles. We will look at the case law and transfer pricing litigation in various sample countries.

In the US, the struggles with transfer pricing and its consequences have a long history. As argued by Professor Reuven Avi-Yonah, the history of transfer pricing in the US can be traced along with that of the ALS. Transfer pricing cases therefore can be traced and tied to the period or either rise or fall of the ALS. Before the adoption of use of the ALS by courts, transfer pricing disputes were litigated and decided on, on the basis whether there is ‘clear reflection of income’ or rather, ‘evasion of taxes’. For example, in *Seminole Flavor Co. v Commissioner*, the Tax Court indicated that to determine whether the transaction is arm’s length, one should not wonder whether unrelated parties would have entered into a similar transaction; instead, the inquiry should be as to whether the actual transaction was fair and reasonable. For some Courts in this

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320 See e.g. Asiatic Petroleum Co. v. Commissioner, 31 B.T.A. 1152 (1935); aff’d 79 F.2d 234 (1935).
321 See *Seminole Flavor Co. v Commissioner*, 4 T.C. 1215 (1945).
era, the comparison with independent and unrelated parties to determine arm’s length was irrelevant and unnecessary. On the other hand during the same period, other courts applied the ALS in deciding transfer pricing disputes, leaving total uncertainty as to the standard to be applied in transfer pricing cases. For example, in Hall v. Commissioner, the Tax Court used comparables from uncontrolled and unrelated transaction to adjust the otherwise price set at 90% to 10%. The Court indicated that gross income has been arbitrarily shifted and the Commissioner adjustment ‘reflected Hall’s income as if he had been dealing with unrelated parties.’ Finally, in late 1960s, the legislation attempted to settle the debate by requiring that transfer pricing methods and ALS principles relying on comparables be used in examining the cases. The Courts eventually agreed that for all Section 482 cases, ALS should be mandatorily used to determine if an adjustment is necessary. This period marked the rise and pinnacle of the ALS which soon came to wide scrutiny.

Early in the 1990s, there was emerging a wide realization that the sacro saint principle established in late 1960s, the ALS, did not work in the large majority of cases. Repeatedly, the government lost in trial because most situations could not be properly examined under the ALS due to the lack of comparables. Various cases prompted this realization and the outrage therefrom. In U.S. Steel Corp. v. Commissioner for example, US Steel owned a Liberian subsidiary, Navios which it used to ship steel to the United States. The prices set by Navios were set in a way that it would allow a match with the prices of the domestic steel manufactured in the

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322 Id., See also Palm Beach Aero Corp. v. Commissioner, 17 T.C. 1169 (1952) (With the court stating a ‘fair compensation... reflects arm’s length dealing’).
323 See Hall v. Commissioner, 32 T.C. 390 (1959), aff’d 294 F.2d 82 (5th Cir. 1961).
324 Id.
325 See 1968 regulations to Article 482. (Treas. Reg. 1.482-2).
327 See U.S. Steel Corp. v. Commissioner, 617 F.2d 942 (2d Cir. 1980).
US. Navios which also shipped very minimum amounts of steel for unrelated parties, did so at the same price as its intra group pricing. The Tax Court ruled that the internal price was not at arm’s length. However, the Court of Appeal reversed and argued that because Navios charged the same amount to unrelated albeit negligible parties, the intra-group price was at arm’s length in the absence of other comparables. Even the *E.I. Dupont de Nemours & Co. v. United States*\(^{328}\) where the government had a sounding and last major victory in transfer pricing litigation in the US, many commentators have attributed such victory to the internal damaging memorandum of the taxpayer revealed in court, instead of a clear understanding and application of the ALS methods. In recent years, many transfer pricing disputes have come through the umbrella of Cost Sharing Agreements and continue to show the lacking character of the ALS through resounding taxpayer victories at trial.\(^{329}\)

In Germany, the struggle to prevent companies from shifting taxable profits out of or into Germany by way of inappropriate transfer pricing arrangements has led to the creation of five basic defense mechanisms with respect to adjustment of income and has generated extensive litigation. The defense mechanisms are: (1) attribution of assets and income and determination of tax base;\(^{330}\) hidden profits distribution;\(^{331}\) hidden capital contribution;\(^{332}\) deduction of corporate interest cost;\(^{333}\) and the adjustment of income in the case of business connections abroad.\(^{334}\) All five defense mechanisms are designed to curb abusive transactions and allow for appropriate adjustment whenever necessary, even though litigation. For example, in 1986, the German

\(^{328}\) See *E.I. Dupont de Nemours & Co. v. United States*, 608 F.2d 445 (Ct. Cl. 1979).

\(^{329}\) See *Xilingx Inc. v. Commissioner*, 125 T.C. 37 (2005) and subsequent history. See also *Veritas Software Corp. v. Commissioner*, 133 T.C. 14 (2009).

\(^{330}\) See Section 39 to 42 of the German Fiscal Code (Abgabenordnung).

\(^{331}\) See Section 8(3) of the German Corporate Tax Act (Korporationssteuergesetz).

\(^{332}\) See Section 8(1) of the German Corporate Tax Act (Korporationssteuergesetz).

\(^{333}\) See Section 8a of the German Corporate Tax Act (Korporationssteuergesetz).

\(^{334}\) See Section 1 of the German Foreign Tax Act (Aubensteuergesetz).
Federal Tax Court dealt with the transfer of an operating unit between sister companies without compensation for the goodwill involved in Decision IR 150/82. The Court found that the transfer constituted a hidden distribution of the goodwill to the common parent and a subsequent contribution by the common parent to the subsidiary. Also, the Court ruled that substantial losses over a three-year period elicit a presumption that the agreed transfer price is inappropriate if the transaction is intra-group. The presumption, the Court indicated, is rebuttable and taxpayer can show that the losses over three years are not due to an inappropriate transfer price. This decision caused the German legislator to engage in an overhaul of the regulations concerning taxpayers’ documentation and cooperation in the area of transfer pricing. It should be noted that transfer pricing litigation has increased in Germany in recent years. Further, other methods of resolving transfer pricing disputes are used in Germany and are arguably preferred. The other methods include technics used through Double Tax Treaties, Mutual Agreement Procedures, Advanced Pricing Agreements, and Arbitration.

In Australia, there has been a long history applying transfer pricing principle and the ALS. The long history of Australia with transfer pricing offers a rather rich jurisprudence, mostly made of settled cases. Overall, the Australia Tax Authority (“ATO”) does not hold an impressive record of winning transfer pricing cases. Similar to the US, transfer pricing litigation in Australia is mostly won by taxpayers. However, the ATO regularly settle cases with taxpayers, leading to considerable payouts from taxpayers, mostly due to procedural mishaps from the taxpayer. Additionally, there has been an increasing importance afforded to alternative methods of dispute

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335 See Bundesfinanzhof, Judgment of 20 August 1986, I R 150/82, bsTBI II 1987, 455.
338 Australia adopted a transfer pricing legislation in 1921. See P.A. Harris, Metamorphosis of the Australian income Tax: 1866-1922 (Sydney 2002).
resolution. Arbitration is very often used in transfer pricing litigation in Australia. Similarly, Advance Pricing Agreements and Mutual Agreements Procedures are increasingly used as a way to avoid or decrease future disputes between the ATO and taxpayers.

Current transfer pricing rules in Australia are based on the Income Tax Assessment Act (“ITAA”) of 1936, and continue to produce ample disputes, specifically on the method used to establish transfer prices. One of the main and recent cases decided in the Administrative Appeals Tribunal of Australia (“AATA”) is the Roche Products v. Commissioner of Taxation litigation. The main question before the court was the appropriate transfer pricing method to be used to determine whether prices are arm’s length. The case was initiated because the ATO determined that the Australian subsidiary of the Swiss Roche Pharmaceuticals Group was insufficiently profitable due to the overpayments made to affiliated group companies located in Switzerland and Singapore. Both parties to the litigation both forward a number of experts to examine the method used by the group for transfer pricing, but also to establish a possible arm’s length price for the transactions. All four expert testimonies were different. Each expert arrived at a different conclusion and used slightly different information, methodologies, and adjustments. The tribunal and judges had a tremendous amount of difficulties resolving the case due to conflicting expert testimony along with very conflicting interpretation of the rules from the ATO and the taxpayer. At the end, the tribunal aligned itself with most of the taxpayer’s claims and believed in taxpayer’s experts. The ATO lost in all its claims but one. The acknowledged that pharmaceutical companies rarely sale their products through independent sellers. Instead they use related parties for distribution of the drugs and other products. As a consequence, the tribunal

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reasoned, there is usually no free market in which these products are sold and there are rarely comparable markets for such products. This analysis is not only true for pharmaceutical companies; it is true for most MNEs in the 21st century. The differences in this case provide an explanation as to why most transfer pricing cases are not litigated.

Another case, SNF (Australia) v Commissioner of Taxation,341 was litigated in the Federal Court of Australia and centered on a substantive transfer pricing issue of applicable transfer pricing methods in determining the arm’s length price. Again, the court decision was largely unfavorable to the ATO which sought to recast sales at a lost to a related party. Similar to the Roche Products case, there were remarkable difference amongst the experts who testified and the court ultimately indicated that there was no prescribed transfer pricing method that a taxpayer shall use, but rather it was up to the courts to decide whether the one used by the taxpayer was accurate in establishing the transfer price. The court held, on first instance, that the prices paid by SNF (Australia) were equal in some cases, to prices paid by unrelated parties; rejecting the ATO’s TNMM approach establishing otherwise. The ATO appealed the decision to the full Federal Court.342 On appeal, the Federal Court, after acknowledging some mistake in the first instance, nevertheless upheld the decision and rejected the ATO’s appeal; another resounding victory in a major transfer pricing case in Australia.

In Brazil, the rules and legislative structure around transfer pricing are relatively recent. In fact, the 1990s saw Brazil switch from a territorial tax system to a worldwide tax system;343 and it is only in 1996 that Brazil enacted its transfer pricing legislation.344 Since then however, Brazil has

341 See SNF (Australia) v Commissioner of Taxation, FCA 635 (2010).
342 See Commissioner of Taxation v SNF (Australia), FCAFC 74 (2011).
The study of transfer pricing in Brazil is of particular interest because the country does not necessarily align with the internationally known principle of ALS. In the original transfer pricing legislation of 1996, the legislator in Brazil indicated its intent to adopt and comply with the internationally accepted ALS. However, in the making of the law, Brazil endeavored to incorporate the necessary and practical limitations to the ALS. Aware of the compliance and enforcement cost that are necessary with the ALS, the legislator in Brazil aimed to adopt a transfer pricing legislation efficient enough to mitigate those costs, albeit at the behest of completely embracing the ALS. The law in fact establishes a presumption for acceptable prices and charges. The presumptions allow the tax authorities in Brazil to decide on a case without having to go through the lengthy and uncertain procedure of determining the accurate price through comparables. The legislator basically established workable parameters, which do not totally align with the exigencies of the ALS. The Brazilian system relies of legislative benchmark for its comparability analysis, and uses the presumption in determining the arm’s length price of related parties’ transactions. Although this is a departure from the internationally accepted ALS driven by the OECD, it is worth nothing that Brazil is not a member of the OECD and OECD guidelines and rules are regularly referred to by Brazilian judges as secondary laws, laws with secondary authority. Nevertheless, the law recognizes the three traditional transfer pricing methods in arriving at the arm’s length price through application of the legislative benchmarks.

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345 In Brazil the presumptions are referred to as iuris tantum a recognition by the law of how much should be charged, unless proven otherwise.
In 2005, the Administrative Taxpayers’ Council reached a decision clarifying Brazilian transfer pricing rules. In this case, the tax authorities prohibited a taxpayer, a pharmaceutical company, from using the RPM in applying the legislative benchmarks and establishing the arm’s length price. The tax authorities reasoned that the RPM could not apply to imported goods where the goods are further manufactured in Brazil before their ultimate sale. The judge in first instance agreed with the tax authorities and upheld the tax authorities’ decision to not apply RPM for imported goods that are further manufactured locally before sale. On appeal, the Administrative Taxpayers’ Council reversed the decision. The appeal judges indicated that the law allows taxpayers to use any of the three traditional transfer pricing methods to establish the arm’s length price and that the tax authorities had no power to exclude that. The appeal judges underlined that even though the OECD guidelines would preclude the use of the RPM in similar situation, OECD is merely secondary law in Brazil, and cannot override the express provisions of the Brazilian tax legislation which allows taxpayers to choose any of the three pricing methods. This decision is very important in many regards. One of the aspects that this decision clarifies is that if the transfer pricing rules in Brazil are in contradiction with the internationally accepted ALS, or if they are contrary to the OECD guidelines, there is direct and unquestionable primacy of the local transfer pricing provisions.

Facing the growing transfer pricing disputes, the Brazilian government continues to encourage alternative methods of dispute resolution and encourage taxpayers to dialogue with tax authorities, a premise that was set early on, in Article 21 of the 1996 founding transfer pricing tax legislation. The 2010 law that revisits the 1996 law and

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347 Id., But see Decision N* 103-21.859 (2005) (where the courts recognized that a binding tax treaty signed by Brazil would overrule domestic rules in case of contradiction.)
reshapes the use of benchmarks emphasizes the need for a dialog between taxpayers and the tax authorities to minimize transfer pricing disputes.348

In Chile, transfer pricing rules were not adopted until the late 1990s. Up until then, Chile approached transfer pricing transactions with the general tax provisions and the notion of ‘fair value’.349 In the past two decades however, Chile has engaged in an effort to increase its participation in the global markets by actively seeking to reduce barriers to outbound investments, while providing incentives for inbound direct investments from foreign companies. For that end, Chile joined the OECD and signed dozens of bilateral tax treaties.350 Effective January 1, 1998, the Chilean government enacted transfer pricing legislation and regulations and formally introduced the ALS to the Chilean system.351 Although the regulations are largely based on the OECD concepts and ALS foundation, there are slight details and practical adaptations as to how the ALS should be applied.352 Further, there has not been enough detailed legislation on the application of the Chilean transfer pricing documentation above and beyond the general provisions. For example, Chile allows several transfer pricing methods to be used in arriving at the arm’s length price. One of the methods is the ‘reasonable profitability’ method for which the law does not attach a specific meaning.353 The law only states that arm’s length price should be arrived at through comparison of the controlled transaction with the uncontrolled similar transactions, however no mechanisms as to how the comparability analysis should be done or how the adjustments should be made are provided in the law or the regulations. There is

349 See for example, Art. 64 of Decree Law N* 830 (1974).
350 Chile has signed more than 20 bilateral tax treaties in the past twenty years (including with the US, New Zealand or Belgium), and several more are currently in negotiation.
therefore an uncertainty as to how the transfer pricing rules in Chile would apply. The lack of guidance, whether legislative or regulatory, leads to an atmosphere of uncertainty as to the Chilean transfer pricing regulatory environment. As a member of the OECD, it is arguable that Chile would subscribe to the methods and guideline endorsed by the OECD. However, in an unofficial opinion, the Chilean authorities indicated that the OECD commentaries only have a secondary value and can be used as complementary methods. In addition, the fact that Chile just recently joined the OECD begs the question as to whether its legislative, regulatory and judicial systems have been able to digest, and understand the OECD guidelines as to be able to use them when facing difficulties with local legislations.

Notwithstanding the lack of regulatory guidance and the uncertainty in the Chilean transfer pricing environment, transfer pricing disputes in Chile remain rather embryonic and timid. The most activity has been observed in the arena of transfer pricing audits that have been intensified by the Chilean Internal Revenue Service. The low but increasing level of transfer pricing audits and disputes generates hopes that the judicial system will help in developing a set of clear rules if possible, around transfer pricing in Chile. In the meantime, Chile has positioned itself as one of the fastest growing small economies in the world. Foreign direct investment continues to flow at an exponential rate and Chile is recognized as one of the most ‘attractive’ countries to date.\(^{354}\) The question is whether MNEs are getting a free pass at to their transfer pricing transactions, or are abiding in a satisfactory way, with the general rules of transfer pricing currently applicable in Chile. And even in the hope of an active judicial system, and further details on the application of the ALS, it is safe to predict that taxpayers would be pre-dominant in ligation because any system based on comparability, as seen for other countries, seems bound to fail tax

\(^{354}\) See the World Competitiveness Yearbook (“WCY”) of the Institute for Management Development (“IMD”).
administrations and optimum tax collection. Chile also adopted alternative methods of dispute resolution as well as preventative methods such as Mutual Agreement Procedures or Advance Pricing Agreement (mostly through the ruling request procedure). The recent changes, in 2012, aim at providing more guidance on the application of the Chilean transfer pricing rules, and the compliance requirements on taxpayers.\footnote{355 See Law 20. 630, published in the Official Gazette (9/27/2012).}

In South Africa, transfer pricing regulations came as a necessity as the country realized the magnitude of revenues being eroded from its tax base through questionable pricing in inter-company transactions. With the opening of South Africa to the world in early 1990s and the exponential growth of transnational transactions both in terms of foreign direct investment and exports, the country realized the need to protect its tax base and prevent abusive tax structuring transactions. Sparked by the revelations by Rustomjee, in 1991, that South African capital outflows were approximately double the amount of the country’s foreign debt of the time by 1991.\footnote{356 See Rustomjee (1991).} The South African Minister of Finance, in 1994, appointed a special commission, chaired by Judge Katz, to inquire into the matter of capital flight and offer recommendations. The main recommendations of the Commission were the establishment of solid mechanisms to counter tax avoidance; the need for protective measures against abuse of transfer pricing.\footnote{357 See Katz Commission, Report (1997).} The Commission recommended several methods to counter capital flight but explicitly encouraged the South African Government to adopt the procedures and methodologies put in place by the OECD to prevent tax avoidance. The transfer pricing rules were consequently introduced in 1995, following an amendment to the South African Income Tax Act of 1962.\footnote{358 See Income Tax Act N*58 Section 31 (1962), as Amended in 1995.}
emerged from the amendment and introduced transfer pricing rules, also discusses thin
capitalization measures. Transfer pricing rules, following the recommendations of the 1994
Commission have largely embraced the OECD ALS and the OECD guidelines to transfer
pricing. The specifically indicates that the rules only apply in a cross border sphere, when
transactions involved related parties. Further, the law indicates that the arm’s length price must
be arrived at from the comparison with similar transactions between unrelated parties.

Since its introduction in 1995, transfer pricing legislation in South Africa has continued to
emerge, and ameliorate. The South African Tax Authority continues to issue notices and
guidelines on the application of the transfer pricing rules in the South African Context. In one of
the Notices, in 1999, the Tax Authority clarified the procedures to be followed in South Africa
and under local countries circumstances, to determine the arm’s length price.359 In 2010, South
Africa initiated changes to its transfer pricing legislation in order to better align with the OECD
provisions, specifically with provisions of Article 9 of the OECD Model Tax Convention. The
law change in 2010 specifically aimed to widen the scope of application of the South African
transfer pricing rules. Another major change of 2010 is the reversal, in the burden of proof, from
the government to the taxpayer in transfer pricing litigation. The taxpayer must establish its
transfer pricing method, and show that the method accurately reflects the arm’ length price in its
inter-company transactions.

Transfer pricing litigation in South Africa, like most developing countries, is rather embryonic.
There are no major cases that been litigated in the area of transfer pricing. A typical transfer
pricing controversy in South Africa goes through the following channel: the review of the tax

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returns provided by taxpayer; if transfer pricing risk is identified, the case is referred to a transfer pricing audit specialist. The auditor reviews and weighs the risk, if credible; the transfer pricing auditor can issue a questionnaire to the taxpayer for further information of the covered transactions. The auditor then presents its findings to a panel in charge of determining whether the transfer pricing risks identified are material to bring the dispute forward. If the panel, after transfer pricing review, decides to audit the matter, the taxpayer is issued a Letter of Findings outlining the review from the audit and the proposed transfer pricing adjustments. If the taxpayer objects the position of the tax authority, the matter may go to settlement or alternative dispute resolution. Most cases are settled and the procedure stops here. However, if an agreement cannot be found, the matter is then prone for litigation. South Africa, like many other countries, has increased its scrutiny of potential transfer pricing abusive transactions. The number of transfer pricing audits has increased significantly in recent years. South Africa also provides procedures for Advance Pricing Agreements to anticipate and mitigate transfer pricing disputes.
2. Earning Stripping Through Debt Allocation

One method of shifting profits from a high tax jurisdiction to a low tax jurisdiction is to borrow more in the high tax jurisdiction and less in the low tax jurisdiction. When the borrowings are coming from a low tax jurisdiction to a high tax one, the subsequent interest payments generate interest deductions in the high tax jurisdiction providing more income, interest income, in the low tax jurisdiction. A more common use of this strategy is known as the earning stripping technique whereby debt whether with related or unrelated party does not give rise to tax payment from the interest recipient. For example, a technique commonly used was for a foreign parent in a jurisdiction where interest income is low or not taxed, to grant a loan to its US Subsidiary with the effect that the interest payments on the loan would wipe out all the US earnings of the Subsidiary in the form of interest deductions, minimizing or eliminating US taxation. The related character of modern MNEs makes this shifting of debt achievable without a change in the overall debt profile and exposure of the company as a whole.\(^\text{360}\) It is well accepted that tax planning has a significant effect on the distribution and location of taxable profits of MNEs.\(^\text{361}\)

Many countries, specifically developed countries have adopted tax legislation aiming to curb to use of debt and interest to shift profits.\(^\text{362}\) The US for example has adopted rules related to interest allocation and earning stripping.\(^\text{363}\) Tax authorities in the developed world have designed


\(^{361}\) See Grubert and Mutti, 1991; Hines and Rice, 1994; or Huizinga and Laeven, 2008.


\(^{363}\) See IRC §163(j).
and continue to thrive to implement rules to curb MNEs ability to use debt and financing to shift income to low/no tax jurisdictions.\textsuperscript{364} In the developing countries however, the struggle is more pronounced. Most developing countries struggle to adopt policies that encourage investment while aiming to generate enough national revenues in order to provide basic social services for their people. Enactment of arguably generous tax policies related to interest deduction, specifically on foreign investments, or the non-taxation of interest income from local entities are common practice. MNEs operating in these jurisdictions regularly use them to maximum their overall tax exposure as a group. Many developing countries have enacted US style rules to avoid shifting of income through the use of debt and interest. Nevertheless, those countries face tremendous difficulties in enforcing such rules. Difficulties faced include the lack of appropriate human resources to comprehend the complex rules related to complex strategies that aim and curbing earning stripping for example.\textsuperscript{365} Developing countries have imported most of the developed world complex tax mechanisms design to respond to complex structuring of tax transactions. The level of expertise needed is to equal the level of expertise afforded major MNEs. The issue however is that in developing countries, institutions, including tax institutions are not necessarily ran by experts, most appointment and positions are still dictated by family relations and various political affiliation. The issue is not that the expertise to enforce complex rules is inexistent, the reality that the expertise is not used in an appropriate manner, if at all. For example, one technique used to reduce profit shifting through the use of debt is the interest allocation scheme designed by tax authorities in order to get to the true economics of MNEs transactions and tax them accordingly. Interest allocation technic requires application of very sophisticated formulas and requires a wealth of information on the MNEs. On the one hand, the

\textsuperscript{364} See H.R. 3970, introduced in 2007.  
\textsuperscript{365} See Supra, at 89.
importing developing country of the allocation of interest technic must assure that it has dominium on the formula to be applied. Secondly, the importing developing country must have access to the required information for the technic to be effective. Access to MNEs’ global operations information is a major issue in taxation in developing countries, an issue that manifest itself best in the struggle of those countries with transfer pricing.
3. The Distortive Effect of Hybrid Entities

As discussed above, the past decades have seen a tremendous growth in highly sophisticated tax planning in the international arena. International tax professionals have specifically used differences in tax systems to exercise, at time, questionable tax arbitrages. The commonly known as the hybrid mismatch arrangements and their proliferation is a testament to the ever growing distortion of intended tax effects on the face of internationalization and globalization of commerce.

A hybrid mismatch arrangement is an arrangement that exploits differences in national tax treatment of an instrument, an entity or a transfer between two or more countries. The arrangements usually lead to income being tax in neither of the involved jurisdictions (double non taxation), or lead to tax deferrals which is sustained for a long term, have a similar effect as double non-taxation. In the international tax arena, the most widely used form of hybrid mismatch is a planning scheme that focuses on tax treatment of different entities in different taxing jurisdictions.

The same economic operation can be characterized as a taxable person in the US, for example, while not being a taxable person in the Netherlands. A payment might be taxable in the Netherlands, for example, while not being taxable in the US. Hybrid mismatch regularly distort the working of tax systems and produce consequences that neither taxing authority anticipated.

Hybrid mismatch arrangements require a hybrid entity (entities that are treated as transparent for tax purposes in one country and not transparent in another); dual residency (entities resident in at least two different countries). Hybrid mismatch arrangements generally produce the same results including double deduction (each country involved allows a deductions);\textsuperscript{366} deduction and no

\textsuperscript{366} For example, a parent company in country A ("A Co") indirectly holds an operating company in country B ("B Co"). Inserted between A Co and B Co is an entity ("Hybrid Entity") that is treated as transparent or disregarded for country A tax purposes and as non-transparent for country B tax purposes. A Co holds all or almost all equity interest in Hybrid Entity which in turn holds all or almost all equity interests in B Co. Hybrid Entity borrows from a third party and uses the loan amount to inject it as equity into B Co (or to buy the shares in B Co from either
In general therefore, hybrid mismatch arrangements, though seemingly in compliance with the letter of the law of each country involved, result in non-taxation for all countries involved which is a result neither country intended in adopting its tax policy. The reality of hybrid mismatch arrangements can be analyzed from at least four different policy perspectives: their impact on tax revenues (the goal of hybrid mismatch arrangements is always the lowering of the taxpayer’s overall tax burden, draining the tax revenues of one or all the countries involved); their impact on competition (hybrid mismatch arrangements are only available to MNEs, companies that have operations in at least two countries. The tax advantages those MNEs may derive from hybrid mismatch transactions are not available to smaller companies, making them unable to effectively compete); their impact on transparency (hybrid mismatch benefit more often than not, on their secret character, the general public would usually be unaware of the low effective tax rate that the MNE enjoys, and if the public is aware, they generally don’t fully appreciate the hybrid mismatch.

For example, a company resident in country B (“B Co”) is funded by a company resident in country A (“A Co”) with an instrument that qualifies as equity in country A but as debt in country B. If current payments are made under the instrument, they are deductible interest expenses for B Co under country B tax law. The corresponding receipts are treated as exempt dividends for country A tax purposes. As a result, a net deduction arises in country B without a corresponding income inclusion in country A.

One of the typical schemes to generate a foreign tax credit uses a hybrid transfer of an equity instrument. The most common way to create a hybrid transfer of an equity instrument is with a sale and repurchase agreement concerning shares, where the transaction is treated as a sale and a repurchase of the shares in one country, while in the other country it is treated as a loan with the shares serving as collateral.
transactions as being at the root of such low effective tax rates); and their impact on fairness (only certain tax persons, MNEs, are able to implement hybrid mismatch arrangements and enjoy the tax benefits therefrom, a situation that denotes the unfair character of preferable rules applicable only to a group). Hybrid mismatch opportunities were further developed after the adoption in the US of the so-called Check the Box Election rules (“CTB”).\textsuperscript{369} Originally envisioned to established simplicity and clarity in the classification of entities and the tax treatment therefrom, CTB elections quickly became the prime medium of achieving hybrid mismatch arrangements. If there is an opportunity whereby a partnership or a disregarded entity is treated more favorably than a corporation in a jurisdiction in which MNEs operate, the simple solution is the ‘check’ the entity in a form that yields mismatch tax advantages while not altering the economic reality of the entity and its operations.

The amount of lost revenue to governments from hybrid mismatch transactions is significant and many governments have become more aggressive in identifying and negating the effects of those arrangements. Many rules have been implemented to prevent hybrid mismatch transactions and tax authorities enjoy a rather successful scorecard from hybrid mismatch arrangements litigation. In the US for example, the amount involved in the hybrid mismatch transactions was estimated at approximately $3.5 billion through the foreign tax credits generated by such arrangements.\textsuperscript{370} New Zealand settled, in 2009, cases involving hybrid mismatch arrangements with the taxpayer remitting approximately $1.5 billion to the tax authorities. In Italy, a number of cases involving hybrid mismatch arrangements settled for approximately $2 billion. The noted success of tax administrations in these proceedings, even though the taxpayers arguably respect the letter of the

\textsuperscript{369} See 26 CFR 301.7701.
\textsuperscript{370} See Letter from Everson, Commissioner of Internal Revenue, to the Honorable Charles Grassley, Chairman, Senate Committee on Finance (May 2006), In 2006 Tax Notes Today 114-21 (June 14, 2006).
law, is due to the fact that the hybrid mismatch arrangements clearly violate the intent of the letter law, and the government would usually have an upper hand in these disputes. By speculation therefore, we can forecast that any initiative to limit and/or eliminate these arrangements could easily gather an impressive international coalition and maybe met by a reduced resistance from MNEs. The speculative and simplistic view however, remains questionable as we continue to witness more, not less hybrid mismatch arrangements by MNEs in their international operations.

The international tax system and countries globally continue to face serious risk as to tax revenues, tax sovereignty, and tax fairness. The issues presented generally rotate around tax base erosion through profits shifting. There are many aspects to the problems faced by international taxation but one of the main once is transfer pricing and how easily MNEs seem to be able decide how much taxes to pay, if at all, and where to pay it at. The vast majority of rules currently governing international tax transactions still are based on tax policy considerations founded on the majoritarily territorial nature of taxation in early days. Globalization is not new but, the pace of inter-connectedness and intra-group activities at the global level has never been more pronounced. The internationalization of business activities has never been more accentuated and international tax planning structures have never been at the center of the global debate with such urgency. From the standpoint of MNEs, no transactions is seriously considered unless it global consequences are analyzed. The international dimension and perspective dictates all actions of modern MNEs. Nevertheless, the responses of tax authorities remain largely territorial and local, showing a major disconnect between tax policy and economic reality. The major global of international taxation is the public perception that only the naïve pay taxes, and that is just too easy, for a certain class of taxpayers, to avoid taxation. The global ills of international taxation are made apparent through various tax planning technics including transfer pricing, debt allocation, or hybrid mismatch
arrangements. The global outcry proves that a consensus is forming as to the characterization of the international tax system as a globally failed system. The question now, is how the international tax system has and continues to fail the developing world and developing countries specifically.
B. IIs Specific to Developing Countries

Above and beyond the global ills of international taxation, the ways in which the international taxation is failing globally, there are specific circumstances and specific areas in which the failures are sui generis to developing countries. The importance of effective taxation and the ability of the country to effectively tax economic activities within its borders are of central importance in the developing world. Effective corporate taxation is even of higher importance in the developing world as they rely more heavily on revenues from corporate taxation as compared to the developed world. Increasing number of MNEs continue to expand their operations in the developing markets, making international tax policy and rule-making in those markets ever more relevant and important. The corporate taxation, if ineffective at an international level, would make the entire system a failure and would result in inability to raise the adequate tax revenues. Historically however, developing countries have not been proactive in designing international tax rules that take their individual practical situations into account. Instead, most developing countries have incorporated, throughout time, the international tax rules, policies and doctrines adopted by developed countries. The resulting international tax system applicable in these developing countries has shown to be a total disaster in many fronts.

First, there is a difference in the nature of cross border transactions between the developed and developing world and they should not be addressed in a similar fashion. Historically, highly sophisticated tax planning was less prevalent in the developing countries. Developing countries had basic international tax rules and mere basic international tax planning suffixed to achieve sought results in these jurisdictions. The lack of appropriate rules had the door open to basic tax

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371 It is estimated that developed countries raise approximately 10% of their revenues through corporate tax, while developing countries raise approximately 20% of their revenues through corporate taxation.
planning and the irregularity of tax audit did very little to discourage more aggressive tax planning. The basic rules are now in need of more sophistication as MNEs are cramping up their international tax planning sophistication in those jurisdictions. The current international tax structures in developing countries have shown, at times, not sophisticated enough to govern highly complex transactions. Much legislation in these countries is still incomplete. In several circumstances, the rules can be and have easily been circumvented by taxpayers specifically MNEs. For example a law that prevents the use of transfer pricing to realize profit shifting would have very limited effect in the overall situation of the taxpayer and the tax authorities if similar measures are not adopted to prevent excessive leverage and the use of debt in the country. The result, in either situation, is the erosion of the countries tax base. The closure of the transfer pricing route without a corresponding closure of the excessive indebtedness route can only have limited effect on the overall goal of reducing and or eliminating gamesmanship.

Second, the general issue raised by each developing country tax administration is the difficulty to obtain information necessary to apply most of the international tax law provisions. Developing countries are unable to obtain from MNEs the information they need to understand their global transactions, and assess the risks involved. For example, many developing countries tax administrations report having constant difficulties obtaining information about MNEs foreign operations. The foreign operation information is vastly important in fully understanding the risk of tax losses of the operations in the local country. The inability to access MNEs information in developing countries can be attributed many variables including the following. First, the information issue is due to the lack of effective information gathering rules in developing countries. In the developed world, there are strict rules regarding information gathering for

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372 See Supra, at 89.
taxpayers, specifically MNEs. In the US for example, MNEs are required to provide, by law various types of information on their operation. In fact, such information is also usually received from third parties upon whom the US imposes a legal duty to provide the information. In many instances, the US authorities have not relied on third parties to obtain such information; the US authorities have mandated such entities to provide the information. Moreover, the US has found proactive and innovative ways, and working through the applicable rules, to obtain the required information. On an international perspective, the US has expanded its reach and its ability to get information on foreign operations. Initially, the US led a coalition that continues to advocate for information exchange between governments. Additionally, the US now requires certain foreign institutions to provide information on foreign possessions or operations of US persons. The recent legislative enactment, known as the Foreign Account Tax Compliance Act (“FATCA”) is an information gathering law requiring foreign financial institutions to provide information to the US tax authorities about their US account owners (or the US policyholders or insurers as the case may be). However, in the developing world, there is a blatant lack of effective information gathering rules. Second, there is poor compliance with whatever structure is in place for disclosure and information gathering, and developing countries tax authorities have limited capacity to enforce those rules. Many developing countries have incorporated some rules, albeit ineffectively, regarding disclosures and information gathering. In practice however, it is noted that taxpayers do not comply with these requirements and the inability of tax authorities to enforce such requirements is apparent. Many tax legislations in the developing world require that taxpayers disclose information on their foreign operations for example. But, not many taxpayers satisfy such

374 See I.R.C. §§ 1471-1474. Most of the operative rules are in Treasury Regulations issued under the statute.
disclosures in fact. The dispute system is weak in these countries, leading to a relatively scarce enforcement of such disclosure requirements. In developing countries, audits are not widespread, and international tax litigation is almost inexisten. Finally, developing countries lack adequate tools for obtainment of the required information and their analysis. Very few developing countries have sophisticated e-filing system able to absorb and arguably accurately analyze the massive amounts of taxpayers’ information. The information is still mostly provided in a rudimentary manner, to be processed individually by human resources in a widely ineffective manner and leading to misunderstanding of the global tax picture of the taxpayer with foreign operations.

Third, developing countries face a significant lack of expertise in applying complex international tax rules. In many cases, developing countries transplanted rules that were applicable in the developed world to counter tax abuse within their jurisdiction. However, it is worth noting that for most these rules, the level of complexity is so significant, requiring a highly informed and profoundly specialized workforce. This expertise is lacking in most developing countries, and even when it is available, the government is not a competitive enough employer that the expertise generally finds itself in the private sector, arming it best, at times, to realized highly sophisticated tax planning technics that continue to erode the tax base in these jurisdictions. The insufficiency of man power and the scarcity of skilled staff are chief impediments to the application of rather complex rules of international tax aimed at curbing erosion of tax base in the developing world. The asymmetry between tax authorities in the developing world and well advised MNEs predict the outcome of MNEs mostly getting their way in the face of impotent and not enough qualified tax authorities. Additionally, developing countries have not set up adequate alternative dispute resolution mechanisms. For developed countries, the complex and fact intensive native of

376 See Supra, at 89.
international tax dispute constantly lead to the use of alternative dispute resolution mechanisms to achieve acceptable settlements. In developing countries, there is no structure for alternative dispute resolution to encourage and lead to acceptable settlements. Furthermore, a granting of discretion to tax authorities to settle large disputes may lead to increased widespread corruption. In fact, many observers have argued that the rather limited number of tax audit and other disputes in international tax for MNEs in developing countries is also attributable to the corrupt nature of the tax administration who generally negotiate personal ‘deal’ with taxpayers and let them off the hook when their personal needs are satisfied.\textsuperscript{377} The lack of expertise, combined with a weak alternative dispute resolution structure, leads to rather major failures for international tax in developing countries.

Finally, developing countries have to deal with a tricky balance of adopting aggressive enough rules to curb tax avoidance while not being viewed as anti-investments. For many countries in the developing world, encouraging investment and attracting foreign investment specifically is a central of policy making.\textsuperscript{378} Many developing countries still have weak economies and conventional wisdom instructs them not to do anything that might be perceived as a discouragement to investments. The debate over the effects of tax policy on investment and specifically foreign direct investment is still brewing. A multitude of empirical evidence seems to indicate that at best, the impact of certain tax policy measure on investments is relative. For example, many developing countries have adopted various forms of tax incentives to attract investment, specifically direct foreign investment. Empirical evidence has overwhelmingly


indicated that tax incentives have no direct impact on investment, and foreign direct investment specifically.\textsuperscript{379} Nevertheless, tax incentives continue to flourish in the developing world on the very same and overwhelmingly disproven argument that they increase investment. The struggle for developing countries is that they are afraid to provide an impression of being investments adverse jurisdictions. Since one country has such incentives, other developing countries continue to implement them, regardless of whether they actually of themselves increase investments. At least, the existence of the incentives in the legislative structure is an antidote to the impression of investment adversity within the jurisdiction. In the area of international tax rules, many developing countries continue to witness the constant erosion of their tax base and are reluctant implement aggressive rules as they would provide that very same impression of investment adversity so feared within the developing world. For developing countries, the market, the customer base, the reliable judicial system, and the relatively coherent legislative structure are enough to attract investments and developed countries are not overly worried about establishing an investment adverse atmosphere when adopting common sense rules to curb tax avoidance. In fact, the level of potential coordination in the developed world leads to the very same aggressive scheme being collectively applied leaving taxpayers with few places to escape in the developed world. The US and/or the EU can easily adopt more aggressive rules to combat tax avoidance without overly worrying about businesses not being able to locate there. In fact, developed countries are confident in their markets and labor force and know MNEs will want to locate there notwithstanding. The reality in the developing world is different. Economies are weak, customer base arguably negligible, and no overall coordination. Any tax policy consideration shall pass the muster of its impact on attraction of investments, and least from the perspective of other developing countries having adopted such

\textsuperscript{379} See Easson Alex, Tax incentives for foreign direct investment part I: Recent trends and countertrends, 55.7 Bulletin for international taxation 266 (2001).
measure. Many developing countries may have turned a blind eye on abusive tax practices for the sake of encouraging investments and development within their borders. As developing countries continue to be more aggressive toward MNEs abusive tax practices, the question remains as to whether the relatively lack of aggression in the developed world is due to the lack of information, the lack of efficient rules, appropriate expertise, the struggle to find a balance between curbing abusive tax practices and encouraging investments. The answer seems to us, is all of the above, but whatever the explanation, the failures of international tax in developing countries are profound and vastly consequential are require an urgent attention and remediation.
C. The BEPS Project: a Case Study

The OECD base erosion and profit shifting ("BEPS") project is the most significant multilateral effort to date to change the taxation of corporate cross-border income. The initiative comes after the most significant financial market turmoil since the Great Depression and high levels of unemployment and government deficits within developed countries. As countries look to balance their budgets, MNEs have come under scrutiny on their tax affairs not only from tax authorities, but also from government and non-governmental bodies and the media. There is also an acknowledgement that corporate taxation has not kept pace with the changes in the global economy, particularly the growth in e-commerce, the growth of outsourcing and contract manufacturing, and the changes to global supply chains.

The speed with which the OECD BEPS project has moved has been quite remarkable. The impetus for the project came from the G20 finance ministers meeting in Los Cabos, Mexico, in June 2012, and the ensuing 24-month period has seen a flurry of activity. In January 2013, the OECD published a report titled "Addressing Base Erosion and Profit Shifting" ("the Report").

The Report was presented to the G20 finance ministers meeting in Moscow on February 2013, expressing the urgent need to deal with BEPS in a multilateral and coordinated manner. According to the Report, action was required because BEPS presented an urgent risk to "tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike."

The OECD indicated that the international tax rules have not kept up with the realities of doing business in a globalized world, and that gap between domestic tax systems, combined with

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economic incentives and legal accounting practices, have all given rise to avenues of double non-taxation, allowing some MNCs to pay little to no corporate tax at all. The Report received full endorsement from the G20 finance ministers in Moscow, invited the OECD to move forward and develop an action plan. In July 2013, the OECD released the Action Plan on Base Erosion and Profit Shifting ("Action Plan"),\(^{382}\) identifying actions needed to address BEPS, setting deadlines to develop these actions, and identifying the resources needed and methodology to implement these actions.

The Action Plan lists 15 Action Items and their timelines for finalization:

1. Address tax challenges of the digital economy (September 2014).
2. Neutralize the effects of hybrid mismatch arrangements (September 2014).
3. Strengthen Controlled Foreign Company ("CFC") rules (September 2015).
4. Limit base erosion via interest deductions and other financial payments (September 2015).
6. Prevent treaty abuse (September 2014).
7. Prevent the artificial avoidance of Permanent Establishment ("PE") status (September 2015).
8. Assure that transfer pricing outcomes are in line with value creation – Intangibles (September 2014/September 2015).
9. Assure that transfer pricing outcomes are in line with value creation – Risk and Capital (September 2015).
10. Assure that transfer pricing outcomes are in line with value creation – Other high risk transactions (September 2015).

11. Establish methodologies to collect and analyze data on BEPS and the actions to address it (September 2015).

12. Require taxpayers to disclose their aggressive tax planning arrangements (September 2015).

13. Re-examine transfer pricing documentation (September 2014).

14. Make dispute resolution mechanisms more effective (September 2015).

15. Develop multilateral instruments (September 2014/December 2015).

There have been many Action Item Discussion Drafts released. These include Action 1 on addressing the tax challenges of the digital economy; Action 2 on neutralizing the effects of hybrid mismatch arrangements (two Discussion Drafts released); Action 6 on preventing treaty abuse; and Action 13 on transfer-pricing documentation. Each of these Action Items had a September 2014 report-out date. A Discussion Draft on intangibles was released prior to the Action Plan with a revised Discussion Draft issued on July 30, 2013, which leveraged off the prior work undertaken by the OECD. The Discussion Drafts provide suggested changes to both domestic law and to the OECD Model Income Tax Treaty to be implemented by OECD members in an agreed manner. The Discussion Drafts acknowledged that they are in "early stage," do not reflect any consensus view, and were designed to elicit comments and be later refined. Even though the comment period for each of the action items was brief, they attracted a large number of comments from practitioners, trade associations, non-governmental agencies, and academics. We will look at the Discussion Drafts in turn.
**Action Item 1: E-commerce**

On March 24, 2014, the OECD released a Discussion Draft "BEPS Action 1: Address the Tax Challenges of the Digital Economy" (the "E-commerce Draft"). The draft contains a lengthy discussion of the key features and business models in a digital economy, the opportunities for BEPS that can arise in a digital economy, and potential options to address the tax challenges raised by the digital economy. The E-commerce Draft notes the changes in the modern economy and the expansion of direct to-customer sales vs. the traditional manufacturer distributor-customer model. This change allows companies to make cross-border sales without a physical in-country presence, which results in local countries suffering a loss of in-country sales and distribution revenues and income becoming more difficult to trace. The E-commerce Draft is organized into six substantive sections that roughly align with focus areas identified in Action 1 of the OECD BEPS Action Plan: Information and Communication Technology and Its Impact on the Economy (Section II); The Digital Economy, Its Key Features, and the Emergence of New Business Models (Section III); Identifying Opportunities for BEPS in the Digital Economy (Section IV); Tackling BEPS in the Digital Economy (Section V); Broader Tax Challenges Raised by the Digital Economy (Section VI); and Potential Options to Address the Broader Tax Challenges raised by the Digital Economy (Section VII). Section VII provides an overview of four possible options presented to the task force to address the challenges of taxing the digital economy. Though these options are not task force recommendations and are still under development, they have attracted significant attention from commentators, in fact more attention than the other five sections combined, as they would represent a significant departure from existing tax rules.
The first potential option would modify the exemptions to PE status under paragraph 4 of Article 5 of the OECD Model Tax Convention ("the Convention").\footnote{See OECD Model Tax Convention on Income and on Capital, Art. 5, ¶ 4 (2010) as follows: "Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."} The Ecommerce Draft states that several variations of this option are possible. One approach would eliminate paragraph 4 of Article 5 entirely. Another variation would eliminate just the enumerated exceptions of paragraphs (a)–(d) of Article 5(4) or make them subject to the overall condition that the character of the activity conducted be preparatory or auxiliary in nature, rather than a core activity, thus making such exceptions unavailable to businesses if such activities constitute one of their core activities or functions.

The second option, a variation on alternative PE thresholds, would establish an alternative nexus based on a significant digital presence to address situations in which business is conducted wholly digitally. An enterprise engaged in certain "fully de-materialized digital activities" would have a PE if it maintained a "significant digital presence" in another country's economy. The third option includes three broad alternatives: (1) a "virtual fixed place of business PE" (when the enterprise maintains a website on a server of another enterprise located in a jurisdiction and carries on business through that website); (2) a "virtual agency PE" (extension of the dependent agent PE concept of contracts habitually concluded with persons located in the jurisdiction through technological means); and (3) an "on-site business presence PE". The fourth option would impose a final withholding tax on certain payments for digital goods or services.
Action 2: Neutralize the Effects of Hybrid Mismatch Arrangements

The Hybrid Mismatch Arrangements Discussion Draft was issued on March 19, 2014. The draft is in two parts, with the first part (First Discussion Draft) making recommendations on changes to domestic law, and the second (Second Discussion Draft) discussing the impact of new domestic rules of the Convention and recommended changes to the Convention.384

The draft defines hybrid mismatch arrangements generally as arrangements that use hybrid elements in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to produce a mismatch in tax outcomes. It specifically identifies the key elements of a hybrid mismatch as (1) an arrangement that results in a mismatch of the tax treatment, (2) an arrangement that contains a hybrid element, and (3) the hybrid element causes a mismatch in tax outcomes. The First Discussion Draft identifies two types of mismatch results: (1) payments that are deductible in one jurisdiction but not picked up in another (so-called deduction/no inclusion D/NI outcome), (2) payments that give rise to duplicate deductions on the same expense (so-called deduction/deduction D/D outcome). The draft discusses how to approach hybrid mismatches and states that any hybrid mismatch rules should "meet the criteria for good rule design," which would include clarity, transparency, ease of administration and compliance for both companies and tax authorities, and workability.

The preliminary recommendations target three categories of hybrid mismatch arrangements:

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- Hybrid financial instruments for which a deductible payment made on a financial instrument is not treated as deductible income in the payee's jurisdiction;

- Hybrid entity payments for which differences in the characterization of the hybrid payer results in a deductible payment being disregarded or triggering a second deduction in the second jurisdiction; and

- Reverse hybrid and imported mismatches which cover payments made to intermediate payees.

Preliminary conclusions of the draft include changes to domestic law and linking rules that base the tax treatment of a hybrid arrangement on tax treatment in the other state and result in either a denial of a deduction on the payment or a requirement that the payment be included in income. There is a linking rule that applies if the domestic law fails to address the mismatch. The linking rule contains both a "primary response" and a defensive rule. Primary responses generally focus on the payor or investor jurisdiction, and defensive rules focus generally on the payee or subsidiary jurisdiction. For example, for a hybrid instrument that would be treated as a debt instrument in the payer jurisdiction and as equity in the payee jurisdiction, the first discussion draft recommends that domestic law be amended so that no dividend exemption is available for deductible payments. If domestic law did not capture this, the linking rule would then kick in, first applying the primary rule – denying a deduction, and then applying the secondary rule – having the payee include the payment in income, if the payee jurisdiction did not act.
Action Item 6: Treaties

On March 14, 2014, the OECD released BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (the "Treaty Draft"). The Treaty Draft is divided into three sections corresponding to the specific areas identified in Action Item 6.

First, the Treaty Draft discusses the development of model treaty provisions and outlines recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. The Treaty Draft makes several recommendations to prevent treaty abuse and treaty shopping, including the inclusion of an anti-abuse rule based on the limitation-on-benefits provision found in most US income tax treaties, and the inclusion of a more general anti-abuse rule (main purpose rule) designed to address other forms of treaty abuse that would not be covered by the specific limitation-on-benefits provision. Second, the Treaty Draft clarifies that tax treaties are not intended to be used to generate double non-taxation and recommends the amendment of the Convention to state clearly that the prevention of tax evasion and avoidance is a purpose of tax treaties. Additionally, the Treaty Draft indicates that the Convention should include a preamble expressly providing that the states that enter into a tax treaty intend to eliminate double-taxation without creating opportunities for tax avoidance.

Third, the Treaty Draft discusses the identification of the tax policy considerations that countries should take into account before deciding to enter into a tax treaty with another country. The Treaty Draft states that the clearer articulation of the policy considerations that countries should take into account prior to entering into a tax treaty may limit the number of tax treaties executed with low/ no-tax jurisdictions.

Many commentators welcomed the Treaty Draft's effort to deal with treaty shopping and other treaty abuse situations. There is general agreement from commentators that the entitlement to the benefits of tax treaties should be clarified.386

**Action Item 8: Intangibles**

On June 6, 2012, the OECD published a Discussion Draft on Transfer Pricing Aspects of Intangibles.\(^{387}\) The OECD requested public comments on the draft, and a public consultation was held in November 2012. On the basis of the comments received and in light of the subsequent launch of the BEPS project, the OECD prepared a revised version of the draft on transfer pricing aspects of intangibles ("Intangibles Draft") adopting the process under Action Item 8. \(^{52}\) Action Item 8 specifically aims at developing rules to prevent BEPS from moving intangibles among group members. This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements. The Intangibles Draft is a work in process, and some of the issues identified will be dealt with in other BEPS Action Items. The Intangibles Draft outlines the OECD's view on how comparability factors such as location savings, workforce-in-place and group company benefits should be treated for transfer pricing purposes and proposes changes to the OECD Transfer Pricing Guidelines. The Intangibles Draft states these factors are not intangibles but can involve intangible assets, e.g., a movement of a workforce can involve the transfer of knowhow. Section A of the Intangibles Draft also provides a broad definition of an intangible asset and a definition of unique and valuable intangibles.\(^{388}\) Section B of the Intangibles Draft provides guidance on when entities in

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\(^{388}\) Intangibles assets are defined in the Intangibles Draft as "something that is not a physical or financial asset and which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable situations." Unique and valuable intangibles are defined as those intangibles "(i) that are not comparable to intangibles used by or available
a multinational group should be entitled to the economic profits from exploiting intangibles, with
a focus on the importance of functions performed, assets used and risks assumed in the
development and protection of intangibles. Here the focus is on contribution, not economic or
legal ownership. The Intangibles Draft clarifies that an entity can outsource intangible functions
but must control the provider, and also notes that the return to an entity that merely funds
intangible development should be reduced vs. an entity that performs these functions.
Section C covers transactions involving the use or transfer of intangibles, while Section D
provides guidance on determining arm's length values for intangibles. Most commentators
acknowledged the difficulties posed by the complex transfer pricing structures of intangibles.
Several commentators expressed concerns about the definition of intangibles; the OECD
approach to defining intangibles was to adopt a broad understanding of the notion of intangibles
while requiring specific identification of intangibles. The OECD specifically included
goodwill and going concern as intangibles while excluding workforce or group synergies. The
Intangible Draft also received general push-back on its tight timing. Many commentators argued
that the issues to be addressed are too complex to be considered, even with bifurcated delivery
dates of September 2014 and September 2015 (for special measures on hard to-value
intangibles).390

390 Id.
On 5 October 2015, the OECD released final reports on all 15 focus areas in its Action Plan on BEPS. In an accompanying explanatory statement, the OECD described the next steps in its work on BEPS, including additional work on technical matters and plans for monitoring with respect to the implementation of the BEPS recommendations. In conjunction with the release of the reports, the OECD held a press conference followed by a technical briefing, both by webcast, to provide an overview of the final BEPS output.

The OECD described the final BEPS packages as containing recommendations that fall in several different categories:

- **Agreed minimum standards**: the recommendations on harmful tax practices (Action 5), treaty abuse (Action 6), country-by-country reporting (Action 13) and dispute resolution (Action 14)
- **Reinforced international standards**: the revised OECD Transfer Pricing Guidelines (Actions 8-10) and the revised OECD Model Tax Convention (including Action 7 on permanent establishment status)
- **Common approaches and best practices for domestic law**: hybrid mismatch arrangements (Action 2), controlled foreign company rules (Action 3), interest limitations (Action 4) and disclosure of aggressive tax planning (Action 12)
- **Analytical reports**: tax challenges of the digital economy (Action 1), data and analysis with respect to BEPS (Action 11) and the multilateral instrument for implementing treaty based recommendations (Action 15).

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393 *Id.*
The OECD also briefly discussed the “post-BEPS environment,” stressing the importance of focusing on implementation of the BEPS recommendations in a consistent and coherent manner, monitoring the impact on both double non-taxation and double taxation. The explanatory statement indicates that OECD and G20 countries have agreed to continue to work together on BEPS until 2020. The intention is to develop a more inclusive framework to support and monitor the implementation of the BEPS package. Below is an overview of each of the BEPS Final Reports.\textsuperscript{394}

\textsuperscript{394} Id.
Item 1 – Addressing the tax challenges of the digital economy

The final report on Action 1, *Addressing the Tax Challenges of the Digital Economy*, largely follows the initial Action 1 deliverable on the digital economy released by the OECD in September 2014. Like the 2014 report, the final report provides conclusions regarding the digital economy and recommended next steps to address the tax challenges presented by the evolving digital economy. The final report acknowledges that special rules designed exclusively for the digital economy would prove unworkable, broadly stating that the digital economy “cannot be ring-fenced as it is increasingly the economy itself.” The final report summarizes key features of evolving digital business models that the OECD considers relevant for the overall BEPS analysis; in addition, the final report considers broader direct and indirect tax challenges raised by the digital economy. As an update to the 2014 report, the final report recommends: (i) modification of the list of exceptions to the definition of Permanent Establishment (PE) regarding preparatory or auxiliary activities as they relate to a digital environment and introduction of new anti-fragmentation rules to deny benefits from these exceptions through fragmentation of certain business activities; (ii) modification of the definition of a PE to address artificial arrangements through certain “conclusion of contracts” arrangements (See Action 7); (iii) a correlative update to the OECD Transfer Pricing Guidelines (see Actions 8-10); and (iv) changes to controlled foreign company (CFC) rules to address identified challenges of the digital economy. The final report also addresses the indirect tax treatment of certain digital transactions, recommending that countries should apply the principles of the OECD’s International Value-added Tax/ Goods and Services Tax (VAT/GST) Guidelines and should consider introduction of

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the collection mechanisms included therein. Future work in the area of Action 1 will be conducted in consultation with a broad range of stakeholders, and on the basis of a detailed mandate to be developed by the OECD during 2016 in the context of designing an inclusive post-BEPS monitoring process. A supplementary report reflecting the outcome of continued work on the overall taxation of the digital economy should be released by 2020. The OECD also intends to develop a coordinated implementation mechanism with respect to the International VAT/GST Guidelines.
Action 2 – Neutralizing the effects of hybrid mismatch arrangements

The final report on Action 2, *Neutralizing the Effect of Hybrid Mismatch Arrangements*,\(^\text{396}\) supersedes the interim report that was released in September 2014. Similar to the 2014 report, the final report consists of two parts with detailed recommendations to address hybrid mismatch arrangements and reflects the consensus achieved on these issues. Part I contains recommendations on domestic law rules to address hybrid mismatch arrangements. Part II contains recommended changes to the OECD Model Tax Convention.

The recommendations in Part I include “Specific Recommendations” and “Hybrid Mismatch Rules.” The Specific Recommendations are modifications to provisions of domestic law aimed at avoiding hybrid mismatches and achieving alignment between those laws and their intended tax policy outcomes (e.g., by not applying a dividend exemption at the level of the payee for payments that are deductible at the level of the payer). The Hybrid Mismatch Rules are linking rules aimed at neutralizing one of the following three mismatches in tax outcomes arising out of certain hybrid mismatch arrangements:

- Payments that give rise to a deduction with no taxable inclusion arising from a hybrid financial instrument (including a hybrid transfer), a disregarded payment made by a hybrid entity or a payment made to a reverse hybrid
- Payments that give rise to a double deduction arising from a deductible payment made by a hybrid entity or a dual resident
- Payments that give rise to an indirect deduction with no inclusion arising from an imported mismatch

The Hybrid Mismatch Rules are divided into a primary response and, where applicable, a secondary or defensive rule. The defensive rule only applies where there is no Hybrid Mismatch Rule in the counterparty jurisdiction or where the rule is not applied to the particular entity or arrangement. Furthermore, each of the Hybrid Mismatch Rules has its own scope of application. In a significant expansion from the 2014 report, the recommendations in Part I of the final report have been supplemented with further guidance and a wide array of detailed examples to explain the operation of the rules. Some outstanding issues that were identified in the 2014 report are addressed, such as the treatment of stock lending and sale and repurchase transactions, the treatment of non-interest bearing loans and the treatment of branch structures within the hybrid mismatch arrangement category for hybrid financial instruments. Furthermore, there is detailed guidance on how to treat a payment that is included under a CFC regime. Significant new guidance on the operation of the imported mismatch rule is provided as well, which includes three tracing and priority rules to determine the extent to which a payment should be treated as set-off against a deduction under an imported mismatch arrangement.

The recommendations in Part II with respect to the OECD Model Tax Convention are similar to those included in the 2014 Report, namely: (i) a change to Article 4 of the Model Tax Convention to deal with dual resident entities; (ii) a new provision in Article 1 and changes to the Commentary to address fiscally transparent entities; and (iii) various proposed changes to address treaty issues that may arise from the recommended domestic law changes.

The final report recommends that every jurisdiction should introduce all the rules contained in the report and that jurisdictions should cooperate on measures to ensure these rules are implemented and applied consistently and effectively.
**Action 3 – Strengthening CFC rules**

The final report on Action 3, *Designing Effective Controlled Foreign Company Rules*,[^397] provides recommendations in the form of building blocks with respect to the constituent elements that are necessary for effective CFC rules. The final report notes that the recommendations are not minimum standards, but instead are designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries. The report indicates that the recommended building blocks would allow countries without CFC rules to implement recommended rules directly and countries with existing CFC rules to modify their rules to align more closely with the recommendations.

The six building blocks for the design of effective CFC rules are:

- ✓ Definition of a CFC (including the definition of control)
- ✓ CFC exemptions and threshold requirements
- ✓ Definition of CFC income
- ✓ Computation of income
- ✓ Attribution of income
- ✓ Prevention and elimination of double taxation

The final report recognizes that there are shared policy considerations for jurisdictions in the context of Action 3 (e.g., providing a backstop to transfer pricing and balancing effectiveness with compliance burden and with avoidance of double taxation), as well as different policy objectives that relate to the overall domestic tax systems of individual jurisdictions. Thus,

because each country prioritizes specific policy objectives differently (e.g., the balance between taxing foreign income and maintaining competitiveness), the recommendations provide flexibility to implement CFC rules in a manner consistent with the policy objectives of the overall tax system and the international legal obligations of the specific country concerned. In particular, with respect to the definition of CFC income, the final report recognizes that countries should be allowed flexibility in the design of CFC rules that are consistent with their domestic policy frameworks. As a result, similar to the Action 3 discussion draft, *Strengthening CFC rules*, released in April 2015, the final report sets out a non-exhaustive list of approaches that could be used for the definition of CFC income that raises BEPS concerns.
Action 4 – Limiting base erosion via interest deductions and other financial payments

The final report on Action 4, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*,\(^{398}\) recommends that countries implement a “fixed ratio” rule that would limit net interest deductions claimed by an entity (or a group of entities operating in the same country) to a fixed percentage of earnings before interest, taxes, depreciation and amortization (EBITDA). The final report provides that this ratio should be somewhere between 10% and 30% of applicable EBITDA, levels that are described as having been designed to provide meaningful caps on net (not gross) interest expense, while still allowing most multinationals to deduct all their third-party interest.

The final report further recommends that countries adopt a “group ratio” rule to supplement (but not replace) the fixed ratio rule, and to provide additional flexibility for highly-leveraged groups or industry sectors. Under the group ratio rule, for example, an entity with net interest expense above a country’s fixed ratio could deduct such interest expense up to the level of the net third-party interest/EBITDA ratio of the worldwide group to which it belongs. Countries could also apply an uplift of up to 10% to the group’s net third party interest expense to prevent double taxation. An alternative group ratio rule also could be considered such as an “equity escape” rule, which would allow interest expense so long as an entity’s debt-to-equity ratio does not exceed that of its worldwide group.

Beyond this basic framework, the final report recommends that countries consider the following: (i) using an average of EBITDA for the current year and prior years, to minimize the impact of earnings volatility on interest deductions; (iii) providing for carryforward and/or carryback of

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disallowed interest expense and/or unused interest capacity, within limits; (iv) providing for exclusions for interest paid to third party lenders on loans used to fund public-benefit (infrastructure) projects and for entities with net interest expense below de minimis thresholds; and (v) providing targeted rules that would close down any remaining BEPS opportunities.

The final report indicates that limitations on interest deductions arising under hybrid mismatch arrangements as described in Action 2 should be applied before the interest limitations under Action 4, and the final report suggests that other limitations on interest expense, such as those arising under a country’s application of the arm’s-length principle or thin capitalization rules, also should be applied first. Moreover, interest disallowed under Action 4 should be subject to withholding tax.

The final report reflects the choices made by the OECD, having considered the pros and cons of the various alternatives discussed in the discussion draft, *BEPS Action 4: Interest Deductions and Other Financial Payments*, released in December 2014. In particular, the final report elevates the fixed ratio rule above the group ratio rule. However, while the final report provides clear direction on the basic framework for limiting net interest expense deductions, a number of questions remain. Many of these relate to implementation of the group ratio rule. For example, the final report does not conclude on whether group EBITDA should include tax-advantaged income such as dividend income that is either exempt or sheltered from home country tax due to foreign tax credits, or how to accommodate groups that have members with losses rather than positive EBITDA. In addition, no concrete suggestions are provided for applying the limitations on net interest expense to banks and insurance companies, which the report indicates have specific features that must be taken into account. These remaining items are to be addressed in work to be completed in 2016. Beyond that, the final report leaves open the timetable for
adopting the new rules, but recommends that countries introducing the fixed ratio rule and group ratio rule should give taxpayers reasonable time to restructure existing financing arrangements, and that any grandfathering provisions should primarily apply to third party loans.
Action 5 – Countering harmful tax practices

The final report on Action 5, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*,399 covers two main areas, (i) defining a “substantial activity” criterion to be applied when determining whether tax regimes are harmful; and (ii) improving transparency. In doing so, it touches on a wide variety of topics, including substance requirements for intellectual property (IP) and other regimes, the determination of which IP regimes are allowable and which need to be phased out, what constitutes a harmful preferential regime, which ruling information is to be mandatorily exchanged and to whom, what qualifies as a “ruling” and best practices for cross-border rulings (process of granting rulings, terms, publication).

In the first instance, the final report defines the substantial activity requirement in relation to IP regimes by presenting the “nexus approach” as the agreed approach. Under this approach, the application of an IP regime should be dependent on the level of research and development (R&D) activities carried out by the taxpayer itself. In addition, IP regimes should essentially be limited to patents (under a broad definition) and copyrighted software. Sixteen existing IP regimes were reviewed and found not to meet the nexus approach. No new entrants should be permitted to these regimes (or any other IP regime that does not meet the substantial activity requirement) after 30 June 2016 (or the effective date of a new regime consistent with the nexus approach if this is introduced before that date). The grandfather period may not be longer than five years after the date the regime is closed to new entrants. Enhanced transparency requirements will apply to new entrants into an IP regime after 6 February 2015 and the benefits

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of an IP regime should not be granted in respect of IP acquired directly or indirectly from related parties after 1 January 2016 (except in cases of acquisitions as a result of a domestic or international business restructuring).

When applying the nexus approach to activities other than IP, there would also need to be a link between the income qualifying for benefits and the core activities necessary to earn the income.

The final report lists types of core activities that are necessary to earn the income under different types of regimes focused on financial and other service activities, such as headquarters regimes, distribution and service centers, financing or leasing, fund management, banking and insurance and shipping. With respect to holding activities, the final report states that there may not in fact be much substance required but many of the concerns raised by holding regimes may be dealt with through existing factors that indicate a regime is harmful or through the recommendations under other aspects of the BEPS project (e.g., through the recommendations under Actions 2 and 6).

The second priority area is improving transparency through a framework for the compulsory spontaneous exchange of information on certain rulings.

This framework will apply to taxpayer-specific rulings that are (i) rulings on preferential regimes, (ii) unilateral Advance Pricing Agreements (APAs) or other cross border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits (in particular excess profit and informal capital rulings), (iv) PE rulings or (v) related party conduit rulings. The framework may be expanded to other types of ruling in the future. The information exchange requirement would not relate to the ruling itself, but to certain information with respect to the ruling as contained in a template included in the final report. The framework also deals with questions such as time limits, legal basis,
confidentiality and the countries with which such information would have to be exchanged. Information exchange is to apply not only to future rulings, but also to rulings that were issued on or after 1 January 2010 and were still in effect as from 1 January 2014. An ongoing monitoring and review mechanism, including annual review, is to be put in place to ensure countries’ compliance.
Action 6 – Preventing the granting of treaty benefits in inappropriate circumstances

The final report on Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*,\(^{400}\) which supersedes the interim version issued in September 2014, contains changes to the OECD Model Tax Convention and related changes to the Model Commentary to address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios.

The final report notes that a number of changes have been made to the report that was issued in September 2014 and that further work will be required with respect to certain provisions, including the limitation on benefits (LOB) rule.

The final report is organized in three sections. Section A includes anti-abuse provisions that provide safeguards against the abuse of treaty provisions and offers flexibility in implementation. In this regard, the final report notes that countries have committed to a “minimum standard” to provide a minimum level of protection against treaty shopping. Under the minimum standard, countries would implement: (i) the combined approach of a principal purpose test (PPT) rule and LOB rule; (ii) a PPT rule alone; or, (iii) an LOB rule, supplemented by specific rules targeting conduit financing arrangements. In cases where a county decides to use a combination of the PPT and LOB rules, the final report includes a variation on the LOB rules referred to as the “simplified version,” details of which are outlined in the Model Commentary. In addition to the minimum standard, the final report includes targeted rules to be included in tax treaties that would address other forms of treaty abuse, including situations of dual resident entities, and rules that apply to permanent establishments situated in third states.

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Section B of the final report contains revisions to the title and preamble of the OECD Model Tax Convention so that it is clear that the intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion and avoidance, including through treaty shopping arrangements. Section C identifies tax policy considerations relevant to the decision to enter into a tax treaty with another country, which would also be relevant in determining whether to modify (or ultimately terminate) a treaty if there has been a change in circumstances.

Finally, as indicated above, the final report outlines further work that will be required under Action 6. In particular, the final report refers to the proposals by the United States to modify the LOB rule in the US Model Treaty. It is noted that the LOB rule, and Commentary related thereto, contained in the final report should be considered as draft and subject to change pending further review that will take into account the finalization of the proposed revisions to the LOB rule in the US Model Treaty. Final versions of the LOB rule and Commentary are expected to be completed in the first part of 2016. In addition, the final report specifies that further work is needed with respect to the treaty entitlement of non-collective investment vehicles (non-CIVs) and pension funds and indicates that such work would benefit from consultation with stakeholders. Further work would need to be completed in the first part of 2016 in order to be relevant for the negotiation of the multilateral instrument under Action 15, which is expected to be finalized in 2016.
Action 7 – Preventing the artificial avoidance of PE status

The final report on Action 7, Preventing the Artificial Avoidance of Permanent Establishment Status, proposes changes to the PE definition in Article 5 of the OECD Model Tax Convention to prevent the use of the following arrangements and strategies that are considered to enable a foreign enterprise to operate in another country without creating a PE:

✓ Commissionaire arrangements and similar strategies

✓ The use of specific preparatory or auxiliary activity exemptions, including the artificial fragmentation of so-called “cohesive” business activities into several smaller operations such that each part is able to benefit from the use of such specific activity exemptions

The final report also proposes the use of the PPT rule that will be included in the OECD Model Tax Convention under Action 6 to deal with strategies involving the splitting-up of contracts between closely related enterprises in the context of construction contracts, and an alternative provision in the Commentary consisting of an automatic rule requiring the aggregation of time spent by closely related enterprises at the same building site or construction or installation project to calculate the 12 month threshold.

The final report, compared to the revised discussion draft, BEPS Action 7: Preventing Artificial Avoidance of PE Status, issued in May 2015, contains no major changes in terms of the position taken by the OECD on the perceived BEPS abuses arising from the artificial avoidance of PE status. However, the final report reflects some refinements to the proposed amendments to Article 5(5) as well as Article 5(6). Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the “authority to conclude

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contracts in the name of the enterprise” in order to create a PE. The final Action 7 report would refer to persons (other than an independent agent) that habitually conclude contracts or “habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise,” while the discussion draft referred to “persons that habitually concluded contracts or negotiated the material elements of contracts.” Changes also were made to the proposed wording to tighten the definition of independent agent in Article 5(6) by replacing the concept of “connected parties” with “closely related enterprises;” the final report now includes for this purpose cases where a person possesses directly or indirectly more than 50% of the beneficial interest in the other or, if a company, more than 50% of the aggregate vote and value of the company’s shares or the beneficial equity interests.
Actions 8-10 – Transfer pricing aspects

The OECD has included its updated transfer pricing guidance in one report under Actions 8-10,\textsuperscript{402} covering:

- Amended guidance on applying the arm’s length principle (revisions to section D of chapter I of the OECD Transfer Pricing Guidelines), notably providing guidance on the identification of the actual transaction undertaken, on what is meant by control of a risk, and on the circumstances in which the actual transaction undertaken may be disregarded for transfer pricing purposes

- Guidance on comparability factors in transfer pricing, including location savings, assembled workforce, and MNE group synergies (additions to chapter I of the OECD Transfer Pricing Guidelines). This guidance remains unchanged from the guidance issued as part of the 2014 report on transfer pricing for intangibles

- New guidance on transfer pricing for commodity transactions (additions to chapter II of the OECD Transfer Pricing Guidelines)

- A new version of chapter VI of the OECD Transfer Pricing Guidelines addressing intangibles, including new guidance on the return to funding activities and on hard-to-value intangibles

- New guidance on low-value adding intragroup services (revisions to chapter VII of the OECD Transfer Pricing Guidelines)

- An entirely new version of chapter VIII of the OECD Transfer Pricing Guidelines, covering cost contribution arrangements

In addition, the Actions 8-10 package describes additional work to be conducted by the OECD to produce new guidance on the application of the transactional profit split method. The aim is to produce a discussion draft in 2016 and final guidance during the first half of 2017.

**Intangibles**

The intangibles final report consists of a new version of chapter VI, which builds on the version issued in September 2014. The structure of the final report is the same, containing four sections providing guidance on: (i) identifying intangibles for transfer pricing purposes, including a definition of intangibles for transfer pricing purposes; (ii) identifying and characterizing transactions involving intangibles, including the determination which entity or entities should share in the costs and risks of intangible development and the economic returns from the intangibles; (iii) identifying types of transactions involving intangibles; and (iv) determining arm’s length conditions and pricing in cases involving intangibles, in particular addressing intangible valuation, and arm’s length conditions for hard-to-value intangibles.

The key features of the final report, and key differences from earlier reports on intangibles, are:

- Guidance on which entity or entities are entitled to share in the economic return from exploiting intangibles. The final report clarifies and confirms previous work, stating that mere legal ownership of an intangible does not confer any right to the return from its exploitation. Instead, the economic return from intangibles will accrue to the entities that perform the important value-creating functions of developing, enhancing, maintaining, protecting and exploiting the intangible, and that assume and manage the risk associated with those functions.
- New guidance on determining the arm’s length return for providing funding for intangible development. Where the entity providing the funding exercises control over
the financial risk assumed, that entity is entitled to an expected rate of return commensurate with the risk (for example, based on the rate of return that might be achieved by investing in comparable alternative investments). Where the entity does not exercise control over the financial risk, it is entitled to (no more than) a risk-free return only.

✓ Guidance on valuation methods. The final report confirms that database comparables are seldom appropriate for pricing intangible transactions, and provides guidance on the use of other valuation techniques that may be more applicable.

✓ Guidance on hard-to-value intangibles. Where intangibles are transferred or licensed in development or where their value is highly uncertain, the tax administration is entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm’s length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction. The taxpayer can prove the original pricing was based on reasonable forecasts taking into account all reasonably foreseeable eventualities. There are some similarities with the US “Commensurate with Income” standard.

The guidance on intangibles is effectively final, although one small section within part D on the application of the transactional profit split method for pricing intangibles transactions is likely to be revised when the OECD completes its new guidance on this transfer pricing method.

*Cost contribution arrangements*

The section on cost contribution arrangements (CCAs) replaces existing chapter VIII of the OECD Transfer Pricing Guidelines in its entirety. The objective of the final report is to align the guidance on CCAs with the new guidance elsewhere in the final report on control of risk and on
intangibles transactions. The guidance contained in the final report is similar to the guidance in the discussion draft issued in April 2015, although some aspects have been refined in light of the OECD consultations with business representatives.

The key points contained in the final report are:

✓ CCAs are contractual arrangements among business enterprises for sharing contributions and risks associated with the joint development, production or obtaining of intangibles, tangible assets or services, in the expectation of mutual benefit from the pooling of resources and skills.

✓ The expectation of mutual benefit is a pre-requisite for participating in a CCA. Participants must expect to benefit from the output of the CCA, for example by being able to exploit the rights acquired or services developed in their own businesses.

✓ Control is a pre-requisite to be considered as a participant in a CCA. Participants must have the functional capacity to exercise control over the risks taken in the CCA. This means they must be capable of making the decision to take on the initial financial risk of participation in the CCA, and must have the ongoing decision-making capacity to decide on whether or how to respond to the risks associated with the CCA.

✓ The value of the contributions made by CCA participants must be in proportion to their reasonably anticipated benefits from the CCA. Where contributions are not in proportion to reasonably anticipated benefits, true-up payments may be required.

✓ The value of each participant’s contribution should be determined in line with the value that would be placed on it by independent enterprises in comparable circumstances.

✓ While contributions should be measured based on value, the final report recognizes that it may be more practical for taxpayers to compensate current contributions at cost.
However, this approach may not be appropriate where the contribution of different participants differ in nature (for instance, where some participants contribute services and others provide intangibles or other assets).

Hard to value intangibles

The final report contains a specific transfer pricing approach with respect to hard-to-value intangibles (HTVI). The guidance finalizes an earlier discussion draft released June 2015. HTVI are defined as intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist; and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer. The approach is intended to ensure that tax administrations can determine in which situations the pricing arrangements with respect to a HTVI as set by the taxpayers are at arm’s length and are based on an appropriate weighting of the foreseeable developments or events that are relevant for the valuation of certain HTVI and in which situations this is not the case. Under this approach, ex post evidence provides presumptive evidence as to the existence of uncertainties at the time of the transaction, whether the taxpayer appropriately took into account reasonably foreseeable developments or events at the time of the transaction, and the reliability of the information used ex ante in determining the transfer price for the transfer of such intangibles or rights in intangibles. Such presumptive evidence may be subject to rebuttal if it can be demonstrated that it does not affect the accurate determination of the arm’s length price. Compared to the discussion draft, the final report provides more detailed exemptions and safe harbors when a transfer does not fall within the rules on HTVI.
Risk & Capital

The final report also contains revisions to Section D of Chapter I of the OECD Transfer Pricing Guidelines following the work under Action 9 (transferring risks or allocating excessive capital) and Action 10 (clarifying circumstances to re-characterize transactions). More specifically, the revisions include the following main guidance to consider in conducting a transfer pricing analysis:

- The importance of accurately delineating the actual transactions between associated enterprises through analyzing the contractual relations between the parties together with evidence of the actual conduct of the parties.

- Detailed guidance on analyzing risks as part of a functional analysis, including a six-step analytical framework. This framework considers the identification of the economically significant risks with specificity, the determination of contractual allocation of these risks and the functions relating to these risks. For transfer pricing purposes, the associated enterprise assuming a risk should control the risk and have the financial capacity to assume the risk.

- A capital-rich MNE group member without any other relevant economic activities (a “cash box”) that provides funding, but cannot control financial risks in relation to the funding, will attain no more than a risk-free return, or less if the transaction is commercially irrational.

- In exceptional circumstances of commercial irrationality, a tax administration may disregard the actual transaction. The main question is whether the actual transaction has the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances.
With respect to risk and re-characterization, the final report contains significant changes compared to the discussion draft in December 2014, including the inclusion of guidance on risk as an integral part of a functional analysis, the new six-step analytical framework to analyze risk, the inclusion of a materiality threshold by considering economically significant risks with specificity, the importance of financial capacity to assume risk, which was generally ignored in the discussion draft, and elimination of the moral hazard concept.

*Low value added services*

The guidance on low value adding services under Action 10 finalizes an earlier discussion draft released in November 2014. It takes the form of a rewrite of chapter VII of the OECD Transfer Pricing Guidelines on services. The updated guidance has the stated aim of achieving a balance between appropriate charges for low value adding services and head office expenses and the need to protect the tax base of payor countries.

Key features of the proposed guidance include:

- A standard definition of low value-adding intra-group services as being supportive in nature, not being part of the MNE’s core business, not requiring or creating valuable intangibles and not involving significant risks.
- A list of services that would typically meet the definition. In essence the services listed are back-office services.
- An elective simplified approach to determine arm’s length charges for low value-adding services:
  - A process for determining the costs associated with low value adding services
  - Allowing general allocation keys
  - A simplified benefits test
• A standard 5% mark-up

✓ Prescriptive guidance on documentation and reporting that should be prepared for the MNE to be able to apply the simplified approach.

✓ The ability for tax administrations to include a threshold above which the simplified approach may be denied. Further work on the threshold will be performed as part of step two mentioned below.

Implementation will take place in two steps. As step one, a large group of countries has agreed to endorse the elective simplified mechanism by 2018. The second step looks to provide comfort to other countries that the elective simplified mechanism will not lead to base-eroding payments. It will entail further work in relation to a potential threshold above which the elective simplified mechanism will not apply and other implementation issues.

Finally, the revised guidance encourages tax administrations to limit any withholding taxes on low value-adding services to the profit element in the charge only.

Profit split

One of the objectives of Action 10 was to prepare transfer pricing rules or special measures to clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains. In order to determine for which matters additional clarification would be useful, the OECD released a discussion draft in December 2014. That discussion draft did not include revised guidance. The final report released in respect of Actions 8-10 includes a “scope of work for guidance on the transactional profit split method” which explains, among others, that the revised and improved guidance should:
✓ Clarify the circumstances in which transactional profit splits are the most appropriate method for a particular case and describe what approaches can be taken to split profits in a reliable way.

✓ Take into account changes to the transfer pricing guidance in pursuit of other BEPS actions and take into account the conclusions of the Report on Addressing the Tax Challenges of the Digital Economy, developed in relation to BEPS Action 1.

✓ Reflect further work being undertaken to develop approaches to transfer pricing in situations where the availability of comparables is limited, for example due to the specific features of a controlled transaction, and clarify how in such cases, the most appropriate method should be selected.

This scope of work as included in the final report will form the basis for draft guidance to be developed by the OECD during 2016 and expected to be finalized in the first half of 2017. A discussion draft will be released for public comments and a public consultation will be held in May 2016.

Commodities

The new guidance on commodity transactions under Action 10 finalizes an earlier discussion draft released in December 2014 and includes additional paragraphs to be inserted immediately following paragraph 2.16 of the OECD Transfer Pricing Guidelines. The stated aim is an improved framework for the analysis of commodity transactions from a transfer pricing perspective which should lead to greater consistency in the way that tax administrations and taxpayers determine the arm’s length price for commodity transactions and should ensure that pricing reflects value creation. The key features of the released guidance on commodity transactions include:
 ✓ Clarification of the existing guidance on the application of the comparable uncontrolled price (CUP) method to commodity transactions and the use of publicly quoted prices to apply the CUP.

 ✓ Recommendation that taxpayers document their price-setting policy for commodity transactions to assist tax authorities in conducting informed examinations.

 ✓ Guidance regarding the adoption of a deemed pricing date for controlled commodity transactions in the absence of evidence of the actual pricing date agreed by the parties to the transactions.

 Compared to the discussion draft, the final guidance has minor changes, including a more specific list of the types of adjustments applicable when using a CUP method and clarification that the functions performed, assets used and risk assumed by other entities in the supply chain need to be compensated properly.
Action 11 – Collecting and analyzing data on BEPS

Action 11 is different from the other BEPS Actions because it is concerned with measuring BEPS activity rather than addressing it. Action 11 is intended to estimate the size of BEPS, identify indicators of BEPS, and provide recommendations for improving the measurement of BEPS. The final report on Action 11, *Measuring and Monitoring BEPS*, estimates that global corporate income tax revenue is reduced by 4% to 10% (i.e., US$100 billion to US$240 billion annually).

The six indicators of BEPS identified in the final report are: (i) the concentration of foreign direct investment in low tax countries; (ii) the profit rates of MNE affiliates in low tax countries compared to those in high tax countries; (iii) the profit rates of MNE affiliates in low tax countries compared with the profit rate of their own global groups; (iv) the effective tax rates of MNEs compared to those of domestic-only enterprises; (v) the separation of intangible assets from the location of their production; and (vi) the concentration of debt in MNE affiliates located in higher-tax rate countries.

The final report recommends greater cooperation between the OECD and taxing authorities in the collection and sharing of data. It also identifies several additional measures of BEPS that will become possible using the data collected under Actions 5, 12, and 13.

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Action 12 – Disclosing aggressive tax planning arrangements

The final report on Action 12, Mandatory Disclosure Rules, makes a series of recommendations about the design of mandatory disclosure regimes. The objectives of such a regime are to increase transparency through providing early information to tax authorities, deter the implementation of potentially aggressive schemes and early identification of promoters and taxpayers associated with abusive schemes which are considered to pose BEPS-related tax risks. Countries are free to choose whether or not to adopt a mandatory disclosure regime and the recommendations set out within the Action 12 final report do not constitute a minimum standard. Countries can elect whether to place the primary responsibility for disclosure either on the promoter or on both the promoter and the taxpayer. To the extent a promoter has the primary obligation to disclose a reportable scheme or transaction, the OECD suggests that the burden to disclose switches to the taxpayer in situations where the promoter is offshore, there is no promoter, or the promoter has legal privilege. A promoter should disclose a scheme at the time it is made available to the taxpayer; whereas if the onus for disclosure rests with the taxpayer, the taxpayer should disclose at the time of implementation of the scheme.

Hallmarks are used to test what types of arrangements should be disclosed, with the recommendation being that a mixture of generic (e.g., confidentiality, premium fee) and specific (to target specific transactions such as loss schemes or leasing transactions) hallmarks are used, although just one hallmark needs to be met to trigger a disclosure obligation. In order to reduce the burden of compliance, the final report recommends that certain thresholds are introduced.

(i.e., a main benefit test and/or a de minimis filter). It should only be necessary to consider the hallmarks if such an initial threshold is exceeded. The main amendments to the final report compared to the discussion draft issued in March 2015 relate to how the mandatory disclosure regimes should be implemented in order to capture international tax schemes which have a material tax revenue risk in the reporting jurisdiction. The final report emphasizes that the hallmarks introduced in relation to such schemes should focus on BEPS-related risks in particular (as opposed to general tax planning risks as stated in the discussion draft). The OECD recommends that these schemes should require disclosure where the domestic taxpayer (or the taxpayer’s adviser) could reasonably have expected to have been aware of the cross-border outcome of an arrangement, and they should make reasonable inquiries at the time of entering into such arrangements to determine whether they include cross-border outcomes (such recommendations were not originally contemplated in discussion draft).

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Action 13 – Guidance on transfer pricing documentation and country-by-country reporting

The final report on Action 13, Transfer Pricing Documentation and Country-by-Country Reporting, sets out a three-tiered standardized approach to transfer pricing documentation and country-by-country (“CbC”) reporting, in line with the report issued in September 2014. This standardized approach consists of:

- A “master file” that provides tax administrations with high level information regarding a multinational enterprise’s (MNE’s) global business operations and transfer pricing policies
- A specific “local file” that provides a local tax administration with information regarding material related party transactions, the amounts involved, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions
- A CbC reporting template that requires large MNEs to report the amount of revenue (related and unrelated party), profits, income tax paid and taxes accrued, employees, stated capital and retained earnings, and tangible assets annually for each tax jurisdiction in which they do business. In addition, MNEs are required to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity conducts.

The master file and the local file are to be delivered directly to local tax administrations. CbC reports should be filed in the jurisdiction of tax residence of the ultimate parent entity and shared between jurisdictions through automatic exchange of information, pursuant to government to government agreements.

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government mechanisms under the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties or tax information exchange agreements.

The new CbC reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply to MNEs with annual consolidated group revenue equal to or exceeding €750 million.

In order to facilitate the implementation of the new reporting standards, an implementation package has been developed consisting of model legislation, which could be used by countries to require MNE groups to file the CbC report and competent authority agreements that are to be used to facilitate implementation of the exchange of those reports among tax administrations. As a next step, it is intended that an XML Schema and a related User Guide will be developed by the end of 2015 with a view to accommodating the electronic exchange of CbC reports.

The OECD states it is mandated that countries participating in the BEPS project carefully monitor the implementation of these new standards and reassess no later than the end of 2020 compliance and effectiveness of the new three tier approach.
Action 14 – Making dispute resolution mechanisms more effective

The final report on Action 14, *Making Dispute Resolution Mechanisms More Effective*,\(^\text{408}\) reflects the commitment of participating countries to implement substantial changes in their approach to dispute resolution. The final report contains measures aimed at strengthening the effectiveness and efficiency of the mutual agreement procedure (MAP) mechanism, such as specific actions to be taken by countries, suggested changes to legislation and administrative practices, and changes to the OECD Model Tax Convention and its Commentary. The main objectives of the measures are (i) to allow taxpayers access to the MAP process when the requirements for taxpayers to access the MAP process are met; (ii) to ensure that domestic administrative procedures don’t block access to the MAP process; and (iii) to ensure that countries implement Article 25 of the OECD Model Tax Convention in good faith.

A number of these measures constitute a minimum standard on treaty-based dispute resolution to which all OECD BEPS and G20 countries have agreed to adhere. Compliance with this standard will be subject to peer based monitoring that will be executed through the Forum on Tax Administration’s MAP Forum. The minimum standard is complemented with additional measures designated as best practices to which only some of the OECD BEPS and G20 countries were willing to commit. Finally, the report lists 20 countries that have agreed to implement mandatory binding MAP arbitration in their bilateral tax treaties. According to the OECD, the countries that have made that commitment were involved in more than 90% of the outstanding MAP cases at the end of 2013.

Action 15 – Developing a multilateral instrument to modify bilateral tax treaties

Action 15 explores the technical feasibility of a multilateral instrument to implement the treaty related measures developed during the course of the BEPS project and to amend bilateral tax treaties. The final report on Action 15, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties, provides an overview of the current status of this multilateral instrument and mainly reproduces the report issued in September 2014 (the 2014 report).

Drawing on the expertise of public international law and tax experts, the report explores the technical feasibility and desirability of a multilateral instrument and its consequences on the current tax system. This report considered that such an instrument is desirable as it would achieve swift and consistent implementation of the measures developed during the course of BEPS by avoiding the need to individually renegotiate existing bilateral tax treaties. The report also identifies several obstacles to a multilateral instrument from a technical (public international law and international tax law) and political perspective. Drawing from numerous examples of multilateral treaties in areas other than tax, it describes that these obstacles can nevertheless be overcome, thereby concluding that a multilateral instrument also appears feasible. The report suggests that the scope of such a multilateral instrument should initially only include the treaty based measures of the BEPS project once finalized (e.g., multilateral mutual agreement procedure, provisions on dual residence structures, hybrid mismatch arrangements, triangular cases involving PEs in third states and treaty abuse).

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Based on the analysis in the 2014 report, a mandate for the formation of an ad hoc Group to develop the multilateral instrument was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. This Mandate also was reproduced in the final report on Action 15. The Group is open to all interested countries, including non-OECD or G20 members, with all participating on an equal basis. The Group began its work in May 2015 with the aim to finalize the multilateral instrument and to open it for signature by 31 December 2016. To date, approximately 90 countries are participating. Participation in the development of the multilateral instrument is voluntary and does not require any commitments to sign such instrument, once it has been finalized.

These final reports represent the culmination of work on the BEPS project. These reports include recommendations for significant changes in key elements of the international tax architecture. Such changes are reflected in revisions to the OECD Transfer Pricing Guidelines and the OECD Model Tax Convention and in recommended domestic law provisions. Participating in the discussions that led to these consensus recommendations were all OECD and G20 countries and about a dozen developing countries.

With the release of the OECD final reports, attention turned to countries to determine whether, when and how to implement the various recommendations. Countries had already begun taking action in anticipation of the OECD recommendations, and there has been significant BEPS-driven legislative and tax administration activity around the world since the OECD issued its Action Plan on BEPS in July 2013. Moreover, the G20 Finance Ministers have asked the OECD to develop an inclusive framework for monitoring the implementation by countries of the BEPS

\[410\] Id.
recommendations. That framework is to be developed by early 2016. At the same time, the OECD will be completing follow-on technical work related to several of the BEPS focus areas, including interest limitations under Action 4, treaty abuse under Action 6, permanent establishment under Action 7 and transfer pricing under Actions 8-10. Companies are to evaluate the implications of the recommendations contained in the final reports for their business models and operating structures. Companies also need to closely monitor legislative and tax administrative developments in the countries where they operate or are considering investing. The release of the final reports ushered in a time for companies to prepare for significant potential changes in the international tax environment.

In conclusion, the BEPS Project has moved very fast, and generated enormous interest and comments from both the public and private sectors. The Project has shown a quasi universal agreement that there is a need for a fundamental review of the international tax system. The ambitious timetable assigned to each of the Action Items was a testimony to the urgency of the matter. The urgency is further developed by the worldwide media attention of the perceived tax inequities and the need to provide tax authorities broad enough rules that they could use as they see fit to combat international tax problems causing base erosion and profits shifting. The BEPS has come to terms with the need for global solutions to the international tax problems. Many of the solutions offered mirror the formulary apportionment method and satisfy many tenets of a unitary taxation even though the authors of such measures publicly deny that very fact.\[^{411}\] Ideas of combined reporting, the multilateral global treaty model or the coordination with all interested parties are in conformity with the requirements of a unitary taxation system. It's clear that several

OECD stakeholders want the broadest rules possible to use against taxpayers; however, this means companies will be walking on egg shells with more subjective rules and uncertainty. The likely increase in taxpayer disputes then gets thrown back into an already stretched competent authority network. In the absent a proactive approach and a revamp of the system, solutions and recommendations offered by the BEPS project are mostly bound for failure, and in the process, will generate unnecessary and overwhelming complexity. The need for a new order, based on UT principles has never therefore been more urgent and opportune.
Part 2
The UT as the Panacea for the Current Ills of the International Tax System
As seen above, there is not much disagreement on the fact the current international tax system is broken. The issue however, is the deep disagreement on how to solve it, how to move forward. The idea of a UT at an international level has been floated around but has not attracted much of a thorough research and comprehensive work as to its viability and merits or lack thereof. In many cases, opponents of a global UT have rushed to show how it lacking without measuring from the standpoint of the current ALS system.\footnote{For a thorough recent overview of the problems of UT&FA see David Spencer, Formulary Apportionment is Not a Panacea, Journal of Int’l Taxation 35 (May, 2014).} In this research, we believe that UT has to be understood and appreciate in comparison with the current ALS system. We agree that UT is not a perfect system and does not provide a flawless solution to each and all the problems faced in international taxation. UT, we acknowledge, is not perfect. Nevertheless, it is our belief that a better understanding of the principles around UT would lead any reasonable observer to the conclusion that UT is a far much better system than the current ALS system. Like every rose, the UT has its thorns, but no reasonable person should deny the fact that it remains a rose; at least when compared to current failed system. The goal for this research is not to argue that the UT is a perfect system; one would never find a perfect system. The goal instead, is to revisit and explain what a UT is, provide a better comprehension about its tenets and its functioning, and then opine that in all respects, the UT is a better system that the ALS. We believe that an explanation of what a UT is, and an understanding of its functioning would lead a reasonable reader and observer to conclude that UT is dramatically better than the current ALS. This second part of the research starts with an analysis of what a UT really is, what it entails and how it functions. Then, we will refute the ordinary arguments that are casually levelled against adoption of a UT. Also, we will advocate and outline the major areas in which we believe UT is better than the current ALS. And finally, we will mock a reform proposal based on UT principles.
Chapter V

The Building Blocks of a Unitary Tax System
Any idea of a UT comprises and must comprise at least three main tenets: a unitary business combined reporting, and formulary apportionment. We will look at each in turn.

A. The Unitary Business

To have a UT, there is a need for a unitary business. Whether a unitary business exists depends, as it should, on economic realities. It is therefore important to examine what a unitary business is. This notion is so important that success of any UT will depend on a careful construction and delicate definition of the notion of a unitary business. In the United States for example, the Supreme Court stated in the Mobil case that “the linchpin of apportionability… is the unitary business principle”\(^{413}\) and there is rather extensive case law in the U.S. regarding the definition of the unitary business as it applies to state taxation within the federation.\(^{414}\) On a cross border level however, it is important to conduct an in-depth analysis and examine what definition would be more appropriate. The appropriateness or not of an approach to a unitary system would depend on its impact on the international arena. Questions to be answered include whether the notion should be construed narrowly, or rather widely. What would a narrow or wide construction of the notion of unitary business mean to the international tax system? What would it mean to multinational companies? What would it mean to tax authorities and developing countries tax authorities in particular? What would be its impact on attempts to promote a wide adoption of the unitary tax system across the globe? Do we need a de minimis provision?

\(^{413}\) See 445 U.S. at 437.

On a very superficial perspective, businesses would be considered unitary if activities of one in one country are “inseparable” with activities of the other in another country. There are currently two approaches to the notion of unitary business. On the one hand a three-prong test, and on the other hand, the so-called alternative approach.

The three-prong test aims at combining at least two factors out of three in order to declare a business unitary. First, there is a need for “common ownership”. Under this test, businesses have to be owned by the same person. This includes both vertical ownership as well as brother sister corporations’ situations. This element can be approached from a wholly legalistic point of view. For instance, one could define the ownership to be certain percentage of stock holding in the corporation. Under this view, any corporation owning for example 50% of another would form a unitary business with that corporation. Such legal ownership could be reduced or increased to some other percentage that could be judged appropriate in view of the circumstances and legal realities and concerns. Likewise, ownership can be approached from a wholly economic point of view. This approach therefore could give less weight to the legal ownership percentage of stock, but rather the substance of the economic relationship between the entities.

See Keesling and Warren; McLure, Jr., Defining a Unitary Business: An Economist’s View, in THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION 89-112 (C. McLure, Jr. ed. 1984). Also, In Floyd, The ‘Unitary’ Business in State Taxation: Confusion at the Supreme Court?, 82 B.Y.U.L.REV. 465 (1982), the author distinguished three relevant applications of the unitary business principle. In the first type of case, the issue is ‘whether various business activities of a taxpayer corporation constitute a single, interrelated business—i.e., a unitary business—or two (or more) separate, discrete unitary businesses.’ Floyd, supra, at 469. In the second type of case, the issue is ‘whether a group of affiliated corporations form a part of a single, unitary business and thus can be ‘combined’ . . . so that the net income can be determined . . . as if the unitary business were conducted by a single corporation.’ Id. at 470. In addition, ‘[b]ecause the combined report situation pierces the corporate veil and treats two legally separate entities as one, . . . the court [must] consider both the degree of ownership and management control and the functional integration of the activities of the various affiliated corporations.’ Id. In the third type of case, the issue is ‘whether a particular item of income (or deduction) is unitary business income, or is income generated by an investment or activity which lies outside the unitary business.’ Id. Practically every major case on the unitary business concept can be seen to reflect one of the above categorizations.


See for example, 293 U.S. 465 developing the Substance over form doctrine in the court’s reasoning.
Under this first element, there need to be an agreeable construction of ownership able to trigger unitary business qualification. There is a need for common ownership, but maybe most importantly, common control, whether the control is arrived at through legal ownership percentage or economic substance of the relationship. Our position is that the common ownership prong be measured using all available tools. As a consequence, it is our position that legal ownership at a set percentage should constitute unitary business. However, any such rule should be accompanied by the possibility of including within a unitary business, entities that may not have legal required ownership but for which the economic ownership is determinable. A legal threshold along with an economic reevaluation is a workable standard for establishing a unitary business.

The second element under the three-prong test is the need for a unity of operation. Under this element, the operations of the different business, though in separate geographical areas, must be very related and dependent. Here, the other business would not be able to operate for itself but for the constant interaction with other businesses. All the business must have very close and dependent operations, and the business of one should be reasonably tied to the other or others. Under this element, the frequency of interaction between the businesses could be helpful. Factors as to whether the costs are shared within the business entities are also helpful. Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions. As indicated by Olivia Klein, the regularity of transactions between the entities as well as their constant use of transfer pricing and the potential for transfer pricing rules manipulation are

418 See for example, Container Corp of America v. Franchise Tax Board, 103 S.CT 2933 (1983).
419 See Chase Brass & Copper Co. v. Franchise Tax Bd., 10 Cal.App.3d 496, 502-04, 95 Cal.Rptr. 805, 808-09, cert. denied, 400 U.S. 961 (1970); see also Hellerstein (discussing restrictive and broad interpretations of unitary business tests).
helpful indicators. This element emphasizes the unity of operation and indicates that if the operations tie the entities together, then such entities may eligible for unitary business treatment. The last element of this test is the unity of use prong, centralized executive force and general system of operation.\textsuperscript{420} This element emphasizes the use in the business, whether the entities commingle assets, whether assets used by one business are put in use by the other. The unity of use focuses on the use element and factors such as the industry in which the entities operate and the specificities of their use and practices are helpful.

The three-prong test is an analysis of element by element in determining whether a business is unitary. It should be noted that most actors agree that at least two of the element should be met in order to qualify as a unitary business. In the United States, the reading of the Supreme Court cases suggests that the common ownership element should always be met, combined with either the unity of operation or unity of use element.

Aside from the three-prong test, there has been developed a more generalized approach called the “dependency test”.\textsuperscript{421} The inquiry under this approach is as to whether the business operations of an entity in a jurisdiction contribute or depend in any way on the business operations outside that jurisdiction. The inquiry here is focused on the contribution and dependency between activities of various affiliated businesses, or parts thereof. Areas of inquiry include: whether the there is a centralized decision making authority; is there outside control; whether risks are shared. This test looks at a unitary business as a functional integration, centralization of management, and economies of scale marked by a flow of value among the affiliated entities. Here, the term “unitary business” means that the taxpayer to which it is applied


is carrying on a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration as independent units.\footnote{422 See John I. Haas, Inc. v. Comm'n, 227 Or. 170, 361 P2d 820, 822 (1961).}

This is the very first step is designing a unitary tax system and this step is very important because the credibility, promotion, and enforceability of such a unitary system would also depend on a careful construction of what constitute a unitary business. This task goes beyond the mere need to provide a definition but lies in the heart of whether there could be a widely adoptable unitary tax system. Further, the definition whether large or narrow, could determine whether a unitary tax system is successful. This part of the research will require in depth analysis and a construct of an approach to the notion of unitary business, an approach that will be consistent with our overall goal of designing a system fair to multinational companies and fair to all tax administrations and those in developing countries specifically. Our analysis will also strive to come as close as possible to the economic reality of business transactions reducing the potential for gamesmanship by multinational companies, specifically.

Once a Unitary business is established, the next step is to require a combined income report for all the corporate entities within the Unitary Business.
B. Combined Reporting

UT requires that items of income be reported on a combined basis. Under combined reporting, the separate accounting would be mitigated as the global entity would be required to account for their operations and items of income globally. One of the preliminary issues to arbitrate here is whether the combine reporting is a combine reporting of income, or a combine reporting of net income.423 This as much an accountings issue that it is a tax law issue. There are two major accounting procedures in the world: the Generally Accepted Accounting Principles (GAAP),424 and the International Financial Reporting Standards (IFRS).425 An adequate application of combined reporting would be more enhanced if either one of these accounting systems is applied uniformly and globally, or if both systems are abandoned for the benefit of a new system that could enjoy global consensus.

A requirement of a combined reporting of gross income would carry specific mechanical specification and would lead to burdensome consequences. Under a global combined reporting of gross income, the unitary business as a whole, would report all of its revenues. At a local level, members of the unitary business would not take deductions, would not account for expenses. The unitary business will in fact report the equivalent of its global revenues under a combined reporting of gross income system. Under this system, expenses and deductions will be taken into account at the global level, at the level of the global unitary business. This approach will render the system cumbersome and might not be practical. The first issue under this approach is the tax base problem that is a very country specific item. A combined reporting of gross income would require a harmonization of accounting standards. All countries will need

425 Id.
similar accounting mechanisms in getting to their tax base. The other issue with a combined reporting of gross income is the ineffectiveness of various country specific incentives and economic booster measures. Under the combined reporting of gross income, deductions are not allowed at the local level, making all country specific incentives inoperative. The combined reporting of gross income is therefore not desirable as it would engender dysfunction and confusion in various respects including the definition of the tax bases, as well as operation of country specific economic booster measures.

A requirement of a combined reporting of net income, on the other hand, will have its operational mechanisms and would yield to more desirable consequences. First, global combined reporting of net income would require that each local country member of the unitary business takes into account its expenses and deductions locally. This will allow for application of each local country accounting principles and a respect of each countries definition and understanding of the notion of tax base. Each member of the unitary business will calculate, locally the amount of its net income by taking into account local deductions and other deductible expenses, and other costs that the local country allows as an offset to gross income and in arriving at taxable income. Second, a global combined reporting of net income would allow for local measures of economic enticement to be effective. For example, under the global reporting of net income, many measures of tax incentives, applicable in various developing countries, would still be effective in achieving the desired encouragement to economic growth. Local members of a unitary business would be able to take the various incentives into account in arriving at their net income that is then communicated the global unitary business. Further, the global combined reporting of net income offers various advantages as regards to simplicity and efficiency. Once
the global unitary business reports its global net income, the application of apportionment formula would be more appropriate.

It is also important, as a preliminary matter, to distinguish the combined reporting with the consolidated return. The consolidated return is a notion that exists in most if not all tax legislations.\(^{426}\) Under the consolidated return, the rules usually pertain to ownership of the corporate entity. As a matter of fact, most tax legislations require consolidated returns to be filed when stockholding in a corporate entity reaches a certain percentage point, usually eighty percent ownership.\(^{427}\) As a consequence, consolidated returns are not based on the business activities of the consolidated corporate entities. In fact a parent company could conduct business in truck manufacturing and file consolidated returns with its wholly owned subsidiary conducting business in a totally unrelated business enterprise. On the other hand however, combined reporting is required when there is a unitary business, and unitary business will usually exist when several corporate entities conduct a common business enterprise.\(^{428}\) The careful construction of the notion of unitary business, as discussed above, would take these considerations into account. In addition, consolidated return would usually require a higher percentage ownership, while a unitary business hence the combined reporting could exist with a more relaxed percentage ownership.\(^{429}\)

The philosophy behind combined reporting is the belief, legitimately so, that the income earned by a related group of corporations engaged in a common enterprise is, in fact, the income of the enterprise as a whole and not that of the various members of the group that have sometimes been

\(^{426}\) See for example, IRC Section 1504.
\(^{427}\) *Id.* For the 80% ownership requirement.
\(^{428}\) For example, Coca Cola International, dealing in the beverages industry.
\(^{429}\) For example, a 50% ownership for combined reporting (and 80% ownership for consolidation).
established solely for intergroup reasons.\textsuperscript{430} Combined reporting therefore reinforces the basic tenet of unitary taxation: approaching multiple but connected entities as a single enterprise and single entity for tax purposes. In the case of multinational companies, combined reporting effectively treats the parent and most or all of its subsidiaries as a single corporation for a country’s income tax purposes. There is a requirement that the profits of the parent and most or all of the subsidiaries be added together in the calculation of the corporation’s profit in a particular country. The country then taxes a share of the combined profit using an apportionment formula. As indicated by Michael Mazerov, combined reporting thus unitary tax is a powerful tool for fighting tax evasion and other tax avoidance schemes.\textsuperscript{431}

Practically, combined reporting would be heavily oriented on companies accounting departments. Large companies would be required to provide the overall income of their entire group that meets the criteria of the unitary business. Some have argued that combined reporting would add compliance cost to large companies. However, this argument is not based on economic reality of accounting practices of multinational companies. In fact, multinational companies possess data for all their operations worldwide; they know the performance of each of their permanent establishment or subsidiaries on a regular basis.\textsuperscript{432} Combined reporting would provide such an antidote to various scheme of tax evasion and would allow adequate taxation by developing countries. The reporting would provide all countries in which the unitary business exists with the necessary information in order for it to apply its taxes, if any. This is specifically advantageous for developing countries because unlike the Arm’s Length Standard which compels them to use the resources they do not have to obtain information the accuracy of which

\textsuperscript{430} Michael J. McIntyre, The Use of Combined Reporting by Nation States, Tax Notes International (2006).
\textsuperscript{431} Michael Mazerov, State Corporate Tax Shelters and the Need for Combined Reporting, Center on budget and Policy Priorities (2007).
\textsuperscript{432} Quarterly or annual reporting is rather common in practice for multinational companies.
they are not sure, combined reporting would shift the obligation to multinational companies in order for them to report their global income (and preferably net income) that would be separately and non-cumulatively subject to tax in their different locations. Even though this sounds like an added compliance burden upon MNEs, in practice we notice that most MNEs already have this information. One could think that the UT would require further efforts from MNEs to find, compile and provide the combined reporting, but this is not accurate as most MNEs already house this information and regularly compile items of income on their global operations. Combined reporting is arguably not an added transaction and compliance cost to MNEs, it is therefore just a matter of compelling MNEs to turn in the information they already have, and have grown accustomed to compiling on their global operations. As indicated above, combined reporting of net income would safeguard the countries’ ability to provide incentives, tax incentives, and would not result in an unreasonable added compliance cost for MNEs. Combined reporting provides a necessary look at the group’s overall performance, after taking into account the country specific requirements for taxability of income, and the overall look for a reasonable economic basis for application of a formula.

Combined reporting will help treat MNEs as a single business entity. Such multinational companies would be under the obligation, to the extent they qualify as unitary business, to provide tax authorities with a combined report of their global income. At this point, the tax authority is left with a simple but very consequential task of applying an adequate formula to levy its tax on its share of the global income.
C. Formulary Taxation

Throughout the history of the current international tax regime, complaints about tax avoidance have mostly stem from the fact that foreign corporations are able to manipulate the rules of transfer pricing based on a legal fiction of separate entities to shift income from high tax jurisdictions to low or no tax jurisdictions. Tax authorities across the globe have constantly tried to design ways to avoid or at least diminish foreign corporations’ ability to manipulate the rules. But recent developments have shown that governments have mostly failed in their efforts to adequately tax income earned within their borders. The primary cause of this failure is the government’s inability to design effective and proactive methods of taxing income of foreign corporations earned in their jurisdictions. The ease with which foreign corporations use transfer pricing rules to pay taxes, if at all, in the jurisdiction of their choosing is perplexing.\footnote{Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543, 560 (2001).} This situation which causes much concern to developed countries is a real threat to developing countries which rely heavily on corporate income tax to finance their operations because much too often, income earned in such countries ends up in tax heavens. It is hard to imagine how the income tax can survive as an effective revenue raising device for countries in general and developing countries in particular unless they design an effective method of taxing income of MNEs specifically. Such system is urgently needed to save the income tax as a whole because the perception that foreign companies do not pay tax could (and probably already does) affect domestic companies’ voluntary tax compliance; after all, it would be politically difficult to sustain a harsher tax regime for domestic corporations. Worse, most domestic companies could pursue merging with international affiliates to rip tax benefits.
UT, through formulary apportionment, emerges as the solid alternative to the current system, and a response to the current problems of the international tax regime. This system relies heavily on a formula to reconcile economic realities. In fact, much of the debate and writing about unitary taxation has been around formulary apportionment. Proponents of the unitary tax system have advanced the idea of formulary apportionment as a curb to income shifting while opponents of the system have raised legal and economic downfalls of formulary methods. Impossibility, in their view, to find a formula that countries around the world could adopt remains the main concern of opponents of the Unitary Tax system. The major task at the heart of each analysis of a UT is therefore to design a formula that could be acceptable to tax authorities across the globe. Such formula design work, in order to be attractive, should keep in mind the necessity to design an effective yet simple enough formula as to assure that it would not require undue administration cost to tax authorities. The goal shall be to design a formula that would contribute to realign international tax rules with global economic reality of MNEs specifically. The formula would be a mathematical combination based on “real economics” of operations, a method that would apply to the combined reporting to basically render the separate entities Arm’s Length Standard irrelevant. As a matter of fact, income will be reported globally through the combined

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reporting system by the unitary global business, and each country will blindly apply its adopted formula to such income to assess a fraction of the global income that is taxable in its jurisdiction because representing the economic reality of the income earned in that jurisdiction. While the definition of the unitary business and the combined reporting are important aspects of the Unitary Tax system, designing a formula is the most daunting and consequential aspect in the advocacy for such a system. Finding a formula that is acceptable to developing as well as developed countries, not to mention multinational companies sounds very difficult, and some would argue improbable on its face. Most writing in the area has stonewalled at this conclusion. This explains the current lack of a complete Unitary Tax system proposed as an alternative for the current system. There is a need to fill that gap. Design of formula remains deeply an endeavor of economists. We will discuss several formula proposals that exist as well as the formulas currently applied by US States. In the presentation of a sample reform proposal, we will present a tentative formula that we would have concluded is a viable solution under this research. However, this research does not supplement the need for economists to develop a complete formula, credible enough to cause global buy-in, and complete enough to serve as the foundation of a complete unitary system capable of replacing the current international tax system. Although such formula proposal would not constitute an insurance policy for universal acceptability, it should result from serious research in the area and offer arguments for as much able to cause consensus as possible. It is also important to note at this point that economists should be guided in the design of this formula by the need to optimize the revenue raising

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436 The Clausing and Avi-Yonah project is, technically speaking, a proposal for the reform of the U.S. rules for the taxation of international income, but its authors clearly believe that if the U.S. adopted their proposal, other countries would soon follow suit. Clausing and Avi-Yonah, note 7, at 21 (arguing that U.S. unilateral adoption of a formulary apportionment system would be a powerful incentive for other countries to adopt it).

capacities in the developing world specifically. The guiding philosophy should therefore be to structure a formula that is most suited to developing countries while not alienating developed countries and MNEs. While all countries are suffering from the current manipulation of transfer pricing rules and would benefit from a well-crafted alternative, it is clear that developing countries with limited resources yet deep reliance on income taxes have the most to lose under the current system and their survival and ability to meet their most basic responsibilities to their people depend on such well-crafted alternative to the current system. It is rarely disputed, as seen above, that a potential unitary tax system would provide much needed simplicity in the international tax arena.

Unlike the current system where compliance with the rules of international tax is just as expensive if not more as paying the tax itself, unitary tax would basically eliminate undue compliance costs to MNEs and administrative burden to tax authorities. The rules would be simpler and their application easier. Many acknowledge that a unitary tax system would provide much needed revenues for developing and developed countries.438 The complaint however, is that MNEs would have to pay more taxes. I intend to show in this research that this is not necessarily true. The simplification that would accompany a unitary tax system would exempt multinational companies from paying tremendous amounts of compliance costs. Rerouting such payments to actual tax payment could in fact lead to MNEs reporting less overall tax and tax related expenses.

The idea of a unitary tax system and formulary approach is not entirely new. As indicated above, writing and proposals exist in the area, however, there is not proposal embodying a detailed and complete system to totally replace the current international tax regime. Further, there is no major

research as to how a switch to unitary system would affect developing countries and what formula design would be more appropriate to them.

There are currently two separate institutional reform proposals for formulary taxation. One published under the auspices of the Brookings Institution’s Hamilton Project and aiming at reforming U.S. international tax rules and drawing inspiration from the U.S. states’ experience with formulary apportionment. The second, coming from the E.U. is part of the works in the Common Consolidated Corporate Tax Base (CCCTB). Both proposals suggest a departure from the current and failed Arm’s Length Standard and adoption of the formulary approach. It is therefore important to draw from the experience of the unitary taxation and formulary approach in the U.S. for example in designing a formula with developing countries in mind. Any design of a formula would have to come from an in-depth analysis of the use of formula by the states in the U.S. The experience of the U.S. states however is not a symbol of uniformity. Each state has historically used its constitutional power to design a formula that best represented its interests.


442 In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), the Supreme Court held that a state may levy a tax on interstate activities as long as the state could show (1) a “substantial nexus” between the state and the activity being taxed, (2) the tax is fairly apportioned to the activities carried out in the state, (3) the tax does not
There has been a growing trend throughout history, however, to encourage uniformity of methods between the different states. Although the difference of formulas between states could make the description difficult, it is the ideal situation in order to examine the effects of the various formulas from experience. Most states have approached formulary taxation through the so called “Massachusetts Formula” advocated by the American National Tax Association and calling for equal weight of three factors: Assets, Payroll, and Sales. The idea is to allocate one-third of the total income to jurisdiction where the assets are allocated, one third to the jurisdiction of the payroll, and the last third to the jurisdiction of the sales. This aims at making sure that the income is allocated and taxed in every jurisdiction where the business has a taxable presence.

It is important to examine these factors separately.

discriminate against interstate commerce, and (4) the amount of the tax is fairly related to services provided by the state.

A committee of the National Tax Association, an organization comprised of state tax officials, designed a model multistate business income tax in 1922, and, in 1933, the organization recommended that the states adopt the Massachusetts apportionment formula, which equally weighted property, payroll, and sales factors. See Joann M. Weiner, Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level 9-10 (U.S. Treas. Dep’t, OTA Paper 83, Apr. 1999), available at http://www.treasury.gov/offices/tax-policy/library/ota83.pdf. In 1957, the National Conference of Commissioners on Uniform State Laws, a nonprofit, unincorporated association that has drafted uniform laws for adoption by state legislatures since 1892, see http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=0&tabid=11, drafted the Uniform Division of Income for Tax Purposes Act (UDIPTA). UDIPTA was intended to serve as the model for state corporation income tax laws. See Weiner, supra, at 10. Of the forty-four states with broad-based corporate income taxes, twenty-one have adopted UDIPTA and most of the others have similar statutory schemes. Jerome R. Hellerstein & Walter Hellerstein, State and Local Taxation: Cases and Materials 596 (8th ed. 2005). In addition, in 1967, responding to the threat of federal legislation, the states created the Multistate Tax Compact and the Multistate Tax Commission to encourage states to adopt uniform state tax laws and regulations, as well as to provide both a vehicle for suggesting legislative and regulatory changes and a forum for conducting joint audits and resolving disputes. Id. at 605. Forty-four of the fifty states participate in the Multistate Tax Commission although only twenty are members of the Multistate Tax Compact, which incorporates UDIPTA.

For example, suppose X Corporation has $1,000 of Illinois sales and $9,000 of sales in other states, $200 in Illinois payroll and $200 payroll in other states, and $750 of Illinois property and no other property, and $3,000 of apportionable income. Of that $3,000 in income, $1,600 would be apportioned to Illinois under the Massachusetts formula. This result would be reached whether one allocated $1,000 by the sales factor ($100), $1,000 by the payroll factor ($500) and $1,000 by the property factor ($1,000), or by allocating the full $3,000 by the average of the three factor ratios (16/30ths).
First, the asset factor derives from the assumption that the presence of significant assets shows real economic activity. Assets show an economic presence, a taxable economic presence. Under this factor, income would be apportioned to a tax jurisdiction depending on the number of assets held in that jurisdiction as compared to the group. For example, company X dealing in the manufacture of computer bags, operates in the U.S. and Cameroon. Company X owns 2 assets: one is a manufacturing plant located in Cameroon and worth 80% of the company’s total assets; and the second is an office building located in the U.S. and worth 20% of the company’s total assets. If a UT is adopted with a formulary apportionment based on the sole one factor assets formula, any income earned by the company as a unitary business would be taxed 80% in Cameroon and 20% in the U.S. The single factor assets formula is easy to apply provided an adequate asset valuation. The asset factor is very applicable to the brick and mortar, the so called ‘old economy’. In fact, a company’s worth used to be measured by the amount of tangible assets it held. The application of the asset factor to assess the true economic reality of transactions and the true MNEs presence leads to respectable results in the old economy context.

The asset factor, though still used in some U.S. States, has very much been criticized as easily subject to manipulation. The asset factor is lacking because it can easily be manipulated by companies. Companies can decide to make massive physical investments in low or no tax countries while maintaining the minimum assets in the country of operations. In example above, it would be rather easy for Company X to locate the manufacturing plant in a low to no tax jurisdiction, channeling most of its income there even though the sales might occur in a different jurisdiction.

Further, the asset factor does not seem appropriate for the current economy and the phenomena of intangible assets. Most of the current corporate assets are in the form of intangibles, hard to
value and easy to relocate. The modern economy relies heavily on intangible assets and the current international tax system continues to struggle in determining their location. With the phenomenon known as the cloud, location of intangible assets has not been more difficult ascertain.\textsuperscript{445} To the location issue, adds the evaluation problem. How to evaluate, for tax purposes, intangible assets? The asset factor will only be effective in revealing the true economics of transactions if the assets involved are adequately valuated. The difficulty is more pronounced when the taxpayer’s valuation is different from a potential valuation from the tax authorities. Litigation does not provide any help in this area as the courts are usually left with fundamentally competing expert testimony as to the value of the assets at a specific time.\textsuperscript{446} The difficulty of valuing assets is shown in the current international tax system where taxation of intangibles often operates on a presumptive value basis.\textsuperscript{447} For intangible assets, time of valuation is very important as those assets fluctuate in value on a daily basis.

The use of the asset factor should find a way to incorporate intangible assets and deal with the fact that such assets are very easy to manipulate or relocate. While physical investment simply for tax advantages could be cumbersome for corporations, intangible assets are very easy to move around and relocate; a well-crafted formula should be mindful of this fact due the growing importance of intangible assets in the MNEs’ world. An estimated 70% of the value of the top 150 U.S. companies is in the form of intangibles.\textsuperscript{448} If the asset factor is used alone, most of the income would go to the low or no tax countries because of the heavy physical investment

\textsuperscript{445} Gil Savir, Cloud IT and Tax IT, Mich Law (2014).
\textsuperscript{447} In the US for example, IRC 179, settling on the contentious issue of useful life of an intangible, decided the provide a fixed 15 year depreciation period for qualified intangibles.
\textsuperscript{448} Sebastian Mallaby, Powerful Brand Carries Worth Far Beyond a Familiar Name, The Times Union (Albany), (Aug. 13, 2006).
therein, or the easily relocable intangible assets there. As a consequence, an undue weight should not be given to this factor even though it clearly constitutes a valid indication of economic activity.

Second the payroll factor is based on the idea that salaries reflect the location of the real income producing activity. The payroll factor is an important factor as it tracks the remuneration that is arguably associated with productivity. It tracks employees of the company and could present a good indication of what income was produced, and where. There is a need to adopt a wide definition of payroll in order to anticipate attempts for creative compensation arrangements unable to meet the payroll factor. The payroll factor will require that the unitary group be taxed at local levels depending on the amount of salaries that are attributable to the specific jurisdiction as compared to the group as a whole. In our example above, if we assume that salaries paid to employees in the U.S. represent 80% of the total salaries of the group, and salaries in Cameroon represent 20% of the total salaries of the group, under a single payroll factor of a UT, 80% of the income of global company X would be taxed in the US and 20% in Cameroon.

Adoption of a payroll factor requires a wide definition of the notion of payroll. Under this factor, payroll will include salaries and wages, as well as all other forms of compensation and friend benefits to employees.

However, providing for an adequate definition of payroll is not the only challenge of this factor. In fact, the economic substance of allocating income according to payroll can be manipulated. If this factor were to be taken alone, developing countries would suffer unless there are methods of evaluation and other various adjustments of salary brackets. It is known that the cost of labor in the developing countries is far less that of the developed countries. In including this factor, it will be important to design an adjustment method that would not entirely rely on the volume of the
salary, but also on what it means in the national context of the country’s operations. In addition, there will be a need to address potential manipulation of the payroll factor by locating most employees in the low or no tax jurisdiction location with any otherwise business impact.449 A well-crafted payroll factor would therefore contemplate the possibility of linking the location of the payroll to the relevant economic activity in that location.

Third, the sales factor is based on the idea that income must be allocated according to the location of sales. This is a theory of consumption whereby the company derives its profits from its consumers and hence should be taxed at the location of its consumers, the location of sales. The sales factor is an important factor in that it strives to track the source of the income. At an age where the determination of the source of income is more and more difficult, the sale factor provides a method to tax the income by sourcing it to its consumers. The U.S. experience shows a growing preference for the sales factor which has shown rather effective at sourcing and raising revenues.450 The Majority of US States now have opted to provide double weight to the sale factor as compared to the other two factors.451 Many commentators, in the US, continue to predict that all the US States will have to adopt, at some point in the future, a single factor formula based on sales.452 The sales factor seems to better track the real economic activity and shows not as subject to manipulation as the other factors. In the U.S., many States including Iowa and New York moved to adopt a single factor formula based on the sales factor. This factor

449 For example, a company can decide to locate all their in house legal department in a tax heaven, most of the income under the payroll factor would be allocated to that tax heaven even though the legal department in fact is entirely assisting the corporation in the high tax jurisdiction.
451 States giving greater weight to sales include New York, California, Alabama, Connecticut, Illinois, Michigan, or the District of Columbia.
assures that the tax authority (and for our purposes the country) from which the money is earned through sales, gets to tax it. In addition, proponents of the sale factor argue that a single sale factor would in fact be beneficial to the tax jurisdiction as it would encourage companies to locate property and payroll in the jurisdiction, thereby creating employment and wealth. If assets and payroll are no longer used to determine tax liability, one would argue that location of payroll and assets would be more beneficial to certain jurisdictions. 

On the one hand, the sales factor can be characterized as beneficial to developing countries. The developing world is and will continue to be, arguably, a consumer heavy world. Many companies in the developed world continue to expand into developing countries and continue to strengthen their efforts in selling their products in these countries. With the projected explosion in the developing countries population and the ensuing increase in the consumer headcount, a sales factor can be seen as beneficial to developing countries tax authorities. For example, the United Nations project that by year 2050, population in the developing world would approximately 80% of the total world population. Major companies including General Motors, Apple or Microsoft are all currently refining their strategies to be more aggressive in reaching the developing countries markets with their products. As the customer base continues to grow in the developing world, the sale factor can show very important for developing countries tax authorities. 

On the other hand, nevertheless, many developing countries are building their economies by serving as factories where products are made and sold to the larger market, specifically in the developed world. Developing countries’ economies are currently relatively small and many

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454 The early case of Wal-Mart in China.
countries have provided the workforce necessary for the making of goods for the purpose of selling abroad. This reality does not negate the importance of the sales factor to the developing countries; however, it does put into question the use of developing countries as factories for purposes of selling to the developed world. A single sale factor would have all those products made in the developing world and sold to the developed market, not taxed by developing countries tax administrations. For example, if assets and payroll factors are disregarded for the benefit of the sales factor alone, Apple would have the ability to install countless plants in India, manufacture iPhones there and sale all of them in the US and Europe. India would not be entitled to tax any of the income from the sale of the iPhones manufactured within its territory. For major MNEs currently, only a small proportion of the goods manufactured in their developing countries factories are in fact sold in the developing world. Most of the products made in the developing world, at least some relatively luxurious products, are sold in the US and Europe, not in Africa, Asia or South America for the most part.

In addition, the sale factor is not totally immune from manipulation and attempts thereof. The main issue with the sales factor is the location of the sale. To determine the location of the sale, the main factor used is the location of the customer. One must determine where the purchaser of the goods is located. In practice, the address of the shipment or the physical place of delivery would determine the location of the customer hence the location of the sale. The issue however, is that such location can be manipulated. One can determine for the goods to be shipped at a place where the sale factor may not be implemented or may be loosely implemented. How to assure that the customer, when ordering goods for shipment, provides the address of his actual location? How to assure that the company, when invoicing customers, provides a place of delivery that is exactly the location of the customer. In this era of ecommerce, how to determine
the physical location of intangible products bought electronically? Similar to all other factor standing alone, the sales factor is limited and would not contribute to a fair system if applied alone.

From the above analysis, it is clear that no one factor, standing alone, could provide a satisfactory formula for global implementation. Each factor, notwithstanding its merits, is malleable and lacking if implemented on a stand-alone basis. The task therefore is to design and agree on a combination of some or all of the factors in building the formula. The task is inherently for economists to wrestle with. Nevertheless, based on available literature on the issue, our tax reform proposal below suggests a formula implicating all three factors, but providing for different weights and different levels of importance in the formula for each of the three factors.
Chapter VI

Current Experiences with UT and Rebuttal of The Regular Arguments Levelled Against UT
Any proposal to adopt a UT has to contend with the various criticisms that have been levelled against UT principles notwithstanding the fact that there is yet to be major research as to its viability. UT is regularly dismissed both in the academic circles as well as in practice circles. Most arguments raised against UT however, are shallow to say the least and not worthy of much attention in reality. We will address three of those common arguments below. To contrast with the criticisms against UT for global application, UT principles have been in place in US States taxation for decades and continue to thrive. The experience of US States with UT can provide significant insight on the merits of the UT. Finally, Europe has flirted and continues to flirt with general implementation and application of the UT. The European Common Consolidated Tax Base draws straight from the UT principle and will be presented below as a form of UT, which is already contemplated by the European Union.
A. Rebuttal of the Regular Arguments Levelled Against the UT

The first argument levelled against the UT is that it is incompatible with the international tax treaty network. A more extensive debunking of this argument will be provided below in Chapter 8. The treaty network compatibility is a pseudo argument. Transfer pricing is currently governed by Article 9 of the treaties, which assumes the SA method because it addresses the commercial or financial relations between associated enterprises. If UT were adopted, Article 9 would become irrelevant in those situations to which UT applies (i.e., where a unitary business is found to exist) because UT ignores the transactions between related parties, and treats them instead as part of a single enterprise. Traditionally, the term PE was meant to include separate entities (subsidiaries). However, in 1933, the League of Nations introduced Article 5 (ancestor to the current Article 9 of the Model) where separate enterprises were no longer considered PE. UT would revive the disregard for separate entities and would apply globally each time a unitary business is found to exist. UT would be governed by Article 7 of the double tax treaties. Under Article 5(7), “[t]he fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State … shall not of itself constitute either company a permanent establishment of the other.” However, it is well established that a dependent agent can be a PE (see Art. 5(5)), and whether an agent is dependent is based on whether the principal exercises legal and economic control over the agent. See, e.g., Roche Vitamins Europe Ltd v. Administracion General del Estado, Case No. STS/202/2012 (Spanish Supreme Court Jan. 12, 2012) (Swiss principal had PE in Spain through an affiliated Spanish company; activity of the subsidiary was directed organized and managed in a detailed manner by the principal); Salad Dressing, Fiscal Court Baden-Wurttemberg, 3 K 54/93, Internationales Steuerrecht 1997 (Swiss principal had a PE at the premises of an unrelated German contract manufacturer based on detailed instruction by principal); Milcal Media Limited, Court of Appeal, Stockholm, Case nos. 7453-54-02 (2005) (Cyprus principal had a PE through Swedish subsidiary

456 The quoted articles are identical in all the tax treaty models except when discussed in the text.
458 See, e.g., Roche Vitamins Europe Ltd v. Administracion General del Estado, Case No. STS/202/2012 (Spanish Supreme Court Jan. 12, 2012) (Swiss principal had PE in Spain through an affiliated Spanish company; activity of the subsidiary was directed organized and managed in a detailed manner by the principal); Salad Dressing, Fiscal Court Baden-Wurttemberg, 3 K 54/93, Internationales Steuerrecht 1997 (Swiss principal had a PE at the premises of an unrelated German contract manufacturer based on detailed instruction by principal); Milcal Media Limited, Court of Appeal, Stockholm, Case nos. 7453-54-02 (2005) (Cyprus principal had a PE through Swedish subsidiary
agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.\textsuperscript{459}

In the case of a modern, integrated MNE that operates as a unitary business, a strong argument can be made in most cases that the parent of the MNE exercises both legal and economic control over the operations of the subsidiaries, especially where the subsidiaries bear no real risk of loss and acquire goods and services exclusively or near exclusively from the parent or other related corporations. The existence of Intranets in most MNEs has resulted in most important operational decisions being centralized. In that case, the subsidiaries should be regarded as dependent agents of the parent. Such a finding is in fact made with increasing frequency in both developed and developing countries.\textsuperscript{460} If the subsidiary is an agent of the parent, Art. 7(2) of the treaties requires the attribution of the same profits to the subsidiary “that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.” Arguably, the application of UT satisfies this arm’s length condition because in the absence of precise comparables, which almost never exist, it is not possible to determine exactly what profits would have been attributable to the subsidiary under separate accounting.


\textsuperscript{460} Le Gall and David Tillinghast, \textit{Can a Subsidiary Be a Permanent Establishment of its Foreign Parent? Commentary on Article 5, par. 7 of the OECD Model Tax Convention}, 60 Tax Law Review 179 (2007).
Another pseudo argument levelled against UT is that it is contrary to the ALS which has risen to the level of a customary international law norm. The argument of customary international law does not, either, impede the application of a UT approach. The argument is based on the contention that because separate accounting and the ALS are embodied in all of the treaties they should be considered binding. But embodiment in the treaties is not enough to create a customary international law ban on UT, since article 7(4) is embodied as well. Most double tax treaties currently applicable contain Article 7(4) which provides:

“Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

The Article allows for application of a formula, and the Article is well embodied in most double tax treaties as we will see in Chapter VIII below. If the ALS is an international customary law norm due to its overwhelming presence in the current tax treaties, at least formulary apportionment should also rise to the level of customary international law norm because it is just as present in the current double tax treaties.

Furthermore, it should be noted that Model Tax Treaties do not, in any way or form, create a ‘right to tax’.⁴⁶¹ The key issue is the actual practice of states, i.e. what countries actually do as

domestic laws reign supreme in the area of taxation, and many of them follow UT approaches in practice. In addition, countries should be free to follow the UN Model which does not adopt the changes made by the OECD, and which is also widely followed.

Finally, it can be argued that even the OECD may be revising its approach. The authorized OECD approach may have marked the high point of OECD commitment to SA. With the beginning of the BEPS project, which is influenced by large developing countries like China and India, it is likely that the OECD may be stepping back from its total commitment to SA. Specifically, the potential adoption under BEPS of country by country reporting (which is already required for extractive industries in the US) can be the basis for implementation of UT. This development is very important for developing counties as many rely heavily on extractive industries. The requirements of the country by country reporting, if implemented, will likely start with the extractive industries as to draw from the US experiences with the system and thereby allow a profound change in taxation of the major industry in the developing world: the extractive industry.

Sovereignty is also an argument used to oppose any application of the UT. It is argued that taxation is a very central topic of a country’s identity and that the determination of a tax policy suitable to a specific country’s needs is the very basic of their sovereignty. We absolutely agree with this premise. Taxation is a matter of a country’s sovereignty and every country should have the right to tax income within its borders. The current system has betrayed the basic premise of each country being able to tax income generated within its borders. The BEPS project analyzed above as well as the many various other schemes that have led to many countries not being able to exercise their power to tax income properly generated within their borders. For those who repudiate UT on the basis of countries’ sovereignty, the answer is that the current system
diminishes countries’ ability to exercise their tax sovereignty more than the UT would ever be able to achieve. In fact, the UT reestablishes countries sovereignty by ensuring that they are able to excessive their taxing power appropriately and thoroughly. The debate though is what it means for a country to exercise its fiscal sovereignty. Does fiscal sovereignty mean that each country should have isolated and uncoordinated tax policies with other nations? Does fiscal sovereignty mean that each country addresses global problems posed by MNEs taxation from a local perspective exclusively? Does fiscal sovereignty mean that countries should not agree on a common general policy manner to go about crafting their tax policies? The answer to these questions, even from the avid critics of the UT, is no. Fiscal sovereignty does not mean fiscal unilateralism or isolation. If fiscal sovereignty meant fiscal isolation, then no one would be able to argue today that the current international tax system is anywhere close to affording countries such sovereignty. In fact, countries are highly connected and coordinated whether through double tax treaties or other bilateral or regional instruments of common application. Fiscal sovereignty is therefore not to be found in the need of a country to be isolated and coordinated with others.

Instead, we argue that UT provides greater fiscal sovereignty in the real sense of the word. On the one hand, and as indicated above, UT would allow countries to tax all the income generated within their borders. The unique ability of the UT to reduce the potential for MNEs to shift income out of some jurisdiction where the income is economically earned and fiscally belongs is an immediate testimony of putting the power back in the hands of each country’s tax authorities. On the other hand, UT does not interfere with each country’s freedom to determine how much tax revenues they would like to raise. The duty of determining tax rates is and shall always remain a country specific duty and each country should be free to set its tax rates at a level it and
only it decides appropriate. The UT does not, or at least our proposal does not advocate for a global uniformity of tax rates. Far from that, our proposal underlines the need for each country to determine its rates and the amounts of tax revenue they are willing to raise based solely on the social consensus and agreement as to what the role of the government should be for that specific country. Each country is free and shall always remain free to have and solve that debate and adopt a tax policy that corroborates the specific country’s position through the levels of tax rates retained. Sovereignty is therefore a pseudo argument against UT because from the perspective of the current system, UT offers a far greater level of sovereignty to countries in dealing with their fiscal affairs, chief of which is their ability to adequately tax income within earned within their borders.

The very many arguments raised against adoption of UT are fundamentally lacking and do not justify a legitimate rejection of the UT. As seen above, most the arguments are at best, pseudo arguments, that actually apply in a more devastating manner to the current international tax system. The debunking and repudiation of the arguments above is in no way an admission that the UT is flawless. Any implementation of the UT, on a global scale, would have to contend with major transitional issues, and the system incontestably would struggle to establish a unique formula for global adoption just as it might at some point not reflect the real time economic returns of various entities within the group. The effort is to minimize such potential negative impact by providing an extensive analysis of the UT. Many criticisms clearly stem from the lack of concrete knowledge of what the UT really. Many academic contributions have superficially brushed off the idea of a UT without, unfortunately, a preliminary in depth explanation and

understanding of what it is. A thorough understanding of the UT compels the conclusion that it ought to be adopted in replacement of the current system under the ALS. The superiority of the UT to the ALS is evident, whether it is regarding its fair results, its ease of operation, its advantages to the developed and the developing world, or its advantages to the MNEs and the private sector. In fact, the long standing experience of UT by the US States and the current experiences of some form of UT in Europe under the European CCTB, and the final BEPS Reports are very informative as to the merits of the UT as compared to the current and failed international tax system based on the ALS.
B. The US States Experience with UT

Each of the US States with an income tax system applies some form of formula of the UT.463 Application of the UT in the US, even though with specificities, can provide a picture and helpful insight on any project of global application of the UT.464 The UT and the use of formulary apportionment in the US States can be traced back to the state of New Hampshire in 1842 when the State enacted a law assigning the administration and assessment of railroad property to a State board.465 In 1868, Pennsylvania enacted a statute applying the apportionment formula concept to the tax base of an entire corporation.466 The Pennsylvania method resulted in an inclusion of the company’s out of state income into the tax base of the apportionment. Following the Pennsylvania experience, the UT principles and apportionment methods primarily conceived for property taxation and instate income, became instruments applicable to interstate commerce and out of state income.467 Interstate apportionment quickly gained popularity as many States followed suit and adopted UT principles.468 Court challenges quickly ensued but mostly unsuccessful.469 The Supreme Court of Kansa explicitly endorsed UT and formulary apportionment in the Missouri River case when it indicated that “a railroad is an entire thing and

463 46 US States currently have an income tax regime in place.
466 See Pennsylvania Statute, May 1, 1868.
467 See 136 Kansas Reports 210. Ohio, April 27, 1893
468 For example, Kansas approved a measure on March 4, 1869 providing assessment of railroad property tax through the application of a formula with included out of state income of the railroad company as the basis for the apportionment formula. The assessment included all of the property owned by the railroad, including that which was located in other states. The assessment was apportioned between the states and then among the Kansas counties and cities through which the railroad ran based upon the proportion of the property’s value within each county.
469 See Missouri River, F.S. & G.R. Co., 136 Kansas Reports 210 (1871); See also Delaware Railroad Tax Case, 85 US 206 (1874); See also, Erie Railway Company Case, 88 US 492 (1875); See also State Railroad Tax Case, 92 US 575 (1876); See also Adams Express Company, American Express Company, and The United States Express Company [165 US 194, 166 US 185.
should be assessed as a whole… a railroad is an entire thing, and cannot be valued or assessed except as a whole…”  

Early in the twentieth century, many States expanded the reach of formulary taxation. What had mostly been applied to property taxation was being expanded to other forms of income. The State of Massachusetts adopted a three-factor formula based equally on assets, payroll and sales on the basis that such factors revealed the true source of the taxpayer’s income. By years 1930s, the concept of UT was widely established and accepted. The formula retained; however, remained subject to contestations and sometimes even chastised by courts. The courts continuously posed the requirement that the formula retained neither be arbitrary, nor produce unreasonable results. Some States, including New York and California, went as far as adopting a UT that would apply to all income of the corporation, including that which is earned in other countries. The courts continued their support by upholding the UT applied by US States, even at a global level.

Under the application of the early UT principles, companies still had to possibility to manipulate their inter-company transactions so as to minimize the income. The State of California instituted, in 1936, the concept of combined reporting to avoid inter-company gamesmanship. The combined reporting, an informational return reduced the potential for tax avoidance through the setting up of separate companies in different States. Various challenges to the combined reporting instituted in California eventually survived and the system expanded to other States.

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473 Id.  
474 See Bass, Ratcliff and Gretton Limited, 266 US 271 (1924).  
475 See Edison California Stores, 183 P.2d 16 (1938).
Taxpayers were not happy with the continued court endorsement of the UT approach. Congress eventually passed measures limiting the scope of application of state UT principle.\textsuperscript{476} In addition, Congress aimed to make uniform across the States, the acceptable principles under UT.\textsuperscript{477} In 1964 and 1965, Congress published reports recommending uniform standards, tax bases, and rules and procedures of apportionment to be applied by States tax administrations. Predictably, States resented the recommendations and were publicly opposed to any federal intervention in what was considered a State tax matter. In response, many States vowed to improve interstate taxation, and got together, formed what became known as the Multistate Tax Compact. The Compact wanted to preempt the federal government, and provide for a more coordinated application of UT principles amongst States.\textsuperscript{478}

Until the 1980s, UT and formulary apportionment flourished across US States and its reach seemed unlimited. Taxpayers used various forms or protest against the UT system usually to no avail. Taxpayers who opposed the ever-expansive use of UT principles used judicial means to curtail application of the UT. However, courts continued to upheld UT principles and their expansive application within US States. Taxpayers opposed to the UT also tried political pressures to eradicate UT, but again, to no decisive avail. Most State legislatures continued to expand the reach of their UT principles. The most convincing tool used to curtail expansion of the UT and the ever-increasing reach of its principles was the economic challenge.\textsuperscript{479} Many States refrained from applying their UT principles to income earned overseas and to require

\textsuperscript{476} In 1959, Congress passed Public Law 86-272 preventing the inclusion into the apportionable base of activities that barely amounted to solicitation of business or delivery of orders.

\textsuperscript{477} See Public Law 86-272 directing the House Judiciary Committee and the Senate Finance Committee to propose a federal legislation to provide uniformity in the application of UT within States.

\textsuperscript{478} The Compact was formed in 1967 with 7 States getting together to solved the challenges of States UT.

global combined reporting for the fear of losing economic activity within their respective States and ultimately loosing revenues. The expansion of the UT was therefore halted.

The UT in US States was however not abolished and today, all the States with income tax apply a form of UT. Some States still tax their MNEs on their worldwide income, and require a global combined reporting for state tax purposes.480 The common way in which US States currently apply UT is either through a single factor based formula, or a differently weighted multiple factors formula.

First, many US States apply the single factor sales formula for their income apportionment. Business representatives are relentlessly lobbying for various changes to formulary apportionment applied by States, and the major trend and change noted is the move for many states to a single factor formula.481 In Illinois, Iowa, Maine, Oregon, or Nebraska, only sales are included in the apportionment formula. Other States use the notion of receipts, close to sales, to determine the apportionment formula.482 The general move to a sales only factor formula is presented as an economic necessity and economic booster. A sales only factor encourages exports whereby goods are produced in one location with no tax concerns, and those goods are sold everywhere, with the only incidence of taxation being the place of the sale of goods. Additionally, the sales factor encourages investments in production facilities and plants because the location of the facilities, plants and other assets would carry no tax consequences. It is unsettled at the very least as to whether businesses actually prefer a single factor sales formula as a general proposition. Several empirical research show that a single factor sales formula leads to

480 See for example, the State of California and the State of Alaska.
481 See Michael Mazerov, The “Single Sales Factor” Formula for State Corporate Taxes, center for budget and policy priorities (Sept 2005).
482 See New York and Texas.
lower taxes paid by business in the various states they operate in. In fact, a single factor sales formula seem appealing to the brick and mortar industry, allowing them to install large amounts of assets at a location of their choosing and only be subject to taxation at locations of their sales. The situation sometimes leads to incongruences as to whether to support or not a single sales factor formula at a specific location. It is not uncommon for a major US company to support the adoption of a single factor formula in one State and oppose adoption of same in another State, all at the very same time. For example, Ford Motor Company was widely in favor and advocated for adoption of single factor sales formula in Michigan for the Michigan Single Business Tax.\textsuperscript{483} However, the same Ford Motor Company, a few years later, vigorously opposed adoption of the same measure in Illinois, calling it unfair to out-of-state companies.\textsuperscript{484} The same attitude was noticed with Kraft Foods which opposed single factor sales formula in Maryland and supported adoption of same in Illinois,\textsuperscript{485} as well as AT&T which supported adoption of single factor sales formula in New Jersey while opposing the same in Oregon within a matter of one month.\textsuperscript{486} The ideal situation for most businesses seems therefore to have a single factor sales based formula in the State in which they manufacture or the State in which they are headquartered, while other States adopt a different formula that is not solely based on sales. The tendency though, is for more and more States to adopt a single factor sales formula or at least double weight sales, making it difficult for companies to manipulate the differences between the States’ adopted formulas.

\textsuperscript{483} See Michigan Single Sales Factor Bill Creates Controversy, State Tax Notes, September 21, 1995.
\textsuperscript{484} See Single Sales Factor Triumphs, but without Throwback Repeal, State Tax Notes (June 1, 1998).
\textsuperscript{485} See Corporation In Line for Big State Tax Break, Chicago Tribune (May 25, 1998); See also Taylor Backing Tax Change, Baltimore Sun (January 6, 2001).
\textsuperscript{486} See Statement of Deborah Bierbaum in Support of Assembly Bill 3420 (June 4, 2001); See also Statement of John McNamara in Opposition of House Bill 2281-A (May 10, 2001).
Second, some States still use the basic Massachusetts formula. Under the Massachusetts’s basic formula, all three factors: assets, payroll, and sales are given equal importance and weighted equally. States such as Hawaii, Kansas, Missouri, Montana, or North Dakota continue to give equal weight to all three factors and apply a three-factor formula for apportionment of income of their corporate residents.\(^{487}\) The equally weighted three factor test has the advantage of not favoring one factor over another; it is advantageous because it grasps all aspects that contribute to income and wealth creation and aims to tax it accordingly. The main criticism of the equally weighted three factor test is that it is not adapted to the modern economy. The assets factor included in such formula is inherently flawed when it comes to intangible assets and the difficulty of valuing them nowadays.

Finally, various States still apply more than one factor in their formulas but grant them differing weights. The most common use of this system is the double weighted sales factor. In Alabama, Idaho, New Hampshire, Vermont, or Kentucky, the sales factor is given double weight in the apportionment formula.\(^{488}\) The States that adopt this formula argue that all three factors are important, but that the assets and payroll factors are highly subject to manipulation and have a more negative impact on investments and job creation. The emphasis on sales, is not only liked by businesses that are headquartered in those States, but also allows for an expanded tax reach of the local consumption. The debate of the move from the equally weighted three factor test to the double weighted sales factor and to the single factor test is reigniting the debate over a uniform formula, ideally amongst the States.\(^{489}\) The original idea and initial efforts of having a uniformed

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\(^{488}\) Id.

and coordinated formula amongst the States\textsuperscript{490} has still not come to fruition half a century later, but has gained more acclaim in recent debates over US States taxation, a debate that is highly important and instructive in the international arena. The experience of the US States with UT has inspired the European Union in their efforts to establish a common consolidated tax base across Europe.

\textsuperscript{490} See Supra, at 483.
C. The European CCTB

Europe has long struggled with tax competition and various countries assigning different goals to their tax policies and tax rules.\(^{491}\) Unilateralism ruled the continent in the past on matters of taxation. Tax policy was determined on a country by country basis and each country reserved the sovereign right to determine its tax rules, with no coordination with other countries whatsoever. With the creation of the European Economic Community in 1957,\(^{492}\) and the efforts to draw Europe closer primarily for the sake of promoting economic progress and avoiding wars, issues of taxation remain deeply territorial and country specific. Europe continued to grow closer and continued to coordinate its economic, social and political policies in order to form a more perfect union and draw countries closer in their economic, social and political ties. Still, taxation remained out of the debate and tax policies remained largely uncoordinated and country specific. In the last few decades however, Europe grew from the era of unilateralism to a belief in bilateralism in tax policy. Many European countries negotiated and signed various bilateral tax treaties with other European countries and non-European countries. Europe has the most expansive bilateral tax treaty network as many European countries have concluded bilateral tax treaties with other countries in Europe and globally.\(^{493}\) Nevertheless, and thus far, the unilateral approach and the bilateral approach have been ineffective in preventing tax abuse and illicit tax competition in Europe.\(^{494}\) To mitigate the tax abuses and respond to general outcry, Europe endeavored to coordinate its tax laws and policy and provide for a common definition of tax base

\(^{492}\) See the Treaty of Rome signed on March 25, 1957 establishing the European Economic Community.
\(^{493}\) For example, there are currently approximately 1,300 bilateral tax treaties and the United Kingdom accounts for over 100 of those treaties.
\(^{494}\) Communication from the Commission, Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM(2001) 582 final, 23 October 2001, p. 10.
and coordinated tax enforcement through exchange of information. The Common Consolidated Tax Base (“CCTB”) is currently the manifestation of the commitment for a multilateral approach, at least across the European Union (“EU”), to tax policy and tax administration. The CCTB amounts to a proposal to develop a tax code for the EU, while leaving to the discretion of the individual member States, the ability to set tax rates. The goal of the CCTB project is to replace the separate accounting and ALS by consolidation and formulary apportionment. Under the CCCTB, a European company would only have to deal with one set of rules in order to calculate its profit for tax purposes – instead of having to comply with up to 27 different sets of rules as at current.495

The long-awaited proposal for a CCCTB was published by the European Commission in 2011.496 The proposal is presented as ‘a complete set of rules for company taxation. It details who can opt [in], how to calculate the taxable base and what is the perimeter and functioning of the consolidation. It also provides for anti-abuse rules, defines how the consolidated base is shared and how the CCCTB should be administered by member States under a 'one-stop shop’ approach.’497 The discussion below only focuses on that part of the report that is relevant to the proposed formula and how it advances UT at a regional level.

The CCTB requires a great degree of consolidation in determining the tax base. European companies would be provided with an instrument for the cross-border consolidation of profits

495 The EU currently has 27 member States and each member adopts a set of rules to determine the tax base.
497 Id.
and losses. All intra-group transactions would be neutralized.\textsuperscript{498} A wide array of companies and legal entities are eligible for consolidation. Permanent Establishments are ipso facto included in the CCTB consolidation. Lower tiers subsidiaries; however, are included in the consolidation only if and to the extent that a two prong test is satisfied. The conditions relate to control and ownership. The parent company must hold more than 50\% of the voting rights and must own more than 75\% of the subsidiary’s capital or – alternatively – must be entitled to more than 75\% of its profits.\textsuperscript{499} With regard to lower-tier subsidiaries, a holding of more than 50\% of the voting rights is deemed to be a holding of 100\%.\textsuperscript{500} By attributing a 100\% for all lower tiers subsidiaries owned more than 50\%, the calculation reflects the fact that a majority of the voting rights at each tier confers to the parent company control over all subsidiaries in the chain of participation. With regard to the ownership threshold, the interests held at each tier have to be multiplied.\textsuperscript{501}

The CCTB also provides for a territorial scope of consolidation. Consolidation under the CCTB is limited to companies operating in the EU. Only EU companies and Permanent Establishments may be part of a CCCTB group. However, companies which are tax resident in third countries may form a CCCTB group with regard to their qualifying subsidiaries and Permanent Establishments located in the EU.\textsuperscript{502} The right to opt for the CCCTB lies with the ultimate parent company of the group if it is tax resident in the EU, otherwise with one of its EU resident subsidiaries or Permanent Establishments.\textsuperscript{503} If the group opts for the CCCTB, all qualifying subsidiaries and Permanent Establishments are automatically included in the group;\textsuperscript{504} and the

\textsuperscript{498} See Art. 59 of the CCTB Draft.
\textsuperscript{499} See Art. 54(1) of the CCCTB Draft.
\textsuperscript{500} See Art. 54(2)(a) of the CCCTB Draft.
\textsuperscript{501} See Art. 54(2)(b) of the CCCTB Draft.
\textsuperscript{502} See Art. 55(2) of the CCCTB Draft.
\textsuperscript{503} See Art. 104(1 and 4(6)) of the CCCTB Draft.
\textsuperscript{504} The principle is known as the “all-in-or-all-out-principle”, See Art. 55 of the CCCTB Draft.
consolidation extends to the entire tax base of all group members irrespective of minority shareholdings.\textsuperscript{505}

Formulary apportionment is at the heart of the EU CCTB proposal. The CCCTB proposal adopts a three-factor equally weighted formula comprising assets, payroll, and sales.\textsuperscript{506} The CCTB has the specificity of providing guidance on the payroll factor. In fact, under the CCTB, the payroll factor comprises both salaries and the number of employees, considered equally.\textsuperscript{507} The CCCTB proposal also includes special apportionment rules for four industries: financial institutions; insurance; oil and gas and shipping; inland waterway transport and air transport. The asset factor is defined to consist of all fixed tangible assets.\textsuperscript{508} Intangibles and financial assets are excluded from the formula due to their mobile nature and the risks of circumventing the system. However, where the entity is a financial institution this is varied to include 10\% of the value of financial assets, except for participating interests and own shares. Financial assets are included in the asset factor of the group member in the books of which they were recorded when it became a member of the group.\textsuperscript{509} Such a modification is arguable seen as necessary because of the significance of these assets to MNEs in the financial industry. The sales factor, normally defined to mean the proceeds of all sales of goods and supplies of services after discounts and returns, excluding value added tax, other taxes and duties and excluding exempt revenues, interest, dividends, royalties and proceeds from the disposal of fixed assets is also varied for financial institutions.\textsuperscript{510} The sales factor is varied from the general definition to include 10\% of its revenues in the form

\textsuperscript{505} The principle is known as the “full consolidation”, See Art. 57(1) of the CCCTB Draft.

\textsuperscript{506} See Art. 86(1) of the CCCTB Draft.

\textsuperscript{507} \textit{Id.}

\textsuperscript{508} See Art. 92 and 94 of the CCCTB Draft.

\textsuperscript{509} See Art. 98 of the CCCTB Draft.

\textsuperscript{510} See Art. 95 and 96 of the CCCTB Draft.
of interest, fees, commissions and revenues from securities. Financial services are deemed to be
 carried out, in the case of a secured loan, in the member State in which the security is situated or,
 if this member State cannot be identified, the member State in which the security is registered.
 Other financial services are deemed to be carried out in the member State of the borrower or of
 the person who pays fees, commissions or other revenue. If the borrower or the person who pays
 fees, commissions or other revenue cannot be identified or if the member State in which the
 security is situated or registered cannot be identified, the sales shall be attributed to all group
 members in proportion to their labour and asset factors.511

 In the Commissioner speech presenting the CCTB in 2011, the European commission
 endeavoured to present the CCTB and a coordinated approach as a panacea to Europe’s tax
 problems and obstacles. The Commissioner indicated in his speech that a common approach and
 a uniform policy to taxation was necessary to strengthen the single market and was necessary for
 Europe’s prosperity as a whole.512 Adoption of common and uniform principles for determining
 the corporate tax base across the EU is seen as a beneficial policy for both the companies in the
 EU, and the EU member States tax administrations. The European Commission has repeatedly
 affirmed its conviction that the only way to address tax obstacles that currently exist for
 companies in the EU operating in more than one EU member States is to provide for a
 consolidated tax base for EU-wide activities. It is in fact of great value for a company to apply
 the same set of rules across the EU instead of contending with 27 sets of differing and sometimes
 antagonistic tax rules. The CCTB proposal does not negate each Member-State’s sovereignty. As

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511 Id.
512 See Speech by Algirdas Semeta, Commissioner responsible for taxation, European Corporate Tax Base: making
proof that a UT is not necessarily an impediment to countries’ sovereignty, the CCTB stands on the principle that there is a need to provide for a uniform way to determine the tax base, as well as a consistent formula to apportion taxable profits amongst intervening jurisdictions. At the same time, the CCTB leaves to the member States, the sovereign right in the way, the degree if at all, to which it taxes the then apportioned income.\footnote{513} Sovereignty is exercised, deservedly so, through the setting and determination of the countries’ tax rates, if at all, that it ought to apply to the income that is earned within its borders.\footnote{514} The application of an equally weighted three factors test for apportionment under the CCTB is an important factor that reiterates the usefulness of UT principles in eliminating or at least mitigating illicit tax schemes. As seen above and through the experience of US States, each of the three factors plays an important role in establishing to true economic reality of business operations and income earnings aspects of corporate organizations. Nevertheless, the EU’s preference for an equally weighted three factor test comes as a surprise in the face of established empirical evidence of the shortcomings of such formula.\footnote{515} The three factors equally weighted test affords an ease of application and straightforwardness to each component of the apportionment formula. The question is whether the EU decided that the advantages of the three factors equally weighted test outweighs the more complicated and arguably more effective formulas that have been developed in the US since the Massachusetts framework. The EU seems to have adopted a preference for rules that are relatively subject to manipulation but easily applicable from a taxpayer and tax authorities’ perspective. Further, most US States started their formulary apportionment regimes with a three

\footnote{513}{Id.}
\footnote{514}{See Christoph Spengel, Common Corporate Tax Base (CC(T)B) and Determination of Taxable Income, ISBN 978-3-642-28432-8 (2012).}
\footnote{515}{See Part 2 Chapter V above for an analysis of each factors limit as a standalone factor in the apportionment formula.}
factor equally weighted test.\textsuperscript{516} It was only in light of reported abuses, or for the sake of encouraging certain business policies that States started, in an isolated manner, to move beyond the equally weighted three factors, and to implement formulas that were more adapted and arguably were more aligned with the State’s policy it aims to advance.\textsuperscript{517} States started giving more importance to the sales factor as to encourage assets investments as well as payroll and jobs within their borders. The literature and empirical research on the matter is inconclusive as to the effects of the importance of the sales factor in the States assets and payroll growth and performance.\textsuperscript{518} As a regional conglomerate, the EU seems to start with the equally weighted well understood and relatively easy to apply apportionment formula. Europe would undoubtedly learn from the application of the equally weighted three factor test, and make changes if any, as the experience with the system would require.

Still, application of the CCTB across Europe would offer a credible and fortunate departure from the ALS, a net advantage to international taxation, and a model that can inspire global international tax reform. An analysis of the benefits of such reform and departure from ALS to the UT, from the perspective of all stakeholders, is necessary to provide more perspective in the urgency and necessity of the reform.

\textsuperscript{516} See Part 2 Chapter VI above for an analysis of the US States experience with UT and the initial quasi consensus on the three factors equally weighted test in the apportionment formula.

\textsuperscript{517} Id.

Chapter VII

The Case for Unitary Taxation as the Answer to the Current International Tax Shortcomings
The UT is a system based on the idea that any MNE is a global unique entity and all its subsidiaries, wherever located, constitute mere parts of the same unitary and unique body, provided that the conditions of the Unitary Business explored above are met.\textsuperscript{519} The current system, as seen above, relies on a fiction that suggests that the different subsidiaries of a common parent are in fact separate and independent entities and shall be seen and taxed as such. The resulting separate accounting and ALS has led to various abuses for countries globally and a largely unwelcomed level of complexity for MNEs operating globally. The needs of countries around the world and of tax authorities specifically are not being met and governments in the south or the west continue to denounce the fail system. Governments in the developed world are dissatisfied with the current system of international taxation; governments in the developing world are outraged by the current system of taxation of MNEs; and the private sector continues to voice its call for a simpler system and adoption of more easily understandable and comply with rules for the taxation of international income.\textsuperscript{520} On the one hand, one can argue that the time is ripe for reform due to the global dissatisfaction with the current system and a realization that the status quo is not sustainable. As indicated by Professor James Hathaway in a different context, there is no better moment for reform than when all parties involved are dissatisfied and happy to express their dissatisfaction and understanding that the status quo is not sustainable.\textsuperscript{521} The dissatisfaction with the current international tax system is widely shared and for that reason, reform is warranted. Further, reform is even more appropriate as there is a viable solution to replace the current and failed system, a solution that would prove advantageous to developed countries (A), MNEs (B), and developing countries (C) alike. This chapter demonstrates that

\textsuperscript{519} See above, Part 2, Chapter V, Section A.
\textsuperscript{520} See Part 1, Chapter IV above for an analysis of the current ills of the international tax system.
\textsuperscript{521} See James Hathaway, Michigan Law Professor, oral speech on refugee law at Michigan Law School in Ann Arbor Michigan, Jan 2015.
reform is not only of the essence because of a global dissatisfaction, but reform is further warranted because there is a viable, more credible and more advantageous alternative, able to leave all the parties involved in a better position than they currently are.
A. Unitary Taxation: The Better Alternative for Developed Countries

The current system of international taxation has failed developed countries in many ways already and continues to pose a threat to the very continued existence and ability of the governments to tax its people as the public perceptions of the fairness and effectiveness of taxation continues to dwindle. The UT presents a viable alternative chiefly because it provides a greater access to information thereby signing the death certificate of the tax heavens phenomenon, but also because it contributes to restoring integrity into the tax system through its at least appearance of fairness.
1. Information Access

Once a determination is made that an entity, along with its sub entities constitutes a unitary business as seen above, it become necessary that the taxation of such unitary business relies on the performance of the unit as a whole. The implementation of the UT requires that information be shared as to the performance of the unit as a whole. By providing the information on the global operations, UT allows for developed countries to access information they need to adequately apply their tax rules. Lack information and the non-sharing of information regarding multinational global performance by tax authorities has let to inadequate taxation. In recent years, many developed countries have made the sharing of information, the cornerstone of their international tax policy and the condition at times for their collaboration with other countries. The US, for example, has required a revision of most its outstanding tax treaties, and now incorporate in all new tax treaties, mandatory sharing of information between the government specifically as it relates to corporate performance of multinational companies within their border.\textsuperscript{522}

We have seen many experiences where lack of information, specifically in the developed world can lead to inadequate taxation, and to a feeling of tax unfairness. The debate regarding the so called ‘Panama Papers’ provided a case study of lack of information decimating tax policy and providing an appearance of tax unfairness not only amongst big companies, but also for individuals. The Panama Papers are a leaked of over 11 million documents that reveal how key financial information is kept private thereby restricting taxation. Though the Panama Papers do not necessary outline any illegality, they do reveal the art of hiding information for the purposes of diminishing potential taxation. A tax authority may only tax the income it is aware of, income

\textsuperscript{522} See recent US tax treaties, and other US treaty revisions for the specific purpose of including an information exchange provisions. Examples include US France, US Luxembourg, US UK.
that is hidden duly escapes taxation and the revelation to the general public of such hidden income, whether legally or not, highlights the distrust in the expected fairness of any tax system and undermines the trust of the many in the system thereby reducing voluntary compliance on which many western tax authorities rely upon to raise revenues. According to the EU estimates, the revenue lost from Panama Papers exceeded a trillion Euros; and the EU vowed to end such mechanisms of hiding financial assets and financial information.\textsuperscript{523}

The UT presents a viable alternative and a beneficial solution for developed countries. Combined reporting would prove to be very effective in developed countries being able to adequately apply their arguably well intended tax provisions to all income. As seen above, combined reporting would require for the multinational company to provide information as to its whole operations and performance globally. The developed countries would have the information handy and would more adequately apply their tax rules. UT prevents any possible Panama papers phenomenon. An obligation to entities to report their global financial data would leave no place to hide as the tax policy would follow economic activities and a unitary business would reveal its financial data globally, from a unitary perspective, for all to see, specifically tax administrations, in order to adequately tax all incomes, and eventually restore the credibility of the system as a whole.

\textsuperscript{523} See declarations of the European Commissioner for Taxation, Pierre Moscovici, as reported in Politico (last retrieved April 7, 2016).
2. Restoring Credibility on the Tax System: Disclosure and Fairness

One of the main existential threats to the survival of the taxation as we know it is the appearance of unfairness that has the ability to diminish people’s trust into the system and may lead to a general revolt and refusal to comply with tax law. If most people feel that the system is unfair, that no one pays their fair share of taxes, that in fact taxes are only paid by the naïve and uninitiated, all might recourse to ultimate goal of not paying taxes and as such governments would lose tremendous revenues. In the developed world, the outrage as to the current international tax system has been one of the major social and popular debates. The press, civil society and politicians aspiring to power have well documented the failures of the system. However, nothing is close to an agreement as to how to move forward, and as a consequence, the broken status quo remains in place and many feel the unfairness is at its highest and the system is designed to benefits some and not all. By not implementing a system that promotes disclosure, that at least appears to put all in the same footing, policy makers continue to fail the basic test of tax fairness and the people continue to express their anger and a prediction of major revolt potentially leading to the end of the tax system as we know are not totally out of the realms of possibilities.

Many feel the current system has developed losers and harbored winners. Most income that multinational companies earn end up in places of their choice having a common characteristic of low to no taxation. In 2012 alone, for example, multinational companies reported more than $80 billion of profits in Bermuda, a country with no corporate income tax, and an amount that exceeded the combined benefits reported in Japan, France, and China. Similarly, the gross profits reported in Bermuda was about 4% of the other profits around the world though sales in Bermuda accounted for less than 0.3% of the overall sales, and share of employees was less than
0.2% of the overall employees.\textsuperscript{524} The losers in this system seem to be the places where economic activities really happen and the taxpayer not sophisticated enough as to manipulate the system.

There is therefore a tension between the winners and losers in fact of the current failed system. Unable to position themselves on the winners’ side, many taxpayers are arguing for a revolt and disobedience in paying taxes. For developed countries, this can be a major issue because developed tax systems are heavily reliant on voluntary compliance and self-declaration. The burden to enforce tax rules outside of the self-compliance system could be overly burdensome for developed countries tax authorities and the lost revenues would be colossal. For example, in a country like the US with more than 300 million individual inhabitants and many more corporate entities, the IRS is not able to get the man power to enforce tax rules at the level of every individual taxpayer. Voluntary compliance has been the bedrock of developed countries tax systems and any departure from that would lead to major catastrophes. However, many taxpayers continue to wonder, in the face of current failures of the tax systems, why they should continue to comply, let alone voluntarily comply with a tax system that fails them over and over again, and that allows other to not pay taxes. The thread of public disobedience is real and developed countries face an urgent challenge to make their systems fairer.

The UT presents a way forward. Under the UT, all actors in the tax arena would have the information they need and would appreciate the government efforts to apply fair rules to all. Under the UT little to no income would avoid taxation and the application of the tax rules to real economic realities and real incomes would reinstitute the integrity and fairness of the system and would boost the belief in the system and solidify the tenets of voluntary compliance.

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\textsuperscript{524} See Report by the Tax Justice Network (2015).
B. Unitary Taxation: The Better Alternative for MNEs

It has become somewhat of a generally shared and agreed upon statement that MNEs do not like to pay taxes. Most commentators seem to agree that MNEs manage to stay away from zones with high taxation and are more lured into jurisdictions with low or no taxation.\textsuperscript{525} The current experience with this empirical fact is that the congregation of MNEs in low to no tax jurisdictions come with a reputational cost. Most MNEs who incorporate or locate their revenues in low to no tax jurisdiction have to deal with the public perception and the reputational inconvenient of existing and being motivated solely by the need to avoid taxes. Needless to say, most MNEs would prefer to avoid such reputational repercussions, even if that meant paying a little bit more in taxes if other advantages were provided.

Further, with the current debate around dealing with low to no tax jurisdictions and aiming to combat what is now known as the ‘race to the bottom’\textsuperscript{526} phenomenon, the international tax arena has created extremely complex rules that do not afford predictability to MNEs. The rules are often so different in various jurisdictions and so complex that the costs for complying to said rules are forever increasing.

This research believes therefore that the UT would be a better system and would prove more beneficial to MNEs because it would afford them simplicity and predictability as well as reduce the amount of compliance costs inherent to the current system.


\textsuperscript{526} See for example, Mendoza Enrique and Linda Tesar, \textit{Why hasn’t tax competition triggered a race to the bottom? Some quantitative lessons from the EU}, 52.1 Journal of monetary economics 163 (2005).
1. **Predictability and Simplicity**

As much as MNEs would prefer to pay as little a tax as possible, MNEs are even more resentful of fiscal unpredictability and their inability to understand the tax environment in which they operate. When a tax environment is unpredictable and cannot be read, and planned around in the design of a business plan, many business enterprises are discouraged from engaging in business in those areas. Tax uncertainty, and tax unpredictability are aspects that weight heavy on the private sector and MNEs.

Current international tax systems are characterized with their uncertainty and unpredictability. Tax systems in general and international tax systems for each country particularly are currently so dissimilar that an understanding of one, does not necessarily show helpful to the understanding of the other. Countries seem to have different interests and aim and promoting different sectors whether in society or in the economy. As a consequence, tax law and tax policy has been the tool readily available to incentivize those social, cultural, or economic priorities. The result has been the creation, in each tax jurisdiction, of a conglomerate of tax rules, quasi impossible to understand and generally unique to the specific jurisdiction. Tax law and tax policy is local, aim at solving jurisdictional specific issues, and continues to grow in complexity. For MNEs, the situation is difficult to understand and comply with. MNEs continue to plead for a simple tax system, which would allow them to predict they fiscal environment and the fiscal component in the planning of their business endeavors.

The institution of transfer pricing in almost all tax systems and the reliance on ALS have introduced a new level of complexity in taxation. The conception and application of transfer pricing principles has ushered an unprecedented level of unpredictability in the tax arena.527

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Several methods initially proposed to apply transfer pricing quickly showed lacking policy makers around the globe have continued to designed new transfer pricing methods without ever eliminating the previous ones, thereby consecrating a convoluted system, extremely complex and at times internally contradictory. Time after time and survey after survey, investors and business managers have pointed to transfer pricing as their main tax worry. The area has become so complex that only a select few law firms and generally ‘big four’ accounting firms are able to assist on transfer pricing matters. However, transfer pricing is just an example of an international tax system that has grown unfit, and un-adapted to the new economies and the new needs of tax policy.

UT, as seen above, provides a set of rules that include coherent definition of Unitary Business, universal requirement of a global reporting, and an agreed upon formula on which to apply the financial data in order to determine the tax liability. The UT therefore outlines a set of rules, and its global adoption would allow for a predictable fiscal environment in each and every one of the jurisdictions MNEs may operate in. If a country adopts the UT, any MNE venturing in business in that country would know, in advance, that the basic tenets of UT would apply in the determination of the tax liability and as such could adequately include the fiscal considerations in the planning of its business venture. For example, if country X adopts a UT system outlining a clear definition of a Unitary Business, a requirement of combined reporting, and a formula based on equally weighted three factor average test, any MNE or any investor planning to engage into business in country X would know how such country would determine tax liability from the operations of the business and the company could plan accordingly. The MNE or investor would not be left to guessing how the investment in the assets would impact its fiscal posture, or how

528 Id.
much the workforce to carry its mission would help or hurt its fiscal outlook, or the occurrence of the sales and their geographical location would impact the investment.

UT aligns fiscal policy with economic reality. If an investor is satisfied with the outlook of its potential investment, taxation should not constitute a drawback to an otherwise promising business endeavor. Taxation and the fiscal environment should be predictable, and tax policy should align itself with economic reality so that each business actor understands that there would be no unknown factors affecting the life, return, or sustainability of their business. Any factors that would not be linked to their business reality and the economics of their operations.

UT offers fiscal simplicity and tax predictability to business investors and presents a better alternative compared to the current system of taxing multinational where most business operators barely understand if they will be tax, on what items, let alone how they would be taxed in each and every single jurisdiction they intend to operate in. By providing simplicity, the UT will also help MNEs cut down compliance cost that are related to navigating the current complex and very unpredictable set of tax rules across various jurisdictions.

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2. Reducing the Cost for Tax Planning and Tax Compliance

MNEs would be the first ones to point to how much they spend, year after year, to make sure they understand the various tax systems in the jurisdictions they operate in and to comply the countless reporting and other requirement of the ever-growing complex tax systems. MNEs nowadays can’t seem to exist without an army of lawyers and accountant just to help them understand the tax systems, and later to help them comply with such systems. Yet, the high cost does not come with a guarantee of accurateness and ease of a step taken care of. More often than not, tax authorities come back to question the understanding of the laws that the experts have provided to MNEs and what they had deemed proper compliance with the law. Tax audits and tax controversy continue to expand the spectrum of ever growing costs MNEs have to incur related to taxation.

The example of the transfer pricing area mentioned above shows how costly the process of paying tax, not just the actual taxes paid, has become for MNEs. As mentioned above, transfer pricing has become very complex and transfer pricing engagements require application of very especially complex rules. The domain is now reserved to a select few lawyers and the ‘big four’ accounting firms mainly because of the man power necessary to conduct a transfer pricing engagement but also because of the technical resources needed, resources that are generally not accessible for ordinary tax compliance.

Ordinary investors, without the capacity to retain a select few number of law firms of the ‘big four’ accounting firms to accompany them and guide them in the process of understanding, planning and complying with international tax, are discourage from engaging in international

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business activities. Because of taxation today, many investors are priced out of international markets and are obligated to conduct business locally where taxation may not pause a major influence.\textsuperscript{532}

UT reduces the planning and compliance costs and alleviates the process of paying one’s taxes. By providing for clear rules of transnational application, the UT cuts through complexity and provides business investors with easier ways to determine their tax liability without necessarily using an overly burdensome army of human and technical resources. The UT proposed in this research is marked by simplicity based on agreed upon tenets of taxation regardless of fiscal jurisdictions.

The argument for simplicity of UT would be even stronger if all countries adopt the same or a quasi-identical formula for apportionment of income for purposes of assessing taxing rights. For example, if all taxing jurisdiction could adopt an equally weighted three factors test as their apportionment formula, UT would provide total simplicity as the same formula would be known as adopted in each jurisdiction, and its application would be predictable. Under such circumstances, a change from one jurisdiction to another would not compel a study of a new formula for assessing tax liability and investors would easily factor in the tax implication of their investment before they carry the same. The presence of uniformity would significantly reduce the cost of complying with tax law.

Nevertheless, and even in the event the same formula is not adopted globally, UT still presents a simpler tax system and less costly to comply with for MNEs than the current international tax system. By adopting UT, even under differing formulas, tax jurisdictions agree on a baseline for approaching tax policy and designing tax rules, tax authorities agree on a number of common

tenets in the conception and application of their tax rules. As a consequence, the planning and compliance cost otherwise related to understanding the fiscal tenets for each taxing jurisdiction and interpretation of their way of assessing tax liability and levying taxes, those costs are immediately inexistent.

The argument generally leveled against UT to the effect that UT would lead to increased tax liability for MNEs falls apart, we believe, when factored in, the amounts of saving MNEs would realize in reducing the costs associated with their fiscal planning and compliance. One of the major expenses for MNEs today is the cost of experts to help them navigate the various fiscal environments where they operate. The various separate efforts in different jurisdictions to tax as much of the income within their borders as possible within the realms of ALS of transfer pricing has led to an increase of tax laws. Due to the growing divergence and the ever increasing complexity, many large law firms and accounting firms are projecting an exponential growth in their tax revenues in the near future. The argument is that whatever MNEs may save by employing an army of experts to help them manage their tax exposure, is far more than whatever that is MNEs may end up paying as additional taxes under the UT. When the dust settles then, MNEs would find the UT more beneficial to them with regards to costs than the current system of needlessly complex tax provisions.

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533 See Supra, at 530.
C. Unitary Tax is Best for Developing Countries

Developing countries may stand to benefit the most under a UT system. As analyzed above, no one else seems to have been more harmed and stands to lose the most in the future if the current international tax system stays in place. The current system is based on complex tax rules, incoherent in their nature, and majoritarily designed by developed countries.\(^5\) The current rules of international taxation require massive human resources and acute expertise for their application and enforcement. In an effort to set broad policies, developed countries have acted through the OECD to establish major guidelines for international tax rule making.\(^5\) The various rules and general guidelines are designed with developed countries capacities and capabilities in mind. Transfer pricing rules for example, with its OECD authorized methods require acute expertise and ability to access a wide array of information that generally seem out of reach for developing countries. Needless to say, therefore, the current international tax system and its encouragement for a tax treaty network has mostly left the developing world in a bad situation. Because developing countries endeavor to adopt tax system that align to some extent with the fiscal environment in the developed world, developing countries tax system are widely not understood by the tax professionals who are supposed to enforce them, and international taxation in the developing world continues to be a disastrous scene.

UT, however, by aligning fiscal policy with economic reality, by aiming at convergence of tax system by and for both the developed and the developing world, is a better system specifically for developing countries because it would provide them the information they desperately need on

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the MNEs economic operations globally, and the administration of the UT would show more feasible for developing countries as compares to the current system.

1. Availability of Information

Any adequate taxation of MNEs requires, as a pre-condition, a proper location of the income to be taxed. In order to properly locate the income to be taxed, each tax authority should understand how the income is made, the processes within each industry and the relationship of the income with the assets of the business as necessary. Under the current system, MNEs possess the information regarding their global operations and the revenues location within their network in accordance with their economic realities. However, MNEs are not required, generally, to provide that data to taxing authorities and many developing countries continue to struggle to figure out that information.

Many developing countries’ tax authorities claim that access to information regarding their transnational taxpayer is the number one impediment for the adequate taxation of those taxpayers.\textsuperscript{536} MNEs sophisticated transactions planning have made it quasi-impossible for tax authorities, specifically tax authorities of the developing world, to understand the scope of the income earned within their borders and therefore adequately tax the same. For example, many MNEs chose to operate in the developing world through traditional subsidiaries, while others, use the legal construct of a PE to operate in the same jurisdictions. For a developing country’s tax authority looking into taxing the presence of the MNEs within its borders, it quite difficult to determine the income earned by the branch present in the country without an understanding, however basic, of the operations of the MNE out of the country. The traditional setting of a

subsidiary as well as the more fiscally innovative set of a PE cause concerns to a developing country’s tax administration when trying to determine the income adequately earned within its borders for taxation purposes.

Generally, local tax authorities do not have the information regarding the structure and functioning of the MNEs outside of the country. Even, the taxation authorities in the developing world seldom fully understand the operations of MNEs within the country. Tax authorities in the developed world have designed ways to access the information or manners to compel MNEs to provide them with such information. However, developing countries do not have what is necessary to access the information and in any event, do not have the powers to compel MNEs to provide to information to them. For example, the US realized an immense tax leakage from the US tax net based on transactions being carried abroad. In order to solve the problem, the US implemented the Foreign Account Tax Compliance Act (“FATCA”).\textsuperscript{537} FATCA is a way for the US taxing authorities to obtain information they need to assure adequate taxation in this area.\textsuperscript{538} This was a way the US designed in order to access the information it needed from taxpayers. However, and upon adoption of FATCA, many MNEs claimed the US government’s overreach and planned to not comply.\textsuperscript{539} The US therefore had to design a way to compel compliance with the Act. The US adopted sanctions especially applicable to taxpayers with a presence in the US.\textsuperscript{540} The US in this instance, because of its power and level of development, found a way to access the information and otherwise find a way to compel MNEs to comply with its provisions.

This situation squarely contrasts with a developing country’s circumstances. On the one hand, a

\textsuperscript{538} See Supra, at 375.
\textsuperscript{540} See Supra, at 375.
developing country’s tax administration does not have the reach the US government may have and on the other hand, a developing country’s tax authority would not be able to design an enforcement method similar to the US because the presence of MNEs in the development is not consequential.

The UT solves most the developing countries tax authorities access to information problems. Under the UT, MNEs are required to report, in all jurisdictions where the operate, information regarding their global operations. The combined reporting is done at the level of both developed and developing countries alike. The information the MNEs will possess internally regarding their global operations and economic results will be the same information used by taxing authorities in the developed world as well as, most importantly, the developing world, to assess taxation. The MNEs information needed for adequate taxation in all localities they operate in will be available to all taxing authorities and would be accessible especially to the taxing authorities in the developing world. As a consequence, the UT is a better system for developing countries, as compared to the current system.

With accessible and readily available information, developing countries’ tax authorities as well as any other tax authorities would be able to design a tax system that is easier to administer and comply with.
2. **Easier to Administer**

The ease of administration of a tax system is arguably the utmost priority of any developing country tax administration contemplating changes to its tax system. Improving tax administration in the developing world has been and continues to be a high priority. Many commentators and experts endeavoring to offer a better tax system to developing countries have sometimes understated the importance of tax administration in the design of any tax policy by or for developing countries. Good tax administration distinguishes successful tax authorities from unsuccessful ones in terms of the amount of revenues they are able to raise for the well-functioning of their governments. Whatever the policy or tax system adopted, the results in the developing world are usually summarized in terms of how effective the tax authorities are at administering such tax policy or tax system.

An effective tax administration is generally evaluated by looking at the ease with which the taxing authorities are able to access the information they need; the ease with which taxpayers are able to apply the rules in complying with the tax system, and tax administrations are able to apply the rules adopted to collect the revenues; and the volume of revenues collected as a result of adequate taxation of all economic activity within the taxing authority’s fiscal borders. By all these measures, developing countries continue to struggle and their tax administration, to say the least, are not optimum. The current system of international taxation has let to difficult to administer systems in the developing world and various attempts to adapt have not received major political will. Any changes to a tax system, even a change to tax administration in order to

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541 See Richard Bird et. al., *Improving Tax Administration in Developing Countries*, 1 JOTA 1 (2015).

542 *Id.*


optimize the revenues must be driven first and foremost by political will. However, the foreign systems empirically ask too much of developing countries governments. Basically, developing countries are asked to, as indicated earlier, deploy the resources they do not have to apply the rules they seldom understand and the outcome of which is at the very least, very uncertain. Complicated tax rules on transfer pricing, analyzed above, are a very current and telling example of what developing countries tax administration deal with.

Adoption of a UT system would usher in an era of more easily administrable tax rules and tax systems for the benefit of developing countries. Basically, a UT systems allows for a more effective tax administration on each of the three measuring factors.

First, the UT would allow for an easy access to information. As indicated above, MNEs, under the UT, are required to make available to all governments tax authorities, including developing countries tax authorities, the information on their global operations and global economic performance. Under the UT reporting obligation therefore, it is no longer the task of a taxing authority, let alone a task of a developing country’s tax authority to look for and find the information it needs to apply its tax rules. In fact, the burden is on the taxpayer to provide such information and for the tax authorities, specifically the developing country’s tax authority, the information is available and easily accessible under the UT. Therefore, based on the first prong regarding the ease with which the tax authorities are able to access the information, the UT establishes a more efficient tax administration system.

Second, the UT allows for clear rules of easier application. Under an ideal UT adopted globally, as we will endeavor to design and propose below, all three tenets would be globally agreed upon. There would be a common understanding of a Unitary Business, an agreement on a combined

\[\text{id.}\]
reporting of net income, and a single agreed upon formula. It such UT is adopted; it would lead
to easy tax administration based on the second prong in the measurement related to the ease with
which rules are compliable by both the tax payers and tax administrations. Under the UT, both
the taxpayers, including MNEs and the tax authorities would have a set of rules, agreed upon and
ready to be applied uniformly. For the taxpayer, there would be total predictability of what
would constitute a Unitary Business, how they would combine report globally, and what formula
would be applicable to them. Therefore, taxpayers would have rules they understand making it
easy for them to comply with the rules. For tax administrations, they would similarly know what
constitute a Unitary Business, would expect taxpayer to combine report globally, and would
know what formula to apply. Therefore, tax administrations, including developing countries tax
administrations, would have clear rules to they understand and can easily apply in their
collection of revenues mission. As a consequence, the UT would lead to more effective and
easier tax administration because it would provide easy to understand and apply rules for both
taxpayers and tax authorities.
Finally, the UT would lead to increased tax revenues and in any event, adequate taxation of all
economic activities in each taxing jurisdictions’ fiscal borders. The UT relies on actual economic
activity and taxation follows economic performance globally. Under the UT, gamesmanships of
relocating profits or choosing jurisdictions within which to be taxed would be reduced if not
eliminated. MNEs would not, with the relation to their actual economic mode of operation and
reality, book profits in a jurisdiction of their choosing while booking losses where they believe
would make the most tax sense. By requiring a global reporting, a disclosure of global economic
performance as well as of global economic footprint, and by requiring the application of an
apportionment formula, the UT endeavors to give tax power where taxing power is economically
due. In practice, developing countries may end up with an increase in tax revenues, and most likely, the countries currently known as tax heavens may see a sharp decrease to however much income they currently are entitled to exercise taxing power over. If the UT is implemented, the result would be a more equitable application of various countries taxing sovereignty and a better empowerment of developing countries in their ability to raise revenues. As a consequence, therefore, the UT would allow for an easier administrable tax system based on the prong of overall revenues raised and equitable global distribution of revenues raising as relates to economic activity and performance from taxpayers.

Notwithstanding the various advantages outlined above, notwithstanding the fact that a UT would be beneficial for developed countries, MNEs, as well as developing countries, none of the advantages could take place unless and until an actual UT is adopted. We offer a proposal below to replace the current system of taxation of MNEs and to take put into practice, the many positive provisions of the UT. The below proposal may not immediately receive unanimous approval from the various stakeholders, but at least it can provide a creditable starting point where fundamentals are agreed upon, a result that has been the objective of this entire dissertation: creating a new baseline for the taxation of MNEs.

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Chapter VIII

The Design of an International Tax Reform Based on Unitary Taxation, and the Case for Its Compatibility with the Current International Tax Treaty Network
The design of a tax system and the proposal of a UT alternative requires an adoption of the basic tenets with overall explanation of their meanings. The hope is to assure that the fundamentals of the UT system are outlined in a manner that is agreeable to most, even though the edges and many details may still require some fine tuning in order for the system to be readily implementable. This chapter will therefore outline the tenets of UT seen above, proposing a definition to be adopted with regards to each key term, explore a proposed formula to be adopted for purposes of apportionment of the MNE’s global income.

After proposing a system, we would analyze why we believe it is not incompatible with the current tax treaty network. In fact, we will argue, the current tax treaty network could facilitate the transition from the current system of taxing MNEs incomes internationally, to the UT system proposed in this research. Unlike many concerns that the tax treaty network is so engrained in the international tax system that UT would be contrary, we will argue that the tax treaty network would in fact serve as a springboard in the transition and for the implementation of the UT proposed in this research.
A. A UT Proposal

This UT is based on and applicable to a common business, required to file combine reporting of net income from all its activities globally, and be applied a formula for the apportionment of such global income to all connected territories for purposes of determining taxing rights.

1. Unitary Business

A MNE would qualify as a Unitary Business if any one of the conditions below are satisfied. However, for any of the conditions to be tested and applied, there must be a shares or interest ownership relationship between the tested entities. The percentage of ownership, unless otherwise indicated below, is irrelevant. Further, the character of such ownership, whether direct, indirect, or constructive is also irrelevant. Nevertheless, such ownership relationship, however insignificant, must always exist before any of the below tests may apply.

a. Common Ownership

A MNE chain will be considered a Unitary Business based on common ownership if either:

- The entity is legally owned, directly or indirectly, by another entity at a percentage of more than 50%. Under this condition, an entity will constitute a unitary business if one entity owns more than 50% of the stock of the other entity. This condition strictly looks at legal ownership of the stock, and if the entity is not incorporated, this condition looks at the interests (whatever its form) being held. Or,
• The entity is economically controlled by another entity which does not meet the required legal ownership threshold. This condition strictly looks at the economic relationship between the two entities. One entity may not hold the legal threshold required but it could entirely control another entity so that that other entity would not be able to exist but for the economic relationship with the first entity, under these circumstances, both entities should be considered as forming a unitary business.

Common ownership is therefore established with legal ownership or with economic control. The legal ownership remains the principle and the economic control may intervene under exceptional circumstances.

b. Unity of Operations and Centralized Functions

A MNE chain will be considered a unitary business based on unity of operations or centralized functions in the below described circumstances:

• Two or more entities constitute a unitary business if their operations are united. The concept if unity of operation requires that the operations of one of the entities are inseparable from those of the other company. As a factual matter, the entities are inherently tied to one another in their operation and as such are eligible for a unitary business treatment. Generally, the frequency of interaction between the entities constitutes a helpful indicator of the community of operations. Further, the unity of operations implies unity of use. The entities may use identical assets, sometimes comingle assets in their operations. The results of their operations are intertwined and the
outcomes are in a continuum of interdependency for their ultimate use or commercialization. For example, a unity of operation will exist if two entities, related in ownership, are the only ones that produce: one car tires, and the other the body of the car, products that would not be useful but for the actions of the other. If, in our example, the entity that produces the cars operates in a similar fashion as the entity that produces the tires and in some regards, uses identical machinery indistinctively owned by one or the other entity, and assuming that these are the only two entities in the business of producing car tires and body of cars, then those entities would satisfy the unity of operations and would meet the unitary business definition under that prong. The bottom line is the not separate, legally or otherwise, two entities that are intricately connected and intertwined and would not exist by themselves on a standalone basis. And when operations are united, when the level of interdependency is established, the unitary business is satisfied and UT should come into play

- Two or more entities constitute a unitary business if their functions are centralized. When there is a stock ownership link and there is coordination of activities generally through centralization of functions, the entities would constitute a unitary business. Centralization of functions can be evidenced by, for example, central purchasing, common advertising, central administrative functions such as accounting or legal, and centralized management through group management divisions. Many MNEs now adopt a system aimed at centralizing the most of their common functions within the group. For example, many global businesses domicile all their accounting functions in one jurisdiction, all their legal functions in one jurisdiction or all their advertising functions in one jurisdiction. Under
this system, regardless of where the several entities of the group reside, all their functions as relate to accounting legal or advertising are centralized in the same jurisdiction. These business structures, when underlined by a stock ownership, would qualify as a unitary business subject to UT rules. Again, the aim here to make sure that all that is economically linked and connected, no legal or fiscal rule or policy should divide.
2. Combined Reporting

All MNE that qualify as a unitary business will be required to report in a combined manner on their
global operations, their net income from all activities and entities around the globe that form part
of the unitary business. The net income to be reported on the combined basis globally should be
computed locally, using of tax base that have been adopted locally. The mechanics of the global
combined reporting of net income are outlined below, followed by a policy justification for the
adoption of the combined reporting of global net income.

a. Computation of all gross income should be done locally

Under a UT system, all gross income is computed locally. Local gross income should mean, for
all jurisdictions, all incomes. The computation of the entity’s income would take into account, all
the incomes the entity receives or otherwise is entitled to as per the rules and tax base definitions
adoption in the jurisdiction in which such entity operates.

As an illustration, for an entity incorporated in country X, gross income for year Y would be the
sum of all incomes received by company X. Such incomes would include for example, all
revenues from sales, all dividends, all interests, all royalties, all gifts, all cancelation of
indebtedness or any other items of income as specifically received by the entity.

This definition of gross income would be closer to the definition that the United States tax laws
give to income. An over encompassing notion that takes into account, all items of income from
whatever source derived. The source or nature of the income would matter less, and items
income of whatever nature and from whatever sources would be included in the local
computation of the entity’s gross income.
b. Factoring of Local Deductions and Incentives

Under the combined reporting of net income, deductions and incentives would be taken into account from a local perspective. The UT would encourage and allow for an alignment of standard business deductions but all deductions would be taken locally within the jurisdiction of the entity’s incorporation.

Similarly, various incentives adopted by different jurisdictions for different reasons should be taken into account at the local level. Many government endeavor, in a legitimate and reasonable manner to provide incentives in order to boost certain sectors of their economies and the UT, by adopting a system of combined reporting of net income, endorses such practices.

For example, the UT would encourage general adoption of standard deductions related to interests or other common business expenses, and such deductions would be taken into account at the local level in arriving at the entity’s net income for that jurisdiction and that specific segment of activities. Further, should the local jurisdiction adopt incentives that are legitimate and reasonable and that do not promote tax evasion, such incentives would be taken into account at the local level in arriving at the entity’s net income for the geographical area and for specific segment of activity.

As a consequence, therefore, deductions should be taken into account locally and local incentives should be factored in arriving at the local entity’s net income for that geographical area and for that activity.
c. Combined reporting of all local country net incomes at the global level

After all the incomes are taken into account and gross income is determined at the local level for the local entities, the deductions and incentives should be taken into account in arriving at the local country and local entities net income.

After the net incomes are computed in local countries and for local entities, the MNE should centralize all that information for all entities that form a unitary business and at the level of the global MNE, should report to each taxing authority in each of the countries where any of the entities that form part of the unitary business conducts activities, the global combined reporting of the group. Each taxing jurisdiction connected to the operation of the unitary business shall be entitled to receive a combined reporting of all net income of the group globally.

For example, if company X operates in countries A, B, C, and D, and local computations established that each of companies A, B, C, and D have $25 of net income for the year, and company X is a unitary business made of operations in countries A, B, C, and D, then each of countries A, B, C, and D shall be entitled to and shall receive a combined reporting of net income totaling $100.
d. Justification of the Reporting of Net Income

The adoption of the combined reporting of net income is motivated and justified by is many advantages including the following:

On the one hand, the UT does not intend to impede with local countries plans and willingness to use their taxing powers to legitimately encourage sectors of activities or boost their economies in some shapes or form. Under the UT, countries sovereignty in the area of taxation is not eliminated. Countries remain free to adopt legitimate and reasonable incentives from a fiscal perspective without running afoul of the UT rules. The adoption of the combined reporting of net income achieves that goal. Under the UT, MNEs would be required to account for their revenues at the local level, and take into account all the legitimate incentives provided in that local jurisdiction in the ultimate computations of the net income for the local jurisdictions. The taxing power, and the sovereign right to determine a country’s tax policy remain therefore largely at the local country level and the local country’s area of decision. For example, and as indicated above, if a country X decides to adopt incentive A and B, subsidiaries or branches of the MNE operating in country X would be entitled and in fact would be able to benefit from those local incentives should they qualify, and the UT would not stand in the way of such local entities benefiting from the local tax incentives. It is worth noting that none of the incentives under the UT would be purely for purposes of encouraging non-economic based tax advantages. The acknowledgement of local countries right to determine their specific tax policy and eventual adopt tax incentive will not constitute a license for the promotion of measure aiming at unfair tax competition or the so-called race to the bottom. The UT is primarily a response to current abusive tax situation, current schemes of tax evasion and tax avoidance; therefore, any attempt to use the local power reserved in forms of incentives to provision tax evasion or undue avoidance would not be
sanctioned. Incentives deemed illegitimate and unreasonable, and that are not based on economic reality would not be taken into account in the net income calculations.

On the other hand, one of the main advantages for the UT is its relative simplicity for all the parties involved. As seen above, UT is a simpler system for tax authorities and a simpler system for businesses. The adoption of the combined reporting of net income underscore the simplicity concerns and goals of the UT. By allowing for the net income to be arrived at from a local level perspective avoids overly complicated and complex computations at the global level for the MNE. The simplicity results from the fact that deductions, if any, are taken into account at the local level, making it unnecessary to compile deductions globally and in some instances to endeavor to understand and reconcile deductions adopted by one jurisdiction to those of another.

Furthermore, many MNEs today already operate this way. It is not unusual for a MNE today to know and keep record of net income from its operations in each and every jurisdiction. The simplicity here would come from the fact that MNEs would only use the information that are already used to compiling, recording and utilizing internally. The net income historically computed by MNEs would be used, eliminating any unnecessary new step under the UT system. In addition, adoption of a different approach, specifically the combined reporting of gross income would engender many complexities and inconsistencies. For example, if the gross income was reported on a combined basis and globally, all incomes received by each of the local entity of a unitary business would be reported at the global level, and it would be incumbent on the global organization to conduct to taxable income and net income computations. Under these circumstances, one would wonder what definition of tax base would be adopted, what accounting principles would be applied and what results would be achieved when the net income computations are done globally and detached from the local provisions and local fiscal systems.
already in place. By avoiding such complexities, the requirement of a combined reporting of net income consecrates and underscore the simplicity characteristics of the UT.

It is worth noting that one could argue that the requirement of combined reporting of net income, notwithstanding is merits, would be an invitation to promote tax evasion and tax avoidance. In fact, one could argue that by giving countries the liberty to adopt their tax incentives for example, the UT basically endorses the fragmentation of the MNEs to all the jurisdiction it operates in, one of the cardinal sins of the current international tax system. However, these arguments would be true but for the requirement of formulary apportionment as discussed below. In fact, deductions and incentives may lead to lower taxable income, but there are no guarantees under the UT system that the jurisdiction in which the taxable income may have seemed reduce would get to tax any of it. Deductions and incentives reduces taxable income, but the countries would not be inclined to adopt more or less deductions and incentives because the number of deductions and incentives or lack thereof, does not impact the share, if at all, of their tax revenues from the MNE operations. The repartition of the tax revenue amongst the jurisdictions remains dictated solely by formulary apportionment under the UT.
3. Formulary Apportionment

One of the most debated issues regarding the adoption or not of a UT is the controversy around formulary apportionment. While some do not seem to agree with idea of a formula at all, other seem to take issue with a kind of formula that could be considered ideal, or the lack thereof. As seen above, any idea of adopting a UT would require not only that there be an agreement on a well-defined and generally agreed upon notion of unitary business, as well as agreement on the combined reporting of net income, but also, there would need to be agreement on the apportionment formula to be adopted. Ideally, all countries would agree on an identical apportionment formula to be applied. Nevertheless, even without an agreement on an identical formula, there are formulas that can be adopted that would satisfy the goals of UT while not providing avenues for double taxation.

The risk, if an identical formula is not adopted is that the same income may be subjected to double taxation of to no taxation at all, coming back to the original problem that the UT aims at solving. For example, if a MNE operates in jurisdictions A & B, and jurisdictions A & B have adopted a UT system but with different apportionment formulas, there will be a real risk of the same income being taxed twice by virtue different apportionment factors being used. Or similarly, there will be a real risk for some of the income not to be taxed at all because an apportionment factor may not include them. In order, therefore to avoid falling in the trap of the current system and avoid encouraging similar techniques of tax avoidance or over taxation, a formula should be universally adopted or at least be of a kind that can be coordinated with a different formula so as not to allow risks of double taxation or for that matter, double non-taxation.
The formula under this research and this model UT tax proposal is the equally weighted three factors test based on assets, wages, and sales. Though imperfect as detailed above, this formula proposal has the merit of being able to be agreed upon by the various jurisdictions and its advantages in taxing economic realities far outweighs its disadvantages.

Under the equally weighted three factors test, assets, wages, and sales each constitute a factor and each has the same weight in determining the countries taxable portion of the overall net income of the MNE. In practice, each jurisdiction would compute the number of assets the MNE holds in their territory, the amount of wages paid to employees in their country, and the amounts of sales concluded from their country, in order to determine the amount of the net income to which they are entitled to impose their taxing rights.

Under this equally weighted test, each of the factors would need a clear and agreeable definition. Under the current proposal, assets would mean all assets whether tangible or intangible. The location of tangible assets is rather easy to determine and in this proposal would constitute the place where the assets can be found. The physical location of the assets will determine in which country they are to be used as a factor for determining the net income attributable to that jurisdiction. However, the physical location of the assets is only applicable to tangible assets. For intangible assets, their location has sparked much debate in the current system of taxing MNE and similarly pose a concern under a UT. Nevertheless, under the UT location of use of the IP would determine its location as an asset. Under this conception, the place of registration of the intellectual property for example, is not the determining factor for location of the intangible. As an illustration, if a MNE has an intellectual property address registered in the state of Israel, however, the use of that intellectual property is solely related to sales of the products the MNE makes into the Cameroonian market. Under these circumstances, the intellectual property would
be considered located in Cameroon as an asset, therefore, the factor would be taken into account in Cameroon. If the intangible property is used in several jurisdictions, the degree of use in each jurisdiction will determine the asset value that would attributable to that jurisdiction and the ultimate value from that intangible that would be included in the country’s assets factor in the formula.

Under this proposal, wages would have the common meaning of salaries on the one hand, but also include the various new forms of compensation in the market. Therefore, the wages factor would include regular salaries, bonuses, incentive based compensation such as stock options, as well as contingent forms of compensation. The issue with the wages factor at an international context is the exchange rate and the cost of labor. Labor cost in the US are empirically more onerous that they would in any developing country and blindly recognizing wages without appropriate considerations would lead to undue attribution of excessive taxable income to developed countries such as the US. Under this proposal, the wage factor is subject to adjustments. To determine how much wages are attributable to a certain jurisdiction and in order to compare said wages with those of another jurisdiction, the computation would not be and the comparison would not limit itself simply to the amounts at stake, but consideration would be taken to how much of the amount represent in overall income in the jurisdiction. For example, country A could pay 100 units of currency X (representing $100) in year 1, and in the same year, the operations in the US have $500 in wages. Under this approach, we would not limit ourselves to comparing and attributing 100 to country A and 500 to the US. Instead, we would look at how much the 100 represent in the overall income in Country A and how much the 500 represent in the overall income in the US. Thereby, adjusting the wages factor so as to account for the real
weight of the wages in each of the jurisdictions, measured as a relative to the overall income of
the jurisdiction.

The sales factor adopted in this proposal refers to the gross amount of sales. Under this proposal,
sales would be deemed located in the jurisdiction in which the buyer is located. Under this
approach the physical location of the buyer is paramount. Under this proposal, the notion of
physical address of the buyer is adopted to determine the location of the sale. For in person sales,
one would rely on the address provided by the buyer at the point of payment. For online sales,
the shipment address as well as address used at the point of payment are indicators of the
physical location of the buyer.

This method of determining the location of sale based on the physical location of the buyer is
important because it is generally unbiased. While the MNE may want a sale to be located in one
jurisdiction instead of another in order to benefit from some tax advantages, for buyers, the
location of the sale is irrelevant for their tax perspective, and they would not use gamesmanship
or even be aware of any tax gamesmanship related to the report of their physical location.

The above outlined international tax proposal based on principles of UT would be beneficial, as
discussed above, to developing, and developed countries while not alienating the private sector.
The proposal is based on a common understanding of the notion of a unitary business, an
agreement on the application of combined reporting of net income, and allocation of taxing
rights based on an apportionment formula composed of an equally weighted three factors test.
The proposal is intended as a basic outline of generally agreeable pronouncements that would be
subject to negotiation and adaptations as needed during the country specific adaption of the UT
system.
Further, the proposal, and the UT system in general are not incompatible to most current international tax rules, in fact, the current international tax set up can serve as a spring board and accelerate the transition and the implementation a UT system.
B. Compatibility of UT with Current International Tax Treaty Network

Transfer pricing is currently governed by Article 9 of the treaties, which assumes the Separate Accounting ("SA") method because it addresses the commercial or financial relations between associated enterprises. Traditionally, the term Permanent Establishment ("PE") was meant to include separate entities (subsidiaries). However, in 1933, the League of Nations introduced Article 5 (ancestor to the current Article 9 of the Model) where separate enterprises were no longer considered PE. If UT were adopted, Article 9 would become irrelevant in those situations to which UT applies (i.e., where a unitary business is found to exist) because UT ignores the transactions between related parties, and treats them instead as part of a single enterprise.

Instead, UT would be governed by Article 7. Under Article 5(7), “[t]he fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State … shall not of itself constitute either company a permanent establishment of the other.” However, it is well established that a dependent agent can be a PE (see Art. 5(5)), and whether an agent is dependent is based on whether the principal exercises legal and economic control over the agent. “An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.”

In the case of a modern, integrated MNE that operates as a unitary business, a strong argument can be made in most cases that the parent of the MNE exercises both legal and economic control over the operations of the subsidiaries, especially where the subsidiaries bear no real risk of loss and acquire goods and services exclusively or near exclusively from the parent or other related corporations. The existence of Intranets in most MNEs has resulted in most important
operational decisions being centralized. In that case, the subsidiaries should be regarded as
dependent agents of the parent. Such a finding is in fact made with increasing frequency in both
developed and developing countries.

If the subsidiary is an agent of the parent, Art. 7(2) of the treaties requires the attribution of the
same profits to the subsidiary “that it might be expected to make if it were a distinct and
independent enterprise engaged in the same or similar activities under the same or similar
conditions.” Arguably, the application of UT satisfies this arm’s length condition because in the
absence of precise comparables, which almost never exist, it is not possible to determine exactly
what profits would have been attributable to the subsidiary under SA.

When the US adopted the ‘comparable profit method’ (CPM) and profit split in the 1994 transfer
pricing regulations, some countries objected that it was violating the treaties because these
methods did not rely on exact comparables to find the arm’s length price. However, these
objections eventually subsided, and the OECD endorsed similar methods in its transfer pricing
guidelines and more recently granted them equivalent status to the traditional methods. The US
has always maintained that both CPM and profit split satisfy the arm’s length standard despite
the lack of precise comparables (and in the case of profit split, using no comparables at all to
allocate any residual profits). Similarly, the US has maintained that the “super-royalty rule” of
IRC sec. 482 (which requires royalties to be “commensurate with the income” from an
intangible, and therefore subject to periodic adjustment) is consistent with the arm’s length
standard, even though no comparables can be found to show that such adjustments are ever made
by unrelated parties.
Before the recent changes to the OECD MC, it was therefore quite plausible to argue that UT was compatible with the treaties if the subsidiary were as a factual matter legally or economically dependent on the parent so as to constitute a PE. In addition, a country that wished to adopt UT could rely on the language of the OECD MC Art. 7(4):

“Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be necessary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

Since it can be argued that in the absence of comparables the result reached under UT is equivalent to what could be reached under SA, this language seems to permit the use of UT for dependent agent PEs.

However, the OECD in 2010 adopted changes to article 7 of the MC that would make this argument more difficult to sustain. Specifically, the OECD adopted the “authorized OECD approach” to the attribution of profits to a PE that treats a PE as the equivalent to a subsidiary, and has suggested that the transfer pricing guidelines that explicitly reject UT should be applied to PEs. In addition, the OECD has followed the US lead and deleted article 7(4) from its MC. However, not all OECD countries accepted these changes, which were also rejected by developing countries, and the UN model which still contains article 7(4).
In fact, the vast majority of existing actual treaties have not been revised to incorporate those changes. In particular, Appendix A (below) shows that many developing country treaties contain article 7(4), even when the treaties are with OECD members. The Appendix lists 174 such treaties by developing countries that contain this language, including recent treaties such as India-Lithuania (2011) India-Nepal (2011) Korea-Panama (2010) and treaties with OECD members such as India-Sweden, India-UK, Mexico-UK, and Sri Lanka-US. In all of those cases, or in the absence of a treaty, countries should be free to implement UT in accordance with the analysis set out above.

The Customary International Law Argument

The argument of customary international law does not, either, impede the application of a UT approach. The argument is based on the contention that because SA and the ALS are embodied in all of the treaties they should be considered binding. But embodiment in the treaties is not enough to create a customary international law ban on UT, since article 7(4) is embodied as well. Furthermore, it should be noted that Model Tax Treaties do not, in any way or form, create a ‘right to tax’. The key issue is the actual practice of states, i.e. what countries actually do as domestic laws reign supreme in the area of taxation, and many of them follow UT approaches in practice. In addition, countries should be free to follow the UN Model which does not adopt the changes made by the OECD, and which is also widely followed.

Finally, it can be argued that even the OECD may be revising its approach. The authorized OECD approach may have marked the high point of OECD commitment to SA. With the unfolding of the BEPS project, which is influenced by large developing countries like China and
India, it is likely that the OECD may be stepping back from its total commitment to SA. Specifically, the adoption under BEPS of country by country reporting (which was already required for extractive industries in the US) can be the basis for implementation of UT. This development is very important for developing counties as many rely heavily on extractive industries. The requirements of the country by country reporting, will allow a profound change in taxation of the major industry in the developing world: the extractive industry.

**Does Article 7 Preclude Application of UT to Entire MNEs?**

One important question raised by Durst is whether the requirement that profits be “attributable” to a PE under Article 7 of the model treaties means that if UT is applied, it must be done on an activity by activity basis. Otherwise, profits would be “attributed” to the PE that have nothing to do with it, because the PE is not engaged in the activity that generates these profits. However, one would rather not make this assumption, because allowing a MNE to split its activities among different subsidiaries is notoriously hard to combat, and facilitates precisely the kind of profit shifting that developing countries in particular have a hard time policing.

In our opinion, the phrase “attributable to a permanent establishment” does not preclude attribution of global profits of a MNE to a PE under whatever formula is adopted for UT purposes. The reason is that once a functional analysis is performed and whatever can be attributed to the various functions by using either comparables or a proxy (such as a fixed percentage of costs as suggested by Durst), the remaining residual can be allocated in any way we wish, since it is attributable to the entire MNE.
Profit splits frequently result in a residual that cannot be allocated under the traditional functional analysis because it results from cost savings that inhere in the relationship of the group members to each other. The classic example is the US case involving Bausch and Lomb (B and L). B and L developed an unpatented technology that enabled it to manufacture contact lenses at a cost of $2.50 per lens, when its competitors had costs of $7.50 per lens. B and L contributed the knowhow to its Irish subsidiary. The question facing the US court was whether to accept B and L’s view that the Comparable Uncontrolled Price method should apply to determine the price charged by the Irish subsidiary to its parent based on a comparison with prices charged by independent lens manufacturers despite the difference in production costs. The IRS argued that the residual profit from the know-how belonged to the US parent that developed it, but the court rejected that view because the residual profit inhere in the relationship between the parties. Had B and L Ireland been unrelated to its parent, the know-how would have been disclosed, the competitors would have used it, and the residual profit would have disappeared.

The OECD Transfer Pricing Guidelines do not say what should be done with residuals under the profit split method. The US regulations follow the White Paper in assuming that any residual results from intangibles and allocating the residual to where the intangibles were developed. This is a view that favors US revenue interests because more intangibles are developed in the US than elsewhere, but not surprisingly it has not been accepted by other OECD members. Nor is it congruent with the facts, since residuals can result from other reasons such as cost savings from synergies or advantages of scale, and they usually inhere in the relationship among the group members and cannot be allocated to any one of them.

The OECD’s preferred method of applying the profit split method is to analyze the functions, assets and risk of each member of the affiliated group. However, in the context of residuals this
method also proves to be illusory. A functional analysis can only be applied to those functions that can be assigned to the group members, such as production or distribution, but it does not help with residuals that result from the relationship among the group members. Assets can include intangibles, which are usually the most valuable assets of a modern MNE, but intangibles also get their value from the relationship among the group members, as illustrated by the B and L case. This makes it very difficult for them to be allocated to either where they were developed or where they are exploited. The Glaxo case in which the IRS and HMRC disagreed about whether the profit from selling Zantac, a drug developed in the UK, into the US market resulted from the intangibles embodied in the drug itself or those used in Glaxo’s marketing resulted in massive double taxation.

Risk is the trickiest concept of all. Recent case studies by the US Joint Committee on Taxation reveal a model in which the entrepreneurial risk for a product is assigned to an affiliate in a low tax jurisdiction and the manufacturing and distribution of the product in high tax jurisdictions are done on a contract manufacturing and commissionaire basis. But it is not clear what the allocation of entrepreneurial risk means among related parties. If a product fails because of technological change or defects in manufacturing or environmental hazards, the risk is effectively borne by the entire MNE, or more accurately by its management who risk being fired and by its shareholders who see the stock price plummet.

Under UT, these issues can be solved by using the formula to allocate the residual by the profit split method. The specific formula used can be negotiated, and is the topic Michael Durst has written about. But in our opinion it is clear that whatever formula is decided upon should be applied under UT to the entire profit of the integrated MNE, and not divided into separate activities, and that this would be perfectly congruent with Article 7.
## Appendix 1: Current tax Treaties with Article 7-4 Language\textsuperscript{15}

<table>
<thead>
<tr>
<th>CONTRACTING STATES</th>
<th>DATE</th>
<th>ADOPTED VERSION OF ARTICLE 7: 7-4 LANGUAGE</th>
<th>TENTATIVE CONCLUSION</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDIA &amp; Japan</td>
<td>March 7, 1989</td>
<td>Art. 28 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>New Zealand</td>
<td>Oct. 17, 1986</td>
<td>Art. 28 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Singapore</td>
<td>Jan. 24, 1994</td>
<td>Art. 30 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
</tr>
<tr>
<td>Israel</td>
<td>Jan. 26, 1996</td>
<td>Art. 29 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Kuwait</td>
<td>June 15, 2006</td>
<td>Art. 30 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Lithuania</td>
<td>July 26, 2011</td>
<td>Art. 31 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Luxemburg</td>
<td>June 2, 2008</td>
<td>Art. 32 “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
</tr>
</tbody>
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\textsuperscript{15} Data compiled from the IBFD, June 2015.
<table>
<thead>
<tr>
<th>Country</th>
<th>Date</th>
<th>Art.</th>
<th>Paragraph Content</th>
<th>Treaty Treatment</th>
</tr>
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<tbody>
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<td>Mexico</td>
<td>Sept. 10, 2007</td>
<td>30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Mozambique</td>
<td>Sept. 30, 2010</td>
<td>30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Myanmar</td>
<td>April 2, 2008</td>
<td>29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Namibia</td>
<td>Feb. 15, 1997</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Nepal</td>
<td>Nov. 27, 2011</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Norway</td>
<td>Dec. 31, 1986</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Oman</td>
<td>April 2, 1997</td>
<td>29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Philippines</td>
<td>Feb. 12, 1990</td>
<td>29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Taiwan</td>
<td>July 12, 2011</td>
<td>29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Country</td>
<td>Date</td>
<td>Article</td>
<td>Provision</td>
<td>Conclusion</td>
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<tr>
<td>Serbia &amp; Montenegro</td>
<td>Feb. 8, 2006</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Sri Lanka</td>
<td>Jan. 27, 1982</td>
<td>Art. 29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Sweden</td>
<td>June 7, 1988</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Syria</td>
<td>June 18, 2008</td>
<td>Art. 29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Tajikistan</td>
<td>Nov. 20, 2008</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Tanzania</td>
<td>May 27, 2011</td>
<td>Art. 31</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Thailand</td>
<td>Mar. 22, 1985</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>United Kingdom</td>
<td>Jan. 25, 1993</td>
<td>Art. 30</td>
<td>“…nothing in paragraphs (1) and (2) of this Article shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be necessary …”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Ukraine</td>
<td>April 7, 1999</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Vietnam</td>
<td>Sept. 7, 1994</td>
<td>Art. 29</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>INDONESIA &amp;</td>
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<td>Netherlands</td>
<td>Mar. 5, 1973</td>
<td>Art. 29</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Switzerland</td>
<td>Aug. 29, 1988</td>
<td>Art. 25</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Iran</td>
<td>April 30, 2004</td>
<td>Art. 27</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Japan</td>
<td>Mar. 3, 1982</td>
<td>Art. 29</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Kuwait</td>
<td>April 23, 1997</td>
<td>Art. 30</td>
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<td>Mauritius</td>
<td>Dec. 10, 1996</td>
<td>Art. 28</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Mexico</td>
<td>Sept. 6, 2002</td>
<td>Art. 28</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Text</td>
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<td>Korea</td>
<td>July 11, 2002</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>New Zealand</td>
<td>Mar. 25, 1987</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Philippines</td>
<td>June 18, 1981</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Poland</td>
<td>Oct. 6, 1992</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Portugal</td>
<td>July 9, 2003</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Slovakia</td>
<td>Oct. 12, 2000</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Syria</td>
<td>June 7, 1997</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Thailand</td>
<td>Mar. 25, 1981</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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</tr>
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<td>Tunisia</td>
<td>May 13, 1992</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Date</td>
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<td>Treaty Provision</td>
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<td>United Arab Emirates</td>
<td>Nov. 30, 1995</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Ukraine</td>
<td>April 11, 1996</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<tr>
<td>Venezuela</td>
<td>Feb. 27, 1997</td>
<td>Art. 29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Vietnam</td>
<td>Dec. 22, 1997</td>
<td>Art. 29</td>
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<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Zimbabwe</td>
<td>May 30, 2001</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Feb. 21, 2000</td>
<td>Art. 29</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Mexico</td>
<td>Oct. 16, 1994</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Malta</td>
<td>Mar. 25, 1997</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Not requiring treaty renegotiation.</td>
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<tr>
<td>Romania</td>
<td>Oct. 11, 1993</td>
<td>Art. 30</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Not requiring treaty renegotiation.</td>
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<td>Sri Lanka</td>
<td>May 28, 1984</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Not requiring treaty renegotiation.</td>
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<tr>
<td>Switzerland</td>
<td>Feb. 12, 1980</td>
<td>Art. 26</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Not requiring treaty renegotiation.</td>
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<td>Tunisia</td>
<td>Sept. 27, 1988</td>
<td>Art. 27</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Sept. 29, 1999</td>
<td>Art. 28</td>
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<td>Sept. 26, 1997</td>
<td>Art. 29</td>
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<td>Myanmar</td>
<td>Feb. 22, 2002</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Not requiring treaty renegotiation.</td>
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<td>Oman</td>
<td>Sept. 23, 2005</td>
<td>Art. 29</td>
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<td>Country</td>
<td>Date</td>
<td>Art.</td>
<td>Relevant Text</td>
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<td>Panama</td>
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<td>Slovakia</td>
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<td>Slovenia</td>
<td>April 25, 2005</td>
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<td>Thailand</td>
<td>Nov. 16, 2006</td>
<td>28</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>United Arab Emirates</td>
<td>Sept. 23, 2003</td>
<td>30</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Venezuela</td>
<td>June 26, 2006</td>
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<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>MEXICO &amp;</td>
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<td>Netherlands</td>
<td>Sept. 27, 1993</td>
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<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Singapore</td>
<td>Nov. 9, 1994</td>
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<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Article</td>
<td>Paragraph 2</td>
<td>Implementation of a Formulary Apportionment Method</td>
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<td>Switzerland</td>
<td>Aug. 3, 1993</td>
<td>Art. 26</td>
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<td>United Kingdom</td>
<td>June 2, 1994</td>
<td>Art. 29</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Norway</td>
<td>Mar. 23, 1995</td>
<td>Art. 29</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Poland</td>
<td>Nov. 30, 1998</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Portugal</td>
<td>Nov. 11, 1999</td>
<td>Art. 28</td>
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<td>Romania</td>
<td>July 20, 2000</td>
<td>Art. 30</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Russia</td>
<td>June 7, 2004</td>
<td>Art. 29</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Slovakia</td>
<td>May 13, 2006</td>
<td>Art. 27</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Spain</td>
<td>July 24, 1992</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>Sweden</td>
<td>Sept. 21, 1992</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Ukraine</td>
<td>Jan. 23, 2012</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Venezuela</td>
<td>Feb. 6, 1997</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>MOROCCO &amp;</td>
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<td>Pakistan</td>
<td>May 18, 2006</td>
<td>Art. 28</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Poland</td>
<td>Oct. 24, 1994</td>
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<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<td>Portugal</td>
<td>Sept. 29, 1997</td>
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<td>Romania</td>
<td>Sept. 11, 1981</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Switzerland</td>
<td>Mar. 31, 1993</td>
<td>Art. 27</td>
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<td>NETHERLANDS&amp;</td>
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<td>Norway</td>
<td>Nov. 13, 1989</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>New Zealand</td>
<td>Oct. 15, 1980</td>
<td>Art. 27</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>South Africa</td>
<td>Mar. 15, 1971</td>
<td>Art. 31</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Slovakia</td>
<td>Mar. 4, 1974</td>
<td>Art. 31</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Venezuela</td>
<td>May 29, 1991</td>
<td>Art. 31</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<tr>
<td>Oman</td>
<td>Oct. 5, 2009</td>
<td>Art. 30</td>
<td>“... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...”</td>
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<tr>
<td>Pakistan</td>
<td>Mar. 24, 1982</td>
<td>Art. 29</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Panama</td>
<td>Oct. 6, 2010</td>
<td>Art. 28</td>
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<td>Poland</td>
<td>Sept. 20, 1979</td>
<td>Art. 30</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Portugal</td>
<td>Sept. 20, 1999</td>
<td>Art. 32</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Qatar</td>
<td>April 24, 2008</td>
<td>Art. 30</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Taiwan</td>
<td>Feb. 27, 2001</td>
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<td>Romania</td>
<td>Mar. 5, 1998</td>
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<td>Saudi Arabia</td>
<td>Oct. 13, 2008</td>
<td>Art. 29</td>
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<td>Slovenia</td>
<td>June 30, 2004</td>
<td>Art. 29</td>
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<td>Article</td>
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<td>Sri Lanka</td>
<td>Nov. 17, 1982</td>
<td>Art. 30</td>
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<td>United Arab Emirates</td>
<td>May 8, 2007</td>
<td>Art. 28</td>
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<td>Uganda</td>
<td>Aug. 31, 2004</td>
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<td>Vietnam</td>
<td>Jan. 24, 1995</td>
<td>Art. 30</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Zambia</td>
<td>Dec. 19, 1977</td>
<td>Art. 28</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
<td>Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.</td>
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<td>Zimbabwe</td>
<td>May 18, 1989</td>
<td>Art. 28</td>
<td>“… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…”</td>
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<td>Implementation Status</td>
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<td>Qatar</td>
<td>Dec. 14, 2008</td>
<td>Art. 28</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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<td>April 26, 1995</td>
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<td>Aug. 1, 1997</td>
<td>Art. 27</td>
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<td>San Marino</td>
<td>May 23, 2007</td>
<td>Art. 29</td>
<td>&quot;... nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary...&quot;</td>
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| Country                  | Date          | Article   | Paragraph | Interpretation                                                                                     | Implementation of a formulary method
|-------------------------|---------------|-----------|-----------|---------------------------------------------------------------------------------------------------|-----------------------------------------------
<p>| <strong>Sri Lanka &amp;</strong>         |               |           |           |                                                                                                   |                                               |
| United Kingdom          | June 21, 1979 | Art. 28   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |
| <strong>United States</strong>       | Mar. 14, 1985 | Art. 28   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |
|                         | As amended by 2002 protocol |           |           |                                                                                                   |                                               |
| <strong>Sweden</strong>              | Feb. 23, 1983 | Art. 28   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |
| <strong>Switzerland</strong>         | Jan. 11, 1983 | Art. 27   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |
| <strong>Thailand</strong>            | Dec. 14, 1988 | Art. 28   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |
| <strong>United Arab Emirates</strong>| Sept. 24, 2003| Art. 31   | “… nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary…” | Implementation of a formulary method would be valid under the treaty thus not requiring treaty renegotiation. |</p>
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