

The Global Fight against Base Erosion and Profit Shifting under the OECD's Country-by-Country Reporting Rules: A Possible Solution?

By

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Submitted in partial fulfillment of the requirements
for the degree of Master of Laws

at

Dalhousie University

Halifax, Nova Scotia

August 2017

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Dedication

I dedicate this thesis to God Almighty, the Source from whom all blessings flow.

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Abstract

The base erosion and profit shifting (BEPS) phenomenon continues to create detrimental consequences in states. BEPS is engendered by two fundamental factors, namely, unhealthy fiscal policies of tax havens and preferential tax regimes, and transfer mispricing by multinational corporations (MNCs). The OECD, through its BEPS Project notes that the lack of transparency in the global activities of MNCs is a major cause of BEPS. To close this gap, the OECD released the CBCR Rules. This thesis discusses the severity of the BEPS phenomenon and assesses the anti-BEPS efforts of the OECD. Upon an assessment of these efforts, this thesis argues for a switch from the application of transfer pricing methods to the formulary apportionment approach. It also argues that this formulary apportionment approach is a better complement to the OECD's CBCR Rules as a tool by which BEPS can be eliminated globally.

List of Abbreviations Used

ALP	Arm's Length Principle
BALRM	Basic Arm's Length Return Method
BEPS	Base erosion and profit shifting
CBCR	Country-by-Country Reporting
CCCTB	Common Consolidated Corporate Tax Base
CFCs	Controlled Foreign Corporations
CPM	Comparable Profit Method
CRA	Canada Revenue Agency
CUP	Comparable Uncontrolled Price
DBCT	Destination-based-cash flow tax
EITI	Extractive Industries Transparency Initiative
EU	European Union
FA	Formulary Apportionment
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
MCAA	Multilateral Competent Authority Agreement
MNCs	Multinational corporations
OECD	Organisation for Economic Co-operation and Development
OEEC	Organization for European Economic Co-operation
QCAA	Qualifying Competent Authority Agreement
UK	United Kingdom
UNCTAD	United Nations Commission on Trade and Development
US	United States

Acknowledgements

I would like to thank everyone who contributed in one way or the other to the success of my thesis and my LLM program in general.

I would like to thank the Schulich School of Law, Dalhousie University and the George Caines Scholarship in Law for their financial support.

My sincere gratitude also goes to my supervisor, Professor Kim Brooks. Her consistent motivation and guidance contributed a great deal to the success of my LLM program. I would also like to thank Professor Geoffrey Loomer and Professor Michael Deturbide for taking time out of their busy schedules to review my thesis.

I would like to thank Professor Richard Devlin for his tutoring. His teachings on legal scholarship gave me insights into what is expected of me as a legal scholar. The seminars on legal scholarship helped me to discover the methodologies that I used in writing this thesis. I would also like to thank Mr David Dzidzornu for his invaluable support towards the successful completion of my program. Thank you for reviewing my drafts, encouraging me and pushing me to do more.

I would like to thank my classmates, some of whom have become close friends, Wendy, Marie-Eve, Anne-Marie, Akin, Niran. You all have been a huge support for me this past one year.

I would like to thank my parents and siblings. I am sincerely grateful for your support and prayers. I would also like to thank my fiancé. You are God's special gift to me, thank you for always supporting me.

Lastly and unreservedly, I am eternally grateful to God Almighty for the great doors he has opened for me to walk in. The grace and strength he has given me to accomplish yet another great feat; one of many more to come.

Chapter 1: Introduction

1.0 The Dominance of Multinational Corporations in World Trade and the Attendant Consequences of BEPS

Multinational corporations (MNCs) rose to the centre of world trade because of globalization, which is simply the “growing interdependence of countries”.¹ Globalization transformed trade activities by corporations from activities within national borders to transnational transactions.² It made possible free-flow of trade across borders, encouraged foreign direct investment abroad, and is responsible for the mobile world that we live in where transactions occur just by the click of a button.³ MNCs continue to maintain their relevance to world economy, as they contribute significantly to the revenue of most countries. Statistics reveal the increasing dominance of MNCs and their significance to world economy. For example, it has been estimated that approximately one-third of international trade occurs with intra-firm transfers by MNCs.⁴ In 2015, the top one hundred MNCs identified by UNCTAD were shown to have more than 500 affiliates each, across more than 50 countries.⁵ Also, according to UNCTAD, foreign direct investment by MNCs jumped by thirty-eight percent to \$1.76 trillion in 2015.⁶

Although MNCs maintain a significant position in world trade, aggressive tax planning activities by them pose a threat to national and global economies.⁷ Base erosion and profit shifting (BEPS)

¹ Peter Dietsch & Thomas Rixen, “Redistribution, Globalization, and Multi-Level Governance” (2014) 1:1 MOPP 61-81 at 62

² Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (New York: Viking Free Press, 2004); see also Jensen, Nathan M. *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment*. (Princeton University Press, 2006)

³ *Ibid.*

⁴ Jensen, Nathan M. *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment*. (Princeton University Press, 2006)

⁵ UNCTAD, *World Investment Report 2016: (Investor Nationality: Policy Challenges)*. United Nations, Geneva.

⁶ UNCTAD, *World Investment Report 2015: (Reforming International Investment Governance)*. United Nations, Geneva.

⁷ Yariv Brauner, “What the BEPS”, (2014) 16 Fla. Tax Rev. 55 at 64.

refers to tax avoidance strategies which exploit gaps and mismatches in tax rules to artificially shift profits from source countries (countries where real economic activities which generated the profits of MNCs occurred) to low or no-tax locations.⁸ The Organization for Economic Co-operation and Development (OECD), in 2013, estimated that about \$100-\$240 billion representing 4%-10% of global corporate income tax is lost to BEPS annually.⁹ The OECD is at the forefront of the global fight against BEPS. Its approach is through the concerted efforts of states, aimed at implementing rules which would operate as anti-BEPS measures.¹⁰ The OECD demonstrated this approach through its BEPS Action Plans that are centred around multilateral implementation of proposed rules.¹¹

Apart from the revenue loss that BEPS creates in countries, BEPS equally threatens the fundamental notion of “fiscal sovereignty” which characterizes statehood. Taxation lies at the core of sovereignty of states,¹² but BEPS-related activities of MNCs affect the exercise of fiscal rights of states. These BEPS-related activities of MNCs are being encouraged by the grant of low or no tax rates to MNCs by tax havens. This lax tax regime in tax havens encourages MNCs to shift profits from source countries to tax havens. Consequently, source countries may be prevented from taxing multinational corporation profits, because MNCs make investment policies based on the differences in these national fiscal policies. They leverage the gaps in the investment

⁸ OECD, Base Erosion and Profit Shifting: www.oecd.org/tax/beps/ (last accessed 21 April 2017).

⁹ OECD, *Measuring and Monitoring BEPS, Action 11- 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, (2015) at 102.

¹⁰ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing at 10-11, see also the OECD: G20 Summit, Saint Petersburg, Russian Federation, online: www.oecd.org/g20/summits/saintpetersburg/ (last accessed 21 April 2017).

¹¹ *Ibid.*

¹² Allisson Christians, “Sovereignty, Taxation and Social Contract”, 18 MINN. J. INT’L L. 99 (2009).

framework of the different jurisdictions in which they operate to reduce the amount of taxes they pay on their global profits.¹³

In addition, BEPS creates an atmosphere of inequity for private individuals and domestic firms, given that this category of taxpayers lack the opportunities open to MNCs for tax avoidance. Consequently, these categories of taxpayers are left to bear the consequences of the reduction in domestic revenue, through increases in taxes for private individuals and domestic firms.¹⁴

The history of the OECD's work against BEPS formally began in 1998, when it released a report entitled "Harmful Tax Competition: An Emerging Global Issue".¹⁵ In this Report, the OECD proscribes the use of low tax rates by countries to attract portfolio capital from MNCs without real ties with economic activities producing this capital. In the words of the OECD, the use of low tax rates by tax havens to attract MNC profits results into a "race to the bottom"¹⁶. It makes countries adopt unhealthy fiscal measures which "may hamper the application of progressive tax rates and the achievement of redistributive goals"¹⁷. The OECD admits that this situation results in "harmful tax competition" which "diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems."¹⁸ The OECD's approach for tackling harmful tax practices changed in 2013 through its BEPS Project from solely targeting unhealthy fiscal measures by tax havens, to

¹³ Reuven S. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation", (2010) 2: 1 World Tax J. 2, at 3-18. Avi-Yonah discusses the Bureau of Economic Analysis' annual surveys of operations of U.S. Parent Companies and Their Foreign Affiliates in 2005, which shows that the difference in tax rates world over influence the financial decisions of US MNCs.

¹⁴ See Lee Corrick, "The Taxation of Multinational Enterprises in Thomas Pogge & Krishen Metha ed, *Global Tax Fairness* (United Kingdom: Oxford University Press, 2016) 173-4.

¹⁵ OECD, *Harmful Tax Competition: An Emerging Global Issue*, 1998.

www.oecd.org/tax/transparency/44430243.pdf (last accessed 25 April 2017)

¹⁶ *Ibid* at 14.

¹⁷ *Ibid*, see also see also Andrew P. Morriss & Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign against 'Harmful Tax Competition'," (2013) 4:1 Columbia Journal of Tax Law 3.

¹⁸ *Ibid* at p. 8.

generally addressing the inadequacies in rules governing taxation of MNCs which encourage the BEPS related activities by MNCs.

The BEPS Project is the OECD's most recent initiative which targets the inadequacies in rules governing taxation of MNCs.¹⁹ Through the BEPS Project, the OECD recognizes that the current international taxation rules which govern how multinational corporations are taxed encourage BEPS related activities by (MNCs), and as such there ought to be amendments to the rules through the concerted efforts of states.²⁰

The OECD, in 2013, released fifteen action plans reflecting issues perceived as gaps in current international tax rules which create opportunities for BEPS. The OECD's BEPS Action plans are aimed at promoting transparency and ensuring value creation, that is, ensuring that the profits of MNCs are taxed in jurisdictions where the economic activities generating those profits occurred. The OECD's fifteen BEPS action plans can be summarized under six broad headings: (1) tackling the challenges in digital economy that undermine value creation; (2) addressing hybrids and mismatch arrangements in transactions that counteract value creation; (3) dealing with provisions in double taxation treaties that encourage BEPS; (4) solving the challenge of lack of information about the global activities of MNCs; (5) creating effective mechanisms for dispute resolution; and (6) developing a multilateral instrument for the effective implementation of the outcomes of the BEPS project.

¹⁹ *Supra* note 10.

²⁰ *Ibid* at 10-11.

1.1 Purpose and Rationale

In this thesis, I take on the challenge of assessing the viability of the Country-by-Country Reporting (CBCR) Rules, which is the thirteenth proposed action plan by the OECD. This necessarily leads to an analysis of international transfer pricing rules, which are addressed in BEPS Action Plans 8-10. According to the OECD, the CBCR Rules, when implemented by states, would help solve the problem of lack of information about the global activities of MNCs. The problem of lack of information about the global activities of MNCs, which includes circumstances surrounding the transfer prices fixed on both internal and external transactions, contributes significantly to the ineffective application of the arm's length principle for taxing multinational corporation profits.²¹ The arm's length principle involves a comparison of the prices fixed by MNCs on related-entity transactions with prices that would have been fixed if the transactions were between unrelated entities. Transfer pricing guidelines exist in most states, requiring MNCs that carry on business activities within their jurisdictions to file documentation with tax authorities, showing how the transfer prices fixed on their transactions conform to the arm's length principle/standard. This documentation, however, has been said to provide only limited information about the global businesses of MNCs, thus, they have proved ineffective in preventing transfer mispricing, which ultimately results into BEPS.

The OECD therefore proposes adjustments to the transfer pricing documentation through the requirement that MNCs with consolidated revenue of not less than €750 million or near equivalent in domestic currency file CBCR with states where they conduct business activities. These reports are to contain information about the structures of MNC groups, their nature of businesses and

²¹ *Ibid.*

details about the economic activities carried on by each member of the MNC group. The CBCR Rules require MNCs to file information on the global businesses of MNCs with relevant tax authorities, including the total profits made by MNCs across jurisdictions and the amount of taxes paid in those jurisdictions. According to the OECD, the information contained in CBCR would assist states to combat BEPS globally.

However, in this thesis, I maintain a different position as to the efficacy of the CBCR Rules in advancing the global fight against BEPS. My position is based on my assessment of key provisions of the CBCR Rules in the context of the problem of BEPS which the rules were designed to solve. I evaluate the effectiveness of the CBCR Rules in the context of the OECD's objective to end BEPS globally. The contribution of this thesis is to evaluate the key provisions of the CBCR Rules (internal assessment) and the broader principles upon which they are based, that is, the arm's length principle in the context of the OECD's declared objective to end BEPS globally (external assessment). In turn, the goal of this assessment is to reveal the gaps in the OECD's CBCR Rules as one of the action plans as a tool to end BEPS.

Between 2013 when the OECD in its BEPS Action Plans highlighted the importance of detailed transfer pricing documentation²² until July 2017 when the OECD reviewed its transfer pricing guidelines with specific rules on CBCR, the OECD has released six sets of guidance and

²² See Action Plans 8-13 *supra* note 10.

implementation packages containing the content of the CBCR Rules and the mechanism for enforcement²³. Richard Murphy, the inventor of CBCR²⁴, declares:

All that country-by-country reporting demands is that multinational corporations publish a profit and loss account and limited balance sheet and cash flow information for every jurisdiction in which they trade as part of their annual financial statements²⁵.

The OECD's CBCR requires MNCs to report:

...annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs 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 engages in.²⁶

Lack of information about the operations of MNCs has been identified as a major hindrance to the effective application of transfer pricing rules based on the arm's length principle by tax authorities.²⁷ Although tax authorities, by the provisions of their transfer pricing rules, require MNCs to file some documentation on their transfer pricing policies, the information provided by these MNCs is limited to transactions under assessment by tax authorities. Notwithstanding the

²³ OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014;
OECD/G20 Base Erosion and Profit Shifting Project Action 13, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting*, February 2015;
OECD/G20 Base Erosion and Profit Shifting Project, *Action 13: Country-by-Country Reporting Implementation Package*, 2015;
OECD/G20 Base Erosion and Profit Shifting Project, *Guidance on the Implementation of the Country-by-Country Reporting: BEPS Action 13*, 12 October 2016;
OECD, *Signatories to the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports* (CBC MCAA), online: www.oecd.org; and
OECD (2017), *Guidance on the Implementation of Country-by-Country Reporting – BEPS Action 13*, OECD, Paris.

²⁴ Richard Murphy: Time for Country-by-Country Reporting: www.economia.icaew.com/opinion/march-2014/richard-murphy-country-by-country (last accessed 19 July 2017)

²⁵ Richard Murphy, Country-by-Country Reporting in Thomas in Thomas Pogge & Krishen Metha ed, *Global Tax Fairness* (United Kingdom: Oxford University Press, 2016) 96.

²⁶ OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014.

²⁷ See United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, Department of Social Affairs, United Nations, New York, 2013 for the reports of emerging economies as to the challenges they face in applying effectively the arm's length principle.

existence of transfer pricing rules, tax administrations still complain of lack of adequate documentation necessary for the assessment of MNC transactions.²⁸ The implication of the current situation under the various transfer pricing rules is that there is limited information about the global businesses of MNCs, and this prevents tax authorities from doing a good job of ascertaining the appropriateness of the transfer prices fixed by MNCs. Thus, the OECD desires to solve this problem of lack of information through the CBCR Rules.

This thesis evaluates the key provisions of the CBCR Rules in the context of the OECD's declared objective to end BEPS globally for four major reasons. BEPS continues to threaten the revenue of source states; impede the exercise of fiscal rights by states; create an atmosphere of tax injustice for other taxpayers; and threaten the legitimacy of corporate income taxation as a source of revenue in general. Therefore, I discuss the gaps in the CBCR Rules, which if not amended, further promote BEPS rather than combat it. I identify these gaps and propose amendments to them. The purpose is to dispense with the arm's length principle, and to adopt the formulary apportionment (FA) approach to govern taxation of MNC profits. The switch to the FA approach as proposed by this thesis is towards the fulfilment of the OECD's goal to end BEPS globally, from the standpoint of the CBCR Rules.

The CBCR rules as they are lack general application because they apply to MNCs with consolidated revenue of not less than € 750 million threshold. I query this prescribed threshold because there is no evidence that only MNCs above this threshold engage in BEPS related activities. In a similar way, the rules preclude non-signatories to the OECD's multilateral

²⁸ OECD, Public Consultation Discussion Draft on Transfer Pricing Documentation And Cbc Reporting, 30 January 2014: www.oecd.org/tax/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf (last accessed 21 July 2017).

instrument for exchange of CBCR²⁹ from accessing the CBCR Reports even if they have within their jurisdictions entities of those MNCs which filed the CBCR Reports. This threshold leaves out eighty-five to ninety per cent of MNCs,³⁰ combined with the exclusion of non-signatories from the exchange of CBCR, these two clauses by all sense of objectivity go against the OECD's intention to fight against BEPS globally.

The second argument that I make in this thesis is that the arm's length principle, the current standard that applies to the taxation of multinational corporation profits, would impede any level of success that the CBCR Rules may bring. This argument is that in light of the various problems that characterize the application of the principle, the CBCR rules rather than operating as a tool to end BEPS may further promote it. I, therefore, weigh these problems and consider the solutions that the CBCR Rules seek to provide to see if the rules can sufficiently deal with the issue of BEPS globally if the arm's length principle is retained as the OECD proposes. My assessment, however, reveals that the problem of BEPS would remain with us for as long as the arm's length principle is being used to divide multinational corporation profits. This is because related entities generally exploit organizational and internalization advantages, which are embedded in business transactions with related entities.³¹ As such, the assumption that characterizes the arm's length principle, which is that it is possible for the transfer prices fixed by MNCs to be at arm's length, is not attuned to the realities of business transactions between related entities. The huge amount that is being lost to BEPS annually as declared by the OECD, the threat which the BEPS related activities of MNCs continue to pose both to the fiscal rights of states, and the cardinal principle of

²⁹ *Ibid* at 29.

³⁰ OECD/G20 Base Erosion and Profit Shifting Project Action 13, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting*, February 2015.

³¹ Reuven S. Avi-Yonah, Kimberly Clausing, & Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 Florida Tax review 497.

fairness, account for my argument for the avoidance of the transfer pricing rules in total. I therefore make a proposal for an alternative means for taxing multinational corporation profits, that is, the formulary apportionment approach.

1.2 Objective of Thesis

In light of the problem of lack of information, which the OECD intends to solve through the CBCR Rules, this thesis examines three important provisions of the CBCR Rules that define the viability of the OECD's global fight against BEPS through the Rules. These clauses are the threshold clause; the confidentiality clause; and the rule on "appropriate use" of CBCR Reports. The threshold rule requires MNCs with consolidated revenue of not less than € 750 million to file CBCR reports. The confidentiality clause proscribes publication of CBCR, and the "appropriate use" clause disallows tax authorities from utilizing information derived from the CBCR reports in assessing the tax liabilities of MNCs. The confidentiality clause prevents signatories to the OECD's CBCR Rules from sharing the CBCR reports with non-signatories even if these non-signatories have within their jurisdictions entities of MNCs that filed the CBCR Reports.

The analysis of these key provisions of the CBCR Rules reveals that the rules at present are not positioned in a way to make it possible to solve the problem of BEPS globally through them. First, there is no evidence that only MNCs above the prescribed threshold engage in BEPS related activities. Second, the prohibition of the exchange of CBCR Reports with non-signatories to the OECD's Multilateral Information Exchange Instrument of the CBCR Rules³² removes some countries from the OECD's laudable initiative to end BEPS globally through the CBCR Rules.

³² OECD, Signatories of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (CbC Mcaa) And Signing Dates Status as of 22 June 2017: www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf (last accessed 21 July 2017).

Third, non-publication of CBCR may hamper the OECD's desire to eliminate BEPS globally. The proscription of the publication of CBCR Reports is unhelpful in the objective assessment of the activities of MNCs in a way that promotes transactions that are in alignment with value creation, that is, transactions that allow source countries to tax profits derived from activities carried out by MNC entities within their jurisdictions. With a proposed standard of "accountability" being introduced into the global activities of MNCs, I argue for publication of CBCR. This may in turn assist tax authorities in effectively taxing MNCs, since there is public awareness about the BEPS related-activities of MNCs. Public disclosure of CBCR would go a long way in attracting comments on the appropriateness or otherwise of transactions between MNC entities from individual taxpayers and may prove relevant in checking incidences of unfair assessments by tax authorities.

The third provision of the CBCR Rules that I assess against the OECD's objective to end BEPS globally is the "appropriate use" clause. This clause sets out the scope of the CBCR Reports filed. According to the provisions contained in that clause, tax authorities are allowed to utilize the CBCR Reports to assess high level transfer pricing risks or other BEPS related risks. Tax authorities are not allowed to rely on the CBCR Reports to adjust the tax liabilities of MNCs. Also, tax authorities are permitted to share the CBCR Reports only with parties to the OECD's mechanism for exchange of CBCR Reports. Only 46 countries are parties to this mechanism. In my assessment, these limitations on the use of the CBCR Reports defeat the OECD's objective to end BEPS globally. Based on these arguments, this thesis displaces the claim by the OECD that the current CBCR Rules are well-positioned to deter BEPS globally, and proposes amendments to these provisions in alignment with the OECD's stated objective. Altogether, the CBCR Rules have lofty ideals; they seek to promote transparency about the global activities of MNCs and to check

incidences of BEPS. These key clauses in the CBCR Rules, if not amended, would further aggravate the problem of BEPS.

The second main argument in this thesis is the impossibility of a global fight against BEPS with the retention of the arm's length principle as is done in the OECD's BEPS project. Currently, the arm's length principle faces a barrage of economic and practical challenges that make it unsuitable for taxation of business activities of MNCs. The principle opens opportunities for MNCs to engage in abusive transfer pricing, which leads to BEPS. The arm's length principle entails a consideration by tax authorities of the question that: "What would independent enterprises do?"³³. In search of an answer to this question, tax authorities search for comparables, either internal or external. Internal comparables entail a search for the prices that would have been fixed if the transactions being assessed were between entities of MNCs and unrelated entities. External comparables, on the other hand, require determining the prices that contracting unrelated entities would have fixed for the transactions being assessed.³⁴ The arm's length principle is premised on the determination of the "reasonable price". In determining what is the reasonable price of goods and services between related entities, resort is had to the market value.³⁵ The justification for the use of market value is explained by Hanlin & Claywell, "[t]he foremost reason to use the Market Approach is that, when suitable data are available, it provides a verifiable and objective measure of value. Actual sales, in a public market at arm's length of similar interests, are compelling evidence".³⁶

³³ Lorraine Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States" in Thomas Pogge & Krishen Metha ed, *Global Tax Fairness* (United Kingdom: Oxford University Press, 2016) 155.

³⁴ *Ibid.*

³⁵ W.A. Hanlin Jr & J.R. Claywell, "The Market Approach" in J.P. Catty (2010), *Wiley Guide to Fair Value Under IFRS* (John Wiley & Sons).

³⁶ *Ibid.*

Stanley S. Surrey justifies “market value” as benchmark for the application of the arm’s length principle:

The use of this arm’s length standard is a natural reaction. Tax administrators do not question transactions that are governed by the marketplace. If Company A sells goods to unrelated Company B at a certain price or furnishes services at a particular price, the income of both companies is determined by using that price. One company may be large and the other small; one may be a monopoly; one may be financially strong and the other in a weak condition. But these and other factors which may affect the price at which the transaction occurs are not the concern of the tax administrator. His task is not to correct the injustices or unfairness of the marketplace nor to turn bad bargains into fair arrangements [...] Given this acceptance of the marketplace, a tax system – and tax administrators working within it – when faced with intra-group transactions not governed by that marketplace but instead by the policies and goals of the overall enterprise, naturally seeks to replace the intra-group arrangement with the norm of the marketplace. Presumably, most transactions are governed by the general framework of the marketplace and hence it is appropriate to seek to put intra-group transactions under the general framework. Thus, use of the standard of arm’s length, both to test the actual allocation of income and expenses resulting under controlled intra-group arrangements and to adjust that allocation if it does not meet such standard, appears in theory to be a proper course.³⁷

However, as is often the case, the peculiarities of the transactions between MNC entities makes it difficult for tax authorities to find comparables. Often, MNCs determine the market value of products and services supplied and to that extent, the answer to the question of what would independent enterprises do? becomes a herculean task. This eventually results into modifications of the arm’s length principle by states³⁸, which in most cases, is borne out of assumptions by tax authorities on what constitutes the “reasonable prices” in given instances. In summary, the synergistic opportunities open to MNCs in their transactions create difficulties in ensuring that

³⁷ S.S. Surrey, “Law and Policy in International Business” 10 (1978): 1978 (Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions.

³⁸ For instance, the United States modified its transfer pricing rules in 1992 creating an alternative for the determination of arm’s length based on allocation of profits to jurisdictions on a formulary basis in the event that comparables do not exist. There is also an introduction of a “sixth” transfer pricing method by some states. China introduced the concept of “location savings advantages” in its transfer pricing rules.

these transactions promote value creation, makes the arm's length principle unsuitable as a tool capable of being deployed by states to end BEPS globally.

Therefore, against the inadequacies evident in the application of the arm's length principle, this thesis proposes an alternative approach: the unitary taxation (formulary apportionment) approach. The unitary taxation approach looks in detail at the economic activities resulting into the profits of MNCs for tax purposes. Under this approach, tax authorities justifiably impose corporate income taxes on "actual" profits of MNCs as against the uncertain profits apportioned via the arm's length principle. The adoption of the arm's length principle, first in 1933 and subsequently in double taxation treaties, may have been justifiable given the limited impact of globalization on trade during those periods. However, against the increasing expansion of international trade, which creates difficulties in ascertaining fair market values, the retention of the principle does not appear to be plausible, both against the principle of accountability and transparency.³⁹

The arm's length principle, as this thesis argues, is not fit for taxing the globalized business activities of MNCs because it fails to take into consideration the economic realities of modern transactions within related entities. I argue that this principle should be replaced with the formulary apportionment approach (the FA approach). The FA approach is not entirely a new concept in taxation of MNCs. It is similar to the fractional apportionment approach, which was proposed by the Fiscal Committee of the League of Nations in 1933⁴⁰, although with some distinctions in terms

³⁹ R.S. Avi-Yonah & I. Benshalom, "Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3 *World Tax Journal* 376; C.F. Steiss & L. Blanchette, "The International Transfer-Pricing Debate", 43 *Canadian Tax Journal* (1995) 43:5 1572; K. Sadiq, "The Fundamental Failing of the Traditional Transfer Pricing Regime – Applying the Arm's Length Standard to Multinational Banks based on a Comparability Analysis", (2004) 58:2 *Bull. Intl. Taxn*; C.E. McLure, National Tax Rules and Sovereignty, in A.K. Vaidya, *Globalization: Encyclopedia of Trade, Labor, and Politics* (ABC-CLIO 2005).

⁴⁰ see generally Mitchell B. Carroll, *Global Perspectives of an International Tax Lawyer* (New York: Exposition Press, 1978)

of the difference in the amount of taxable profits under the two approaches. Under the fractional apportionment approach, only the fraction of profits of MNCs are allocated to states. Under the formulary apportionment approach, however, the general profits of an enterprise are apportioned to jurisdictions based on the value of contributions by individual entities of MNCs operating in those jurisdictions. To some extent, the formulary apportionment approach is utilized in Canada and some states in the US⁴¹, in the way these states apportion profits to provinces/states based on the contributions by entities of corporations in these jurisdictions.⁴² However, the novelty in the formulary apportionment approach being proposed as an alternative to the arm's length principle, as against the approach in some states in the US and Canada that have adopted this approach, is the expansion of the taxable profits of MNCs to include profits from cross-border transactions.

The profit split method, as one of the transfer pricing methods contained in the OECD's Transfer Pricing Guidelines⁴³, is also similar to the FA approach. The profit split method is premised on the allocation of profits based on "value creation", that is, economic activities performed by entities of MNCs using "allocation keys", such as functions performed, asset used, and risks assumed.⁴⁴ The profit split method, in a way, is similar to the formulary apportionment approach in the way it allocates profit to jurisdictions based on the contribution by entities of MNCs, summarized under the heading "value creation". The concept of "value creation" redefined the basis upon which MNCs are taxed especially on intangibles, which are hard to value in terms of ascertaining the jurisdiction where services creating those intangibles took place. In general, giving prominence to

⁴¹ The FA approach began in the US in the state of California via the Unitary Tax Reform Law, 1986.

⁴² By virtue of the provisions of the Uniform Division of Income for Tax Purposes Act and Part IV of the Regulations to the Income Tax Act in the US and Canada respectively.

⁴³ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris.

⁴⁴ Sol Picciotto, "Towards Unitary Taxation" In Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness*. (United Kingdom: Oxford University Press, 2016)

the concept of “value creation” ensures that only those jurisdictions that contributed to the profits of MNCs get to tax the profits of MNCs⁴⁵. The radical change to the OECD’s Guidelines, however, through the alternative approach proposed in this thesis, is the elevation of the formulary apportionment approach as the sole standard for the apportionment of profits from the cross-border transactions of MNCs both for tangible and intangible goods and services. Regionally, the European Union via the Common Consolidated Corporate Tax Base (CCCTB) project, is also proposing unitary taxation (same as the formulary apportionment approach) in the EU.⁴⁶ The implication of this is that the CCCTB when implemented in the EU will ensure that multinational corporations allocate their profits to states in the EU based on economic activities which occur in signatories to the CCCTB mechanism.⁴⁷

Formulary apportionment, as this thesis argues, requires MNCs to account for the values declared as taxable profits across jurisdictions. The concept of accountability is essential to the basis upon which taxpayers, including MNCs, are taxed. To this end, I argue that MNCs ought to be required to justify values that they declare as profits and loss in the jurisdictions in which they operate. This, in turn will promote accountability and eliminate fiscal avoidance eventually. Picciotto argues broadly for the inclusion of the notion of “accountability” in international regulatory processes⁴⁸. This notion of “accountability” features in World Trade Organization Agreements⁴⁹

⁴⁵ OECD (2014), *Guidance on Transfer Pricing Aspects of Intangibles*, OECD Publishing, Paris.

⁴⁶ European Commission, Taxation and Customs Union: <www.ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en>

⁴⁷ See the assessment of the EU’s CCCTB project by the following authors: Lura Cerioni, “The Commission’s Proposal for a CCCTB Directive: Analysis and Comment”, 65 *Bulletin for International Taxation* (2011) pp. 515-530; Monica Erasmus-Koen, “Common Consolidated Corporate Tax Base: A “Fair Share” of the Tax Base? 18 *International Transfer Pricing Journal* (2011) pp. 237-247.

⁴⁸ Sol Picciotto, *What Rules for the World Economy in Regulating International Business Beyond Liberalization*, (United Kingdom: Palgrave MacMillan, 1999) at p. 20.

⁴⁹ See Article 6 of the World Trade Organization Agreement on Trade-related Investment Measures as contained in the Final Act of the 1986 —1994 Uruguay Round of trade negotiations www.wto.org/english/docs_e/legal_e/ursum_e.htm#eAgreement.

and Mutual Agreements on Investment (MAI),⁵⁰ as a condition precedent for trade liberalization and economic growth between states. According to Picciotto⁵¹, accountability in investment agreements is achieved when governments subject their policy making processes to the test of public opinion. I adopt this line of argument in my thesis, and argue specifically for the inclusion of the notion of “accountability” in how MNCs are taxed through the adoption of the FA approach to replace the arm’s length principle.

I further argue that apart from the incidences of BEPS which are occasioned by transfer mispricing through the strategies utilized by MNCs to avoid taxes, transfer mispricing also alters the functionality of taxation in terms of equity. In this context, equity refers to the fairness of tax administration which entails fair treatment of all taxpayers, whether as private individuals, domestic firms or as MNCs. The inability to combat BEPS activities by MNCs therefore alters the notion of tax fairness, and this ultimately creates tax injustice against taxpayers other than MNCs. As Seligman rightly notes, taxes apart from the fact that they serve as a dependable source of revenue also have social implications:

It is sometimes asserted that the fiscal object of taxation is simply to secure revenue, while the social object is to effect some desirable change in social relations. This antithesis rests upon a failure to observe that finance, like economics, is a social science, and that even from the narrow political point of view of the relation between the government and the citizen, the government cannot derive any revenue—that is, cannot take any part of the social income without inevitably affecting social relations. The fact that the government has in mind solely the fiscal aim of securing revenue does not alter the social consequences of the particular revenue.⁵²

⁵⁰ See the treatment of Investors and Investment Clause under the OECD’s Draft Multilateral Investment Agreement, 1998.

⁵¹ *Supra* note 42.

⁵² Edwin R.A Seligman, *Modern Problems in Taxation* (New York, The Macmillan Company, 1931 reprinted by Augustus M Kelley, 1969) at 316-317.

In sum, this thesis explores the consequences of the proposed CBCR Rules and their potential in the global fight against BEPS, finding that their application will not resolve the thorny issues of BEPS.

1.3 Literature Review on the Efficacy of the Arm's Length Principle

Scholars have discussed the issue of BEPS and have argued for and against the arm's length principle as a viable approach to combat it. In discussing the weaknesses of the arm's length principle, I discuss the arguments of eleven scholars. In general, Reuven Avi-Yonah, Kimberly Clausing and Michael Durst take an anti-arm's length principle position in their papers as they examine the non-suitability of the principle as a means to tax MNC profits. After an assessment of the transfer pricing regime in the US, they propose that the formulary profit split method replace the transfer pricing regime in the US. These authors discuss the challenges embedded in the application of the transfer pricing principles in assessing and taxing the profits of MNCs in the US. They trace this to the integrated nature of businesses conducted by related entities, and the difficulties in applying the separate entity approach to them. Further, they propose that the formulary profit split method be applied in allocating taxing rights over the profits of MNCs to states, based on the amount of sales which occurred in these states using the destination-basis sales formula. These authors extend the proposal for the adoption of the formulary profit split method to other countries. They discuss the advantages of this method to global taxation of MNCs, and the need for coordination of taxation policies to ensure uniformity in the taxation of MNCs. Further, they explain why they prefer the destination-basis sales formula to other indicia of economic activities, such as payroll and assets. They state that payroll and assets may incentivise profit shifting to low or no tax jurisdictions which would bring about the same problem of BEPS

inherent in the current transfer pricing regime. According to Avi-Yonah, Clausing, and Durst⁵³, sales is the only economic activity that is not prone to distortions out of the other two factors because it is based on external factors; consumers. They argue that payroll and assets will distort international investment patterns because they can be manipulated by MNCs. Again, this proposal for the formulary approach using sales alone, leaves out other jurisdictions where these other two economic activities; payroll and assets are carried on. They also address some issues which scholars have raised against the adoption of the formulary approach. This include the question of the arbitrariness or otherwise of the FA approach, and the need for cooperation among states for the effective implementation of the approach. They all propose the formulary apportionment approach as a suitable alternative.⁵⁴

Avi-Yonah in a separate article examines the modifications that have been made to the arm's length principle in the US Transfer Pricing Guidelines.⁵⁵ He maintains that apart from the Comparable Uncontrolled Price (CUP) method, other methods like the cost plus, resale, comparable profit method and the profit split in the guidelines have features of the formulary apportionment approach. Thus, he argues that "despite the common practice of contrasting the ALS and the formulary methods of dealing with the transfer pricing problem, they are actually not dichotomous. Instead, they form the two extreme ends of a continuum."⁵⁶ He proposes a complete switch to the unitary taxation approach as the only way by which abusive transfer pricing/transfer pricing manipulation can be solved.

⁵³ Avi-Yonah, Clausing & Durst *supra* note 31 at 507.

⁵⁴ *Ibid.*

⁵⁵ Avi-Yonah, R.S., "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", (2006) 9 Finance and Tax Law Review 310.

⁵⁶ *Ibid* at 2.

Kimberly Clausing joins her voice to the campaign for a switch to the unitary taxation approach, drawing from the US. state experience⁵⁷. She considers in detail issues that may create practical difficulties for the effective application of the unitary taxation approach, such as the measurement of the formula component in MNCs' books of account, definition of consolidated business to which the approach applies, impacts of the approach on tax treaties, possibility of BEPS as a reaction by MNCs to unitary taxation, and impact of the unitary taxation approach on government revenue. These issues are relevant to my proposal for a switch to the FA approach, and are discussed in detail in chapter five of this thesis.

Avi-Yonah, in another article, proposes a compromise between the unitary taxation and the arm's length principle in the United States, for the fear that the US may fail to adopt the unitary taxation approach simpliciter⁵⁸. In his article, he requests that the formulary apportionment approach be adopted to tax the residual profits of MNCs with the application of the profit split method under the arm's length principle. Under the current US transfer pricing rules, such residual profits are viewed as the result of high-profit intangibles and, as such, are allocated to where the intangibles were developed. Avi-Yonah proposes an alternative valuation in the form of an allocation formula based on the jurisdiction where the economic activity which generated such profit occurred, which in this case would be the destination of sales. This approach, however, restricts the application of the FA approach. It fails to reconcile all economic activities which result into multinational corporation profits. This approach is an antithesis of the FA approach which I propose.

⁵⁷ Kimberly A. Clausing, Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment (2014). www.ssrn.com/abstract=2359724

⁵⁸ Reuven S. Avi-Yonah, "Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation", (2010) World Tax Journal 13-18.

Sol Picciotto argues against the retention of the arm's length principle. He examines the individual efforts by states to prevent fiscal avoidance, which resulted in double taxation agreements between states, especially circumstances surrounding the adoption of the arm's length principle. According to Picciotto, the arm's length principle detracts from an understanding of the integrated nature of business activities between related entities and, as such, is unsuitable for taxing MNC profit.⁵⁹ Scott Wilkie's argument is focused on the nature of the arm's length principle. He maintains that the principle is based on assumptions instead of the economic realities that shape MNC activities, and therefore should be abandoned on this premise.⁶⁰ The work of Yariv Brauner⁶¹ and Richard Vann⁶² on the arm's length principle is essentially directed at the challenges inherent in the application of the principle in taxing intangibles. They argue that the weaknesses of the principle are more pronounced in this regard because of the difficulties involved in valuing intangibles. Wells and Lowell discuss the arm's length principle as one of the many errors of the OECD. Their presentation of the principle reveals the intention behind the adoption of the principle which they say was a tactic to rob source countries which are mainly developing countries of taxable MNC profits due them.⁶³

⁵⁹ Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (United Kingdom: Cambridge University Press, 2013); Sol Picciotto, "Towards Unitary Taxation" In Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness*. (United Kingdom: Oxford University Press, 2016)

⁶⁰ J. Scott Wilkie, "Reflecting on the Arm's Length Principle": What is the "Principle"? Where Next? In W. Schon and K.A. Konrad (eds.), *Fundamentals of International Transfer Pricing in Law and Economics*, MPI Studies in Tax Law and Public Finance Volume 1 (United States: Springer, 2012)

⁶¹ Yariv Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes", (2008) 28 *Virginia Tax Rev* 79:28.

⁶² Vann, Richard J., *Reflections on Business Profits and the Arm's-Length Principle* (November 17, 2010). *The Taxation of Business Profits Under Tax Treaties*, pp. 133-169, B.J. Arnold, J. Sasseville, E.M. Zolt, eds., Canadian Tax Foundation, 2003; Sydney Law School Research Paper No. 10/127. Available at SSRN: <https://ssrn.com/abstract=1710945>.

⁶³ Bret Wells & Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin" (2012) 65 *Tax Law Review* at 580.

Lorraine Eden argues for the reinvigoration of transfer pricing rules as the solution to the gaping holes in international tax rules that create BEPS.⁶⁴ In her assessment of the challenges posed by the abusive transfer pricing by MNCs that occasion BEPS, she proposes that the current allocation rules between source and residence countries be tightened. To this end, she proposes that residence countries tax the worldwide profits of resident MNCs (including unrepatriated profits) with tax credits for foreign taxes paid. For source countries, she proposes “a regime with stronger anti-abuse rules”, such as Controlled Foreign Corporations (CFC) Rules. In her word, “I see an “income tax design” problem, not a transfer pricing problem. The solution is to re-establish the international tax regime.”⁶⁵ I argue against Eden’s proposal in chapter 5 on the ground that her proposal for worldwide taxation of MNC profits by residence countries will further distort international taxation rules, and advance BEPS in source countries.

From an economic standpoint, Dhammika Dharmapala’s work⁶⁶ contributes significantly to the topic. He assesses the efficiency consequences of the current rules for taxing US MNCs and the proposed alternatives to them. These consequences include: distortions to the use of external debt, distortions to the choice of organizational form, distortions to asset ownership and more. He assesses the following proposed alternatives: territorialism with a reduction in the corporate tax rates, formulary apportionment, and the destination-based cash flow tax (the DBCT). He opts for the 'Destination-based cash flow tax' (the DBCT) as a more viable approach. According to him, the formulary apportionment approach can be manipulated by MNCs; producing other shades of distortion other than the ones being experienced under the separate entity/arm’s length principle.

⁶⁴ *Supra* note 29.

⁶⁵ *Ibid.*

⁶⁶ Dharmapala, Dhammika, “The Economics of Corporate and Business Tax Reform” (2016). University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 757. www.ssrn.com/abstract=2737444

According to him, the DBCT approach, which jettisons the source and residence rules and focuses on the destination of consumption, is more viable in effectively taxing US MNCs. This approach is like that which Avi-Yonah, Clausing and Durst propose⁶⁷, and my critique of their proposal applies here as well.

Wolfgang Schön proposes a radical change to the current international tax rules for states in the European Union.⁶⁸ According to him, the appropriate response to the inefficiency of the arm's length principle is the modification of the international tax rules to expand the taxing rights of source countries. This is to ensure that additional profits derived by local entities or permanent establishments of foreign-based MNCs are not left untaxed. This line of argument supports my proposal, because the implication of my proposal for the FA approach is to deter artificial allocation of values by MNCs, which will in turn give prominence to the taxing rights of source countries.

1.4 Literature Review on CBCR

The subject matter of CBCR has also received review by scholars. Maria T. Evers, Ina Meier and Christoph Spengel for instance discuss the import of CBCR as an effective measure to combat BEPS.⁶⁹ They argue that even if CBCR has prospects in the fight against profit shifting, the expected benefits exceed the related costs.⁷⁰ For instance, they note that CBCR may just be an avenue for tax administrations to know about the global activities of MNCs but not as a tool to fight against BEPS. Their argument is premised on the weaknesses of the arm's length principle,

⁶⁷ *Supra* note 31.

⁶⁸ Wolfgang Schön, "Transfer Pricing, the Arm's Length Standard and European Union Law" Max Planck Institute for Tax Law and Public Finance Working Paper, 2011.

⁶⁹ Maria Theresia Evers, Ina Meier & Christoph Spengel, "Transparency in Financial Reporting: Is Country-by-Country Reporting Suitable to Combat International Profit Shifting?" June/July (2014) Bulletin for International Taxation, IBFD at 295-303.

⁷⁰ *Ibid* at 296.

specifically the inability to ascertain the appropriateness of transfer prices declared by MNCs with the principle. Considering the fact MNCs utilize the opportunities inherent in transfer pricing to erode profits, with the ineffectiveness of the arm's length principle to verify the appropriateness of transfer prices fixed, Evers, Meier and Spengel conclude against the prospects of the CBCR as a tool to end BEPS.

Arthur J. Cockfield and Carl D. MacArthur examine one of the provision of the Rules: the confidentiality clause in the OECD's CBCR Rules against the argument that this clause would affect negatively the trade activities of MNCs when implemented.⁷¹ Their assessment of the empirical studies on this subject reveal that there are two opposing positions. The first position is that MNCs withhold information because of trade and confidentiality concerns while the second position is that MNCs withhold information to hide their BEPS-related activities which they engage to shift profits from high-tax jurisdictions to low or nil-tax jurisdictions. Cockfield, MacArthur⁷² and Reuven S. Avi-Yonah⁷³ broadly examine the issue of corporate privacy under Canadian law and the US law respectively. They all argue that corporate entities lack the right to privacy.

Evidently, scholars have different perceptions about the context in which the problem of BEPS arises and have proposed solutions to BEPS in line with their perceptions. This thesis considers the implications of these different proposals and settles for the formulary apportionment approach (using sales, payroll, and tangible assets as allocating factors) as the most viable approach to deter BEPS. The thesis further examines the substantive provisions of the country-by-country Reporting

⁷¹ Arthur J. Cockfield, Carl D. McArthur "Country-by-Country Reporting and Commercial Confidentiality" (2015) 63:3 Canadian Tax Journal 627 at 644.

⁷² *Ibid* at 650.

⁷³ Reuven S. Avi-Yonah, "Country-by-Country Reporting and Corporate Privacy: Some Unanswered Questions" Colum. J. Tax. Tax Matters 8, no.1 (2016): 1-3.

Rules in the context of the OECD's declared objective to end BEPS globally. Since the provisions of the CBCR Rules have not been expanded upon by scholars, it is safe to say that this thesis makes an original contribution to international tax discipline in this regard.

1.5 Research Questions

BEPS produces detrimental consequences across jurisdictions. More importantly, it is a challenge that would remain if significant actions are not taken by states to effectively address its root cause. The OECD is at the forefront of the global fight against BEPS via its BEPS project. This is why this thesis examines the implications of this effort from two angles and asks two specific questions. First, what are the implications of the OECD's CBCR Rules in the context of the OECD's global fight against BEPS? Second, to what extent is the arm's length principle effective in the global fight against BEPS?

This thesis makes the following claims. First, the transfer pricing rules leave room for MNCs to further engage in BEPS related activities, and thus a non-viable approach by which to fight BEPS globally. Second, the OECD's CBCR Rules, though having a lofty objective, fail to serve as an effective composite tool capable of being utilized by states to end BEPS globally. Third, drawing on the literature, I argue that the nature of the business activities of MNCs prevents an effective application of the arm's length principle as a solution to abusive transfer pricing. Fourth, I argue that the unitary taxation (formulary apportionment) approach (using the trident formula) is best in aligning profit with value creation and preventing BEPS.

The OECD's approach to BEPS is structured as if the challenge is a legal problem. This is why it requires national enactment of rules to implement measures for the purpose. This thesis argues that though the interaction of the different investment laws encourages BEPS, the root cause of BEPS

is what the OECD must address. The appropriate question ought to be “what makes BEPS possible,” rather than “what are the loopholes in the international tax system that encourage BEPS”. A *legocentric* approach for tackling an economic problem comes across as a round peg trying to fit into a square whole. If it were the case that the business structures of MNCs allow them to artificially attribute profits to jurisdictions, and it appears impossible to have power over how and what profits MNCs declare, the solution that this thesis proposes is a viable approach that ensures that only the profits commensurate to economic activities are apportioned across jurisdictions.

1.6 Structure of the Thesis

The research questions highlighted above are addressed under six chapters, including this chapter, that set out the theme of discussion, which is the problem of BEPS, the OECD’s approach in combatting BEPS globally through the CBCR Rules, and alternative approaches to end BEPS globally. In this chapter, I also discuss, briefly, the existing problems in international taxation which the CBCR Rules were designed to solve. Chapter 2 examines in detail the root cause of BEPS; transfer mispricing and low tax rates by tax havens. This chapter also discusses the effect of BEPS on the fundamental notion of “tax justice”, the impact of BEPS on the fiscal rights of states, and the consequences of BEPS on national and global economies. The purpose of this chapter is to discuss BEPS considering the factors responsible for it, and to understand the magnitude of the consequences of the BEPS activities of MNCs on source countries, other taxpayers, and the significance of taxation as a legitimate source of revenue. Chapter 3 discusses previous attempts by the OECD and the UN to end BEPS in source countries through the harmful tax competition report by the OECD in 1998, current transfer pricing rules, and the gaps in those attempts. Chapter 4 is the crux of this thesis. In this chapter, I assess the objectives and key

provisions of the CBCR Rules considering the problems which the Rules were designed to solve. I identify gaps in the provisions of the Rules and propose amendments in alignment with the OECD's objective to end BEPS globally. Other than the assessment of key provisions of the CBCR Rules, I assess the compatibility of the CBCR Rules with the arm's length principle in the fight against BEPS in Chapter 5. My assessment reveals that the problem of BEPS may remain unsolved with the CBCR Rules, even if amended. The aim of this chapter is to demonstrate the differing situations in the 1930s when the arm's length principle was adopted and, now where globalization makes it increasingly difficult for source countries to effectively tax multinational corporation profits through the individual accounts of MNC entities. Therefore, I make a proposal for the formulary apportionment approach to replace the arm's length principle. This alternative approach apportions business profits to states according to the level of their contributions to real economic activities, such as sales, payroll and tangible assets which generated such profits. I argue that this alternative approach works best with the CBCR rules as a tool to combat BEPS globally if the rules are amended to reflect the changes which I propose in chapter 4 of this thesis. I conclude my arguments in this thesis in Chapter 5 and sets out clearly my recommendations on the OECD's declared intent to end BEPS globally through the CBCR Rules.

Chapter 2

Base Erosion and Profit Shifting (BEPS): Nature of the Problem

2.0 Introduction

As stated in chapter 1, the objective of this thesis is to assess the viability of the OECD's Country-by-Country Reporting Rules (CBCR Rules), proposed in the context of its declared global fight against Base Erosion and Profit Shifting (BEPS). This chapter discusses two root causes of BEPS: activities of tax havens and transfer pricing by MNCs.¹ It also examines the revenue consequences that BEPS creates for states, the future of the fundamental fiscal right of states, and the fairness of corporate income taxation as a tool to fulfil fiscal policies in general. The focus of this chapter is the magnitude of the problem of BEPS, which the OECD seeks to end through the application of CBCR Rules. This chapter is divided into seven sections. The first section, section 2.0, gives background on the BEPS phenomenon and harmful tax competition, and differentiates it from unarmful tax competition, that which does not produce BEPS. Flowing from the background about BEPS provided in section 2.1, section 2.2 discusses the use of transfer pricing by MNCs as a cause of BEPS. This section explains the underlying reasons why MNCs utilize tax avoidance strategies in general, and in particular, the transfer pricing strategy for corporate tax avoidance. It offers detail on how transfer pricing is utilized by MNCs to cause BEPS, giving practical examples. In the same vein, section 2.3 discusses how tax havens engender BEPS. Moving away from the causes of BEPS identified in sections 2.2 and 2.3, sections 2.4 - 2.6 discuss the implications of BEPS first on the corporate tax base of states, then, on the fiscal rights of states, and lastly, on the

¹ See for instance Lorraine Eden *infra* note 25 at 208; Kleinbard *infra* note 16. See generally sections 2.0 – 2.3 for the discussion of BEPS including its root causes; transfer pricing by MNCs and activities of tax havens.

notion of tax justice both for states and for taxpayers other than MNCs in sections 2.4, 2.5, and 2.6 respectively.

2.1 What is BEPS?

The OECD says that “BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to **arrangements** that achieve no or low taxation by **shifting profits away** from the jurisdictions where the activities creating those profits take place.”² This definition points out that the root cause of BEPS is the strategic shifting away (eroding) of profits from where they were generated (source countries), and moving these profits into tax havens. The combination of these two activities is what makes BEPS possible. In other words, failure to attach multinational corporation profits to source countries is what causes BEPS, and this affects the fundamental design of the tax system.³

BEPS is a major problem that confronts governments the world over. Although it does not appear as a new development in the history of taxing MNCs⁴, its effect is increasingly being felt by governments, especially because of the consequences it continues to create for countries, despite concerted efforts to obviate its causative factors.⁵ Initially, the problem of BEPS was categorized

² OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing at 10 (emphasis supplied).

³ Michael Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, (2008) 24 *Oxford REV. ECON. POL'Y* 698 at 713.

⁴ Pascal Saint-Amans, “What the BEPS are we talking about”: www.oecd.org/forum/what-the-beps-are-we-talking-about.htm (last accessed 10th June 2017).

⁵ Countries are spending time discussing the issue of BEPS and ways to address it, see for instance, G20 Leaders Declaration Los Cabos, Mexico, June 19, 2012: www.g20.utoronto.ca/2012/2012-0619-loscabos.html. This declaration generated the OECD BEPS Action Plans. There are also national discussions centred around ways to deter BEPS, see for instance, Julie Martin “U.K Puts Executives in Hot Seat Over Transfer Pricing Practices”, (2012) *Worldwide Tax Daily* 221-4; Australia’s Assistant Treasurer, Minister Assisting for Financial Services & Superannuation and Minister for Competition Policy & Consumer Affairs, David Bradbury’s Speech to Taxation Institute of Australia’s 28th National Convention “Stateless Income: A threat to National Sovereignty” (2013): www.ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=dj

as “fiscal fraud” occasioned unilaterally by the fiscal policies and laws of tax havens.⁶ There is now recognition that it is the non-harmonization of national rules affecting taxation of multinational corporation profits that gives rise to BEPS.⁷ BEPS affects both developed and developing countries. This might be the reason why the OECD is being aggressive to deter it, though, ironically, some of its members are considered to be tax havens.⁸

BEPS activities by MNCs is an important topic because of the significance of MNCs to the global economy.⁹ The severity of BEPS on national economies and the global economy is discussed fully later in this chapter, specifically in section 2.4. However, it is important to highlight the severity of revenue loss to countries, estimated as amounting to eighty per cent of the world economy.¹⁰ In terms of revenue, BEPS affects developing countries more than developed countries.¹¹ According

[ba&Year=&DocType>](#) ; European Commission Recommendation Regarding Measures Intended to Encourage Third Countries to Apply Minimum Standards of Good Governance in Tax Matters (2012): <http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_fraud_evasion/c_2012_8805_en.pdf> ; European Commission, “Anti-tax avoidance Package” : www.ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en_EC ; BRICS states take next step towards BEPS implementation, (2016): <www.bvdinfo.com/en-gb/blog/transfer-pricing/brics-states-take-next-step-towards-beps-implement>

⁶ See OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris.

⁷ *Supra* note 2.

⁸ See Tax Justice Network, Financial Secrecy Index 2015 for a list of countries listed as tax havens such as Switzerland, Netherland, Luxembourg which are OECD members and some British commonwealth countries and Dependencies such as the British Virgin Islands, Jersey, Isle of Man, Cayman Island : www.financialsecrecyindex.com/introduction/fsi-2015-results ; See also Dhammika Dharmapala and James R. Hines, “Which Countries Become Tax Havens?” *Journal of Public Economics*, Vol. 93, October 2009, 1058-1068; Tax Justice Network, “Identifying Tax Havens and Offshore Finance Centers: < www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf . The OECD’s gray list is posted at www.oecd.org/dataoecd/38/14/42497950.pdf ; 2008 Government Accountability Office (GAO) Report, International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions, GAO-09-157, December 2008 cited by Jane Gravelle, “Tax Havens: International Tax Avoidance and Evasion” (2015), Congressional Research Service, www.fas.org/sgp/crs/misc/R40623.pdf at 4.

⁹ Prem Sikka and Hugh Willmott *infra* note 34 at 6; see also Mahmood Monshipouri, Claude E. Welch, Jr., Evan T. Kennedy, “Multinational Corporations and the Ethics of Global Responsibility: Problems and Possibilities” *Human Rights Quarterly* (2003) 965–989 at 966.

¹⁰ Wray Bradley, “Transfer Pricing: Increasing Tension Between Multinational Firms and Tax Authorities” (2015) 7:2 *Accounting and Taxation Journal* 65-73 at 69.

¹¹ See section 2.4 *infra*.

to the International Monetary Fund (IMF), the increased Foreign Direct Investment (FDI) in developing countries since the early 1980s has tripled to about thirty per cent.¹² As such, tax revenue forms a significant source of income for developing countries, and BEPS poses a huge threat to their tax base.¹³ Not only does BEPS pose a serious threat to national economies and, in turn, the global economy, it also violates the notion of “fairness/justice/equity” in taxation, as well as the fiscal rights of states.¹⁴ In short, the problem of BEPS, which the OECD seeks to address, is fundamental to both states and their citizens.

Globalization elevated commerce from rudimentary trade within national borders to transnational business transactions.¹⁵ This significant development in world history, however, has deleterious consequences, one of which is BEPS by MNCs.¹⁶ Using ingenious tax avoidance strategies, MNCs move profits from high-tax jurisdictions to low-tax jurisdictions to maximize their global profits.¹⁷ Although market forces are known to regulate demand and supply in the economics of trade, unfortunately, economic factors are distorted by MNCs when they engage in profit shifting because of the privilege that international taxation affords them to exercise their discretion in allocating profits to jurisdictions.¹⁸ Consequently, MNCs exploit this privilege to shift profits from a high- to a low-tax jurisdiction, for example by maximising expenses in the former and revenue in the latter. Kleinbard gives a practical illustration of how MNCs engage in tax planning activities in the US context, where a foreign tax credit system prevails:

¹² IMF Policy Paper (2014) “Spillovers In International Corporate Taxation”:

www.imf.org/external/pp/ppindex.aspx at 6-7.

¹³ *Ibid.* Figure 1. “Revenue from the Corporate Income Tax in Percent of Total Revenue” at 7.

¹⁴ Peter Dietsch & Thomas Rixen, “Redistribution, Globalization, and Multi-Level Governance” (2014) 1:1 MOPP 61-81 at 62.

¹⁵ Yariv Brauner, “What the BEPS” (2014) 15:2 Florida Tax Review 55-111 at 64.

¹⁶ *Ibid.*

¹⁷ Edward Kleinbard “Stateless Income” (2011) 11:9 Florida Tax Review 700-770 at 753.

¹⁸ *Ibid.*

...The firm's tax director functions as the master distiller, confronted by hundreds of casks of foreign income, one cask sits waiting to be tapped by the master distiller as needed, and each drum of foreign income drawn from a cask brings with it a different quantum of foreign tax credits. The master distiller takes instructions from the chief financial officer as to how much cash must be repatriated to the United States each year, and then sets about perfecting a blend of income and credits so that the residual U.S. tax on the resulting liqueur is as small as possible.¹⁹

Similarly, tax havens utilize the advantage of mobility of capital in international trade to attract MNC income through their fiscal policies, with such fiscal policies producing negative fiscal externalities.²⁰ In a world that is characterized by freedom of fiscal choices without external interference, countries engage their policy tools to attract investment. This is termed "tax competition", which Ring defines as follows:

...a country's use of any feature of its tax system to "enhance" its competitive advantage in the marketplace for capital, investment, and/or nominal business presence. The tax features readily susceptible to enlistment in this mission include tax rates, tax base, administrative system transparency, disclosure, information sharing, and special credits, exemptions and deduction.²¹

Although tax competition in itself is not detrimental, it turns out to be detrimental when it engenders BEPS in other countries and becomes "harmful tax competition". It is harmful because other countries, including their citizens, suffer from the fiscal policies of tax havens. As such, the critique of tax havens is not solely because of their low tax rates which of course is an exercise of their sovereignty. The critique is directed at the fiscal policies and activities of tax havens which encourage aggressive tax planning activities of MNCs and private individuals thereby causing

¹⁹ *Supra* note 17 at 725.

²⁰ Peter Dietsch, "Tax Competition and Its Effects on Domestic and Global Justice" *infra* note 128 at 99.

²¹ Diane M. Ring. "Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation." (2009) 9 Florida Tax Review 555-596 at 6-7.

other states to suffer revenue losses.²² In other words, the difference between the grant of fiscal incentives which engender BEPS, and the use of fiscal policies by states to attract actual investment lies in the objective economic consequences. Arguably, tax competition would exist even in the absence of tax havens but it may be impossible for harmful tax competition to exist in the absence of tax havens. To buttress this salient point, Dietsch and Rixen note: “tax competition for FDI is illegitimate when it both is strategically motivated and leads to a reduction in the aggregate level of fiscal self-determination of other states”.²³ They term this: “virtual tax competition”, and differentiate it from “actual tax competition” which does not cause harm to other states because there is a genuine economic activity being carried on by MNCs.

The use of tax incentives to attract and retain MNCs is necessary for states in a globalized era, and indispensable where investment and income flows between countries are not in balance.²⁴ Actual tax competition, therefore, does not engender BEPS.²⁵ The bottom line is that the use of incentives by states to attract MNC profits which are produced in other states, thereby depriving those other states of their returns, is what engenders BEPS.

Harmful tax competition by tax havens and transfer pricing manipulation by MNCs are two distinct yet complementary primary factors responsible for BEPS globally.²⁶ Tax havens, through fiscal incentives, lure MNCs to establish business entities in their jurisdictions. Low tax rates are one

²² Clemens Fuest & Nadine Riedel, “Tax Evasion and Tax Avoidance: The Role of International Profit Shifting Draining Development?” in Peter Reuter, ed. *Draining Development? : Controlling Flows of Illicit Funds from Developing Countries* (Washington DC: The World Bank, 2012) 109 at 122.

²³ Dietsch and Rixen *supra* note 14 at 73.

²⁴ Vann, Richard J, “Current Trends in Balancing Residence and Source Taxation” (2014) Sydney Law School Legal Studies Research Paper No. 14/107 1 at 8. Available at SSRN: www.ssrn.com/abstract=2538269

²⁵ See Apeldoorn *infra* note 141 for a contrary argument. Apeldoorn argues that both virtual and actual tax competition affect states’ fiscal sovereignty.

²⁶ Lorraine Eden, “Transfer Pricing Manipulation” in Peter Reuter, ed. *Draining Development? : Controlling Flows of Illicit Funds from Developing Countries* (Washington DC: The World Bank, 2012) 205 at 208.

notorious strategy utilized by tax havens. Heckemeyer and Overesch's empirical research which synthesizes evidence from twenty-five studies on the subject reveal that tax rates are significant factors considered by MNCs in their location decisions.²⁷ MNCs have always considered tax rate differentials before establishing entities across jurisdictions. For instance, Grubert and Mutti conducted a research on US MNCs using 1982 data on a cross section of thirty-three countries.²⁸ They found that host country taxes and tariffs are important decision factors for MNCs in determining where they will locate their production. They also found that MNCs take advantage of tax planning opportunities by shifting taxable income to low-tax countries, thereby eroding the base of high-tax countries.²⁹

The concept of BEPS examined above identifies tax havens as one of the causes of BEPS. The next section looks in detail at how their activities engender BEPS.

2.2 Tax Havens as a Cause of BEPS

This section discusses the tax haven phenomenon. It argues that the fiscal policies of tax havens, which encourage the aggressive tax planning activities of MNCs, contribute significantly to the BEPS problem. The discussion first delves into the nature of a tax haven.

2.2.1 What are Tax Havens?

Tax havens are countries that feed on income generated in other countries but transferred into them by MNCs through tax avoidance strategies.³⁰ Tax havens maintain lax fiscal policies to attract the

²⁷ Heckemeyer J. and Overesch M. (2013), *Multinational Profit Response to Tax Differentials: Effect Size and Shifting Channels*. ZEW Discussion Paper No. 13-045, Mannheim.

²⁸ Harry Grubert & John Mutti, "Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making", (1991) 73:2 *The Review of Economics and Statistics* 285-293.

²⁹ *Ibid.*

³⁰ Joel Slemrod & John D. Wilson, "Tax competition with parasitic tax havens", *Journal of Public Economics* 93 (2009) 1261-1270.

foreign profits of MNCs, and they remain active despite national³¹ and international actions against them.³² The policies and activities of tax havens easily give them away: they leverage on the ability of MNCs to move capital across jurisdictions into their jurisdictions. This is why they consistently maintain low-tax rates to encourage profit shifting from other jurisdictions.³³

The OECD notes that tax havens can be identified by certain key features, as follows: Nil, or only nominal taxes; lack of effective exchange of information; lack of transparency; and no substantial activities.³⁴ More prosaically, Shaxson says a tax haven is “a place that seeks to attract business by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere”.³⁵ Picciotto defines them in terms of their activities being the root cause of BEPS: “...A tax haven is a country which has facilities specially aimed or adapted to enable avoidance or evasion of another country’s laws or regulations, such as tax, usually for the benefit of non-residents of the haven”.³⁶

According to the OECD, tax havens serve three purposes: they provide a location for holding passive investments (“money boxes”); they provide a location where “paper” profits can be booked; and they enable the affairs of taxpayers, particularly their bank accounts, to be effectively

³¹ For instance, Sub-part F of the US internal Revenue Code was introduced in 1962 as a mechanism to deter income shifting by US MNCs to tax havens. This provision allows for taxation of certain profits of a controlled foreign corporation even if unrepatriated. See Sol Picciotto, “Towards Unitary Taxation of Transnational Corporations” (2012) Tax Justice Network at 6. See, however, a critique of this rule by Giorgia Maffini, “Tax Haven Activities and the Tax Liabilities of Multinational Groups” Oxford University Centre for Business Taxation Working Paper 09/2015 at 2. Maffini notes that this mechanism has weakened due to the introduction of the check-the-box rules in 1996 which now allow for choosing whether certain entities are to be treated as separate corporations for US tax purposes.

³² The OECD’s fight against tax havens which officially began in 1998 through the publication of the Harmful Tax Competition Report *supra* note 6 is an example of an international fight against the activities of tax havens which encourage profit shifting.

³³ See Ernesto Crivelli, Ruud De Mooij and Michael Keen, “Base Erosion, Profit Shifting and Developing Countries” (2015) IMF Working Paper WP/15/118, Figure 2. Corporate Income Tax Rates, 1980–2013 at 14.

³⁴ OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris at 23.

³⁵ Nicholas Shaxson, *Treasure Islands: Tax Havens and the Men Who Stole the World* (London: The Bodley Head, 2011) at 8.

³⁶ Sol Picciotto *infra* note 49 at 238.

shielded from scrutiny by tax authorities of other countries”.³⁷ Due to the nature of the activities performed by tax havens, they exemplify harmful tax competition between states; that is, they create a situation where states compete for foreign investment without substantial link to those investments. Apeldoorn describes this as “virtual tax competition”.³⁸ The succeeding subsection examines how tax havens engender BEPS.

2.2.2 How Tax Havens Engender BEPS

The use of tax havens as instruments for profit shifting by MNCs began after 1950, according to Picciotto.³⁹ The reason there is so much attention on them is because they are home to “shell branches”, “brass plates companies, partnerships, and trusts”, that is, entities of MNCs with insignificant functions but in possession of majority of MNC profits.⁴⁰ As discussed in section 2.1, it is not just the lax fiscal policies and activities of tax havens which subject them to criticisms by other states. The influence of tax havens on MNCs’ global trade as well as the consequences which their policies create for other states in terms of revenue loss are the reasons why there is so much attention on them.

It has been estimated that almost half of all world trade passes through tax havens, though they account for only 3 per cent of the world’s GDP.⁴¹ The Tax Justice Network suggested in 2005 that approximately US\$ 11.5 Trillion in assets were held offshore.⁴² As far back as 1990, Hines and Rice estimated that the fiscal incentives of tax havens attract a quarter of US foreign investment and a third of their foreign profits.⁴³ In 2013, Keightley also looked into the extent to which US

³⁷ OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris, Paragraph 49 at 22.

³⁸ Laurens Val Apeldoorn *infra* note 128 at 3.

³⁹ Sol Picciotto *infra* note 49 at 239.

⁴⁰ *Ibid.*

⁴¹ Bruno Grutner, “Tax evasion: hidden billions for development” (2004): www.taxjustice.net/cms/upload/pdf/taxevasion2004_eng.pdf 2005 at 67.

⁴² James S. Henry, “The Price of Offshore Revisited” Tax Justice Network Briefing Paper (2005): www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf

⁴³ James R. Hines & Eric M. Rice *infra* note 91.

MNCs were involved in profit shifting. He found that the profits declared by US MNC entities in “tax preferred”, “tax haven” countries or profit sanctuaries according to Surrey,⁴⁴ are disproportionate to the level of business activities carried on in those jurisdictions. The tax havens he identified in his report are Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland. He compared the amount of profits which US MNCs reported in these tax havens to those declared in traditional economies such as Australia, Canada, Germany, Mexico, and the United Kingdom. He found that there were incidences of overallocation of profits to tax havens and underreporting of profits in traditional economies. For instance, he notes that:

American companies reported earning forty-three per cent of overseas profits in Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, while hiring four per cent of their foreign workforce and making seven per cent of their foreign investments in those economies. In comparison, the traditional economies of Australia, Canada, Germany, Mexico and the United Kingdom accounted for fourteen per cent of American MNCs overseas’ profits, but forty per cent of foreign hired labor and thirty-four per cent of foreign investment.⁴⁵

MNCs with operation in developing countries also erode profits from these jurisdictions and transfer them to tax havens. In 2013, Christian Aid, a non-governmental organization, conducted research on 1,525 MNCs operating in India. Their research shows that MNCs which have links with tax havens engage in profit shifting “more intensely” than those MNCs with no tax haven links.⁴⁶

In sum, transfer mispricing and harmful tax competition by tax havens are fundamental causes of BEPS. The statistics quoted above evidence that transfer pricing and the fiscal policies of tax havens are significant contributors to the BEPS problem. This points to the need for insight into

⁴⁴ Stanley S. Surrey, “The United States Taxation of Foreign Income” 1. J.L & ECON. 72:94 (1958) 72-96 at 77.

⁴⁵ Mark B. Keightley, “An Analysis of Where American Companies Report Profits: Indications of Profit Shifting, 2013, Congressional Research Service Paper < www.fas.org/sgp/crs/misc/R42927.pdf > at 4.

⁴⁶ Petr Janský & Alex Prats, “Multinational Corporations and the Profit-Shifting Lure of Tax Havens: How Tax Avoidance and Evasion Hinder Development”, (2013) Christian Aid Occasional Paper Number 9 at 10.

the revenue impacts that BEPS has on national economies and the global economy, as well as on the notion of “tax justice” and on the fiscal rights of states. Sections 2.4 - 2.6 take up these concerns.

2.3 Transfer Pricing as a Cause of BEPS

Transfer pricing is one of the notorious strategies which MNCs utilize to engage in profit shifting.⁴⁷ The use of this strategy by MNCs automatically implies profit shifting. This section discusses the nature of transfer pricing as a tool by MNCs to engender BEPS. Specifically, I examine the rationale behind the use of this strategy and the ease with which MNCs utilize it to minimize their global profits. Literature on international taxation is replete with facts and figures proving that transfer pricing contributes significantly to the problem of BEPS.⁴⁸

Picciotto provides a broad definition of transfer pricing: “The term transfer pricing is usually used pejoratively, to refer to the mispricing of cross-border transactions for an illegitimate purpose - such purposes include not only reducing tax liability, but also evading currency controls, and concealing the origins of funds transferred abroad, especially funds derived from criminal activity or corruption”.⁴⁹

⁴⁷ See for example Grubert & Altusher, *Corporate Taxes in World Economy* at 322-23 cited in Kleinbard *supra* note 16 at 733. These authors discussed how in 2002, US MNCs with operations in Ireland were found to be almost three times as profitable in proportion to their sales “as was the mean of all such foreign manufacturing subsidiaries through abusive transfer pricing by MNCs. See also Prem Sikka, “The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness” *Critical Perspectives on Accounting* 21 (2010) 342–356; Raymond Baker, *Capitalism’s Achilles Heel: Dirty Money and How to Renew the Free-Market System* 2005 Hoboken, NJ: John Wiley & Sons at 194-97; Edward Kleinbard, “Stateless Income” (2001) *Florida Tax Review* 11:9 769 at 699; Clemens Fuest & Nadine Riedel, “Tax Evasion and Tax Avoidance: The Role of International Profit Shifting Draining Development?” 111-122; Yariv Brauner, “Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes (2008); Clausing, “Tax-Motivated Transfer Pricing and US Intrafirm Trade Prices” *Journal of Public Economics* 87 9:10 2207-23.

⁴⁸ *Ibid.*

⁴⁹ Sol Picciotto, *Regulating Global Corporate Capitalism*, (Cambridge, UK: Cambridge University Press, 2011) at 233.

Transfer pricing by MNCs involves the allocation of profit and loss on both tangible and intangible property from the transnational business activities of an MNC to its business entities in jurisdictions where they operate. MNCs enjoy the privilege of fixing prices on their transactions.⁵⁰ This privilege, however, comes with the deleterious disadvantage of BEPS by MNCs. BEPS is engendered through transfer pricing when there is misallocation/mispricing⁵¹ of profits/losses on both intra-firm transactions and transactions with third parties. Such misallocation, consequently, erodes revenue from source jurisdictions and transfers them to countries with possibly no legitimate link to those revenues. Sikka and Willmott discuss the link between the discretion which globalization affords MNCs in allocation of profits/losses and BEPS as follows: "...Such discretion can enable them to minimise taxes and thereby swell profits by ensuring that, wherever possible, most profits are located in low-tax or low risk jurisdictions".⁵²

Other than transfer pricing, there are many other tax avoidance strategies. They include allocation of debt and earnings stripping (thin capitalization), contract manufacturing, check-the-box hybrid entities and hybrid instruments, cross-crediting and sourcing rules for foreign tax credits⁵³, and double-Irish and treaty shopping.⁵⁴ These strategies are used because MNCs see tax as a cost to be minimized.⁵⁵ As such, they are encouraged to invest billions of dollars into the tax avoidance

⁵⁰ Prem Sikka & Hugh Wilmot, "The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness" (2010) University of Essex Research Paper at 3.

⁵¹ *Supra* note 26.

⁵² *Supra* note 50. See also Raymond W. Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System* (New Jersey: John Wiley & Sons, 2005) at 30.

⁵³ Jane Gravelle, "Tax Havens: International Tax Avoidance and Evasion" (2015) Congressional Research Service 7-5700 at 9-15: < www.fas.org/sgp/crs/misc/R40623.pdf > see also Peter Dietsch *infra* note 141 at 400-41.

⁵⁴ Edward Kleinbard, "Stateless Income" *supra* note 17 at 706.

⁵⁵ John Christensen & Sony Kapoor, "Tax Avoidance, Tax Competition and Globalization" (2004) 3:2 Accountancy Business and the Public Interest Journal at 9 wherein they cite P.J Henehan, a senior tax partner with Ernst & Young who states as follows: "Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it. This is an essential part of good corporate governance" (Irish Times, March 2004).

industry to ensure that they pay minimal taxes on their global profits.⁵⁶ Sikka and Willmott pinpoint the significance of transfer pricing to MNCs as follows: “Reducing or eliminating taxes is attractive to corporations as it boosts shareholder value, post-tax earnings and returns to shareholders. It also increases company dividends and executive rewards as these are linked to reported earnings. Since the amount of tax payable is dependent on ‘costs’ and ‘income’, corporate attention becomes more intently focused on ‘transfer pricing’ strategies”.⁵⁷ They further explain that the “politics of transfer pricing”, that is, the establishment of subsidiaries, affiliates, joint ventures, trusts, and other special purpose vehicles by MNCs for the purpose of avoiding taxes in high-tax jurisdictions, enables them to take advantage of low taxes and subsidies in low-tax jurisdictions.⁵⁸

This seemingly overbroad discretion that MNCs have regarding allocation of profits, is, ironically, one of the main reasons for which they exist.⁵⁹ Therefore, it ought not be surprising to discover that MNCs engage in transfer “mispricing”. Fuest and Riedel affirm this:

The concept of income shifting raises the question of whether a true or objective distribution of profits earned by the individual entities of a multinational firm can be identified. Achieving this is complicated for a number of reasons. In particular, the entities of multinational firms typically jointly use resourced specific to the firm such as a common brand name or firm-specific expertise. Pricing these resource flows appropriately is difficult because goods traded between unrelated parties are usually different. It is an important characteristic of many multinational firms that the individual entities jointly use resources that could not be used in the same way if they were separate firms.⁶⁰

⁵⁶ See Lorraine Eden *supra* note 26 at 230 citing Friedman M “The Social Responsibility of Business is to Increase its Profits” (1970) New York Times Magazine 33 (September 13) 122-26.

⁵⁷ *Supra* note 50 at 7-8.

⁵⁸ *Ibid.*

⁵⁹ Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (United Kingdom: Cambridge University Press, online edition, 2013) at 172.

⁶⁰ Clemens Fuest & Nadine Riedel *supra* note 22 at 111-12, see also Sol Picciotto, *supra* note 49 at 235.

Therefore, without effective regulation of the prices reported by MNC entities, it is obvious that the possibility of BEPS cannot be ruled out. There is widespread use of transfer pricing strategies for income shifting. On this, Baker notes: “I have never known a multinational, multibillion-dollar, multiproduct corporation that did not use fictitious transfer pricing in some part of its business to shift money between some of its entities”.⁶¹ In sum, MNCs place priority on profit maximization over their fiscal obligations to states where those profits are generated, hence the utilization of aggressive tax avoidance strategies through transfer pricing. The intricacies of the transfer pricing strategy as a cause of BEPS is discussed in the next subsection.

2.3.1 How Transfer Pricing Engenders BEPS

The preceding discussion highlights that MNCs engage in transfer pricing strategies to adjust their profits and losses across jurisdictions where they operate. The techniques utilized for this exercise are important to understand, beginning with what functions transfer pricing performs.

Transfer pricing performs two functions. First, it acts as a managerial tool for coordinating the production and sales decisions of different business segments of an MNC with the objective to enable a decentralized firm to achieve its full profit potential.⁶² Second, and relevant to the discussion in this chapter, is the fact that “transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life”.⁶³ The transfer pricing leading to BEPS concerns is best described as “transfer price manipulation or abusive transfer pricing”.⁶⁴

⁶¹ Raymond W. Baker, *Capitalism’s Achilles Heel: Dirty Money and How to Renew the Free-Market System* (New Jersey: John Wiley & Sons, 2005) at 30.

⁶² Moritz Hiemann & Stefan Reichelstein, “Transfer Pricing in Multinational Corporations: An Integrated Management- and Tax Perspective” in W. Schön and K.A. Konrad (eds.), *Fundamentals of International Transfer Pricing in Law and Economics*, (2012) MPI Studies in Tax Law and Public Finance at 1.

⁶³ Sikka & Willmott *supra* note 50 at 352.

⁶⁴ See Lorraine Eden, “Transfer Pricing Manipulation” *supra* note 26 at 205, 210.

As a strategy for BEPS, transfer pricing enables MNCs to tamper with real activities of their entities that occur across jurisdictions, to allocate profits/losses unilaterally across states so they can maximize after-tax profits.⁶⁵ Because of the legality of tax avoidance and the privilege afforded to MNCs to allocate profits across jurisdictions, it is possible for firms to adjust transfer prices in a tax-sensitive fashion without violating any laws.⁶⁶ Kleinbard notes that three transfer pricing strategies which MNCs engage to avoid taxes are cost sharing arrangements, aggressive contractual terms, and business opportunity.⁶⁷ He explains that many cost sharing arrangements are a strategic assignment by MNCs to their entities located in tax havens so that they may bear the responsibility of developing assets for the benefit of the MNC business. Once those assets are developed, the MNC entity licences them to affiliates for a charge usually “designed to reflect the potential value of a successful product in the EU, as compared to the rest of the world.”⁶⁸ Regarding the second transfer pricing strategy, aggressive contractual terms, especially for intangibles⁶⁹, Kleinbard explains: “In a world where licences of high-value internally-created intangibles have no observable market value and where the arm’s length principle itself fails to assign the synergies created by operating as a multinational enterprise, firms can be expected to adopt intragroup contractual terms that favour low-taxed affiliates.”⁷⁰ Lastly, Kleinbard points to the use of business opportunity strategies by MNCs. These are utilized by MNCs to strategically

⁶⁵ See L. W Copithorne, “International Corporate Transfer Prices and Government Policy” 4:3 1971 *The Canadian Journal of Economics*, 324-341 at 329, see also Hyde & Choe, “Keeping Two Sets of Books: The Relationship between Tax and Incentive Transfer Prices” *Journal of Economics & Management Strategy* (2005) 14:1 165-186.

⁶⁶ Desai et. Al, “The Demand for Tax Haven Operations” (2006) 90:3 *Journal of Public Economics* 513-531 at 515. More importantly, see the case of *IRC v. Duke of Westminster* [1935] All ER 259, a decision of the House of Lords permitting taxpayers to arrange their affairs in the most tax effective way to minimize their tax obligations. It is often cited by taxpayers as a defence against any challenge by tax authorities to their tax planning activities.

⁶⁷ Edward Kleinbard *Supra* note 17 at 733-7.

⁶⁸ Edward Kleinbard *Ibid* at 735. See also Yariv Brauner, “Cost Sharing and Acrobatics of Arm’s Length Transfer Pricing Taxation” (2000) *Intertax* 554 on the ingenious mechanism of “cost-sharing” through which MNCs avoid paying their fair share of taxes.

⁶⁹ Edward Kleinbard *supra* note 17 at 736.

⁷⁰ *Ibid*.

locate business entities where they are sure to be profitable and able to maximize their profits.⁷¹ The significance of these three transfer pricing strategies lies in the peculiarity of the chain of economic activities which take place within an MNC group. First, the MNC structure makes it difficult to ascertain the genuineness of the transfer prices fixed by MNC entities. Second, ownership of intangible assets by MNCs because of their level of profitability⁷² compel MNCs to expand their operations to other jurisdictions⁷³ including tax havens for profit maximization purposes.

The Russian arrangement fits best into the third type of transfer pricing strategy that Kleinbard identifies, namely, the use of business opportunities. This strategy is also reflected in the overvaluation of quoted prices on equipment, parts and raw materials, which is identified as another strategy for base erosion in China's automotive industry.⁷⁴ Aggressive contractual terms were used by Worldcom (before it went bankrupt) through "creative use of transfer pricing for a variety of trademarks, trade names, trade secrets, brands, service marks and intellectual property".⁷⁵ This strategy enabled Worldcom to create an intangible asset named "management foresight" which it licensed to its entity in a low-tax jurisdiction. This entity, in turn, licensed the asset to other affiliates for annual royalty payments. The anticipated tax savings from the use of this strategy was US\$25 million in the first year and US\$170 million over five years. Over the 1998-2001 fiscal years, over US\$20 billion accrued in royalties as payments, mostly for the intangible asset, which

⁷¹ *Ibid.*

⁷² Edward Kleinbard *supra* note 17 at 733-4

⁷³ See John (Yannis) Doukas, Christos Pantzalis, Sungsoo Kim, "Intangible Assets and the Network Structure of MNCs" (1999) 10:1 *Journal of International Financial Management & Accounting*, 1-23.

⁷⁴ Sikka and Willmott, *supra* note 50 at 14 citing Wang H. Policy reforms and foreign direct investment: the case of the Chinese automotive industry. 2003 Vol. VI no 1, *Journal of Economics and Business* (287 –314).

⁷⁵ *Ibid* at 21.

was estimated to have exceeded Worldcom's consolidated net income in each of the years 1998-2001, and in other cases, represented 80 to 90 percent of its subsidiary's net income.⁷⁶

Transfer mispricing is not restricted to developed countries. For instance, it was estimated that Papa New Guinea lost \$9-17 million or, as recently estimated, \$100 million⁷⁷ to transfer mispricing in its forestry sector.⁷⁸ Sikka and Willmott report that the underlying reasons behind this significant loss of revenue in Papua New Guinea was that: "logging companies are grossly understating the value of timber exported . . . timber exports are laundered through the overseas subsidiaries of companies exporting the timber. Importers buy the timber from the subsidiaries at much higher prices than those declared to the PNG [Papua New Guinea] tax office at the point of export".⁷⁹

Specifically, MNCs regularly engage in transfer mispricing of intangibles because their value is hard to ascertain.⁸⁰ Brauner notes the uniqueness of MNC intangibles, their significance to MNC business and governments, and the difficulties tax authorities face in valuing them.⁸¹ In regard to their importance to global trade, he observes: "Intangibles are not just important... they generate significant income for MNEs. Intangibles also generate significant benefits for governments, and such governments struggle with MNEs and between themselves over the taxing rights of the income generated by these intangibles".⁸²

⁷⁶ *Ibid.*

⁷⁷ *Ibid* at 17 citing Forest Trends. Logging, legality and livelihoods in Papua New Guinea: synthesis of official assessments of the large-scale logging industry, vol. 3. Washington, DC: Forest Trends; 2006.

⁷⁸ *Ibid* citing Hunt C. Production, privatisation and preservation in Papua New Guinea Forestry. London: International Institute for Environment and Development; 2002.

⁷⁹ *Ibid.*

⁸⁰ Douglas A. Shackelford et. al "A Unifying Model of How the Tax System and Generally Accepted Accounting Principles Affect Corporate Behavior" National Bureau of Economic Research, Working Paper 12873 (2007).

⁸¹ Yariv Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes" (2008) 28:1 Virginia Tax Review 79-164.

⁸² *Ibid* at 93, see also Jane G. Gravelle & J. Taylor, "Tax Neutrality and the Tax Treatment of Purchased Intangibles" (1992) 45 NAT'L TAX J. 77, 81 cited by Brauner.

In sum, the cost and efficiency benefits which MNCs derive from the discretion to independently fix prices on both tangible and intangibles account for the widespread use of transfer pricing strategies by these entities to lower their tax obligations. Concurrently, considering that MNC tax obligations depend on the amount they declare as “costs” and “expenses”, they are intently focused on utilizing transfer pricing strategies to lower their profits in high-tax countries. This way, they erode these countries’ tax bases.⁸³

2.4 Effect of BEPS on National Economies and Global Economy

The influence that MNCs have on national and global economies makes BEPS a serious cause of concern for states. UNCTAD reported in 2011 that MNCs’ production generated value-added of approximately \$16 trillion in 2010, estimated to be about a quarter of global GDP and one-third of world exports.⁸⁴ Particularly, intra-firm trade contributes significantly to the global economy. The OECD estimated in 2010, based on 2006 financial data, that related-party trade accounted for 7-12 per cent of world trade, and 8-15 per cent of OECD trade.⁸⁵ MNCs have global relevance; of the world’s top 100 economies, 69 are corporations.⁸⁶ Given the influence of MNCs from the statistics set out above, revenue loss from the BEPS activities of MNCs is one major consequence for states. The graph below from the IMF⁸⁷ reveals the percentage of corporate tax revenue received by countries from 1980-2012.

⁸³ Sikka & Willmott *supra* note 50 at 3.

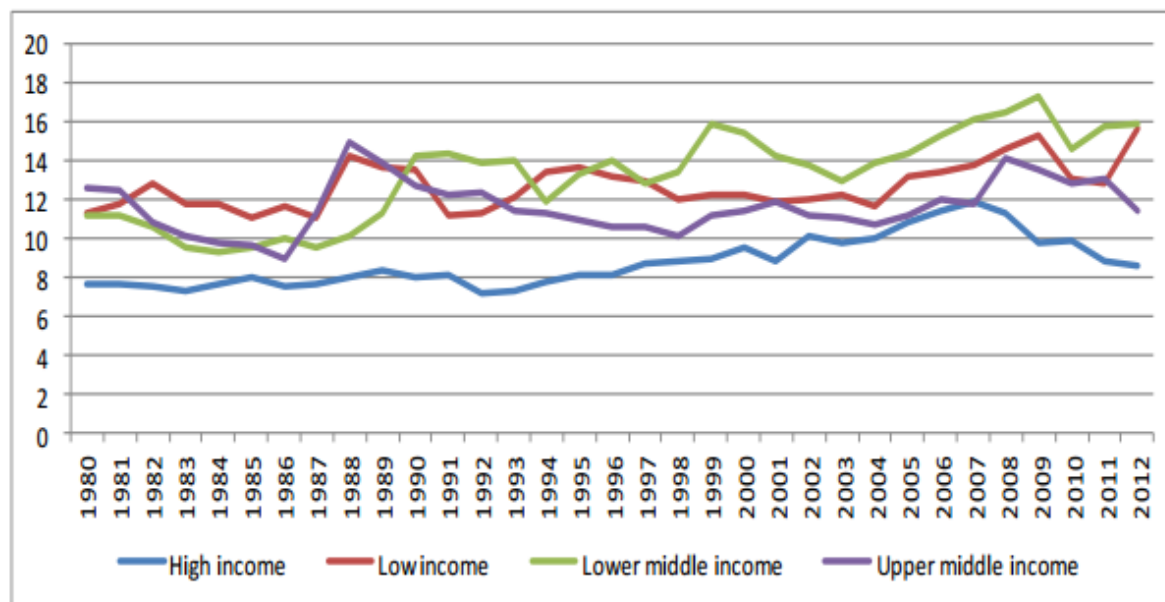
⁸⁴ UNCTAD, *Non-Equity Modes of International Production and Development* World Investment Report, (2011) at X.

⁸⁵ Lorraine Eden, *supra* note 26 at 205 citing OECD, “Intra-firm Trade: A Work in Progress.” Document STD/TBS/WPTGS (2010) 24 (September 8), Working Party on International Trade in Goods and Trade in Services Statistics, Statistics Directorate, OECD, Paris.

⁸⁶ The World Bank, “The World’s Top 100 Economies: 31 Countries; 69 Corporations: www.blogs.worldbank.org/publicsphere/world-s-top-100-economies-31-countries-69-corporations (last accessed 11th June 2017)

⁸⁷ IMF, “Spillovers in International Corporate Taxation” *supra* note 12 at 7.

Figure 1. Revenue from the Corporate Income Tax, in Percent of Total Revenue



Source: IMF Staff estimates; data from IMF's Fiscal Affairs Department database.

Note: Total tax revenue including grants and excluding social contributions; resource-rich countries excluded.

Although corporate income revenue forms a major source of revenue across jurisdictions,⁸⁸ BEPS has been a bane to increased revenue from corporate taxes. It is important to note, however, that there is no precision as to the amount of revenue which countries have lost to BEPS.⁸⁹ For instance, on the impact of transfer pricing manipulation on global revenue, Eden notes that the strongest and clearest evidence of transfer pricing manipulation comes from transaction-level studies of U.S. intra-firm import and export prices and from firm-level studies using Chinese tax data.⁹⁰ As far back as 1990, Hines and Rice, based on their research on US MNCs, found that offshore tax haven affiliates of US corporations account for more than a quarter of US foreign investment. They found that a quarter of US investment and a third of US foreign profits are locked out overseas.⁹¹ However, they did not attempt to determine the resulting tax revenue loss from the US.

⁸⁸ UNCTAD, *Reforming International Investment Governance*, World Investment Report (2015) at 183.

⁸⁹ Lorraine Eden *supra* note 26 at 205, see also Fuest & Riedel *supra* note 22 at 116-119.

⁹⁰ Lorraine Eden *supra* note 26.

⁹¹ James R. Hines, Jr., Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business" (1990)

As to direct evidence of the relationship between transfer mispricing, harmful tax competition by tax havens and BEPS, Clausing notes: “Intra-firm trade prices are likely influenced by the tax-minimization strategies of multinational firms...there is a strong and statistically significant relationship between a country’s tax rate and the prices of intrafirm imports and exports traded with that country”.⁹² Globally, Clausing estimated the amount lost to BEPS worldwide in 2012 to be in excess of US\$ 280 billion.⁹³ She also estimated the revenue lost to profit shifting by US-headquartered MNCs to the US government in 2008 as \$57 billion and \$90 billion⁹⁴. The figures increased in 2012 to US\$77 billion and US\$111 billion.⁹⁵ US MNCs which have been said to be responsible for revenue lost by the US government to profit shifting to tax havens are Apple⁹⁶, Google⁹⁷, and Starbucks⁹⁸. The OECD estimated the loss from BEPS as US\$100-240 billion

National Bureau Economic Research Working Paper No 3477.

⁹² Kimberly A. Clausing, “Tax-Motivated Transfer Pricing and US Intrafirm Trade Prices” (2003) 87 *Journal of Public Economics* 2207–2223 at 2222.

⁹³ Kimberly A. Clausing, “The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond” (2016) 69:4 *National Tax Journal*, 905-34 at 906.

⁹⁴ See Kimberly A. Clausing, “The Revenue Effects of Multinational Firm Income Shifting,” *Tax Notes*, March 28, 2011 available at SSRN: < www.ssrn.com/abstract=2488860> pp. 1580-1586 at 1580 ; and Kimberly A. Clausing, “Multinational Firm Tax Avoidance and Tax Policy,” (2009) 62: 4 *National Tax Journal* 703-725.

⁹⁵ *Supra* note 93 at 931.

⁹⁶ Keightley *supra* note 84 at 2 citing Charles Duhigg and David Kocieniewski, “How Apple Sidesteps Billions in Taxes,” *The New York Times*, April 28, 2012, p. A1 : < www.pulitzer.lamptest.columbia.edu/files/2013/explanatory-reporting/04ieconomy4-29.pdf> .

⁹⁷ Keightley *ibid* citing Jesse Drucker, “Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes,” *Bloomberg*, October 21, 2010, <www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-taxloopholes.html/> and Jess Drucker, “IRS Auditing How Google Shifted Profits Offshore to Avoid Taxes,” *Bloomberg*, October 13, 2011, <http://www.bloomberg.com/news/2011-10-13/irs-auditing-how-google-shifted-profits-offshore-toavoid-taxes.html>.

⁹⁸ Keightley *ibid* citing Dominic Rushe, “Starbucks Dismisses Tax Avoidance Claims,” *The Guardian*, November 1, 2012, www.guardian.co.uk/business/2012/nov/01/starbucks-dismisses-tax-avoidance-claims ; Patrick Wintour and Dan Milmo, “UK and Germany Agree Crackdown on Tax Loopholes for Multinationals,” *The Guardian*, November 5, 2012, www.guardian.co.uk/business/2012/nov/05/uk-germany-tax-loopholes-multinationals.

annually, about 4-10 per cent of global corporate income revenue.⁹⁹ Cobham and Jansky also estimate global revenue losses from BEPS as US\$500 billion annually.¹⁰⁰

In regard to the impact of BEPS on developing countries' economies, UNCTAD notes that developing countries lose \$100 billion annually to profit shifting to tax havens.¹⁰¹ Deplorably, UNCTAD notes that on average, across developing economies, every 10 percentage points of offshore investment is associated with a 1 percentage point lower rate of return *via* tax.¹⁰² The foregoing statistics reveals that there is no discrimination between states when it comes to BEPS. It is, however important to note that developed countries lose more tax revenue from it.¹⁰³ The following graphical representation indicates estimated BEPS losses to some major industrialized states.

⁹⁹ OECD, *Measuring and Monitoring BEPS, Action 11- 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, (2015) at 101.

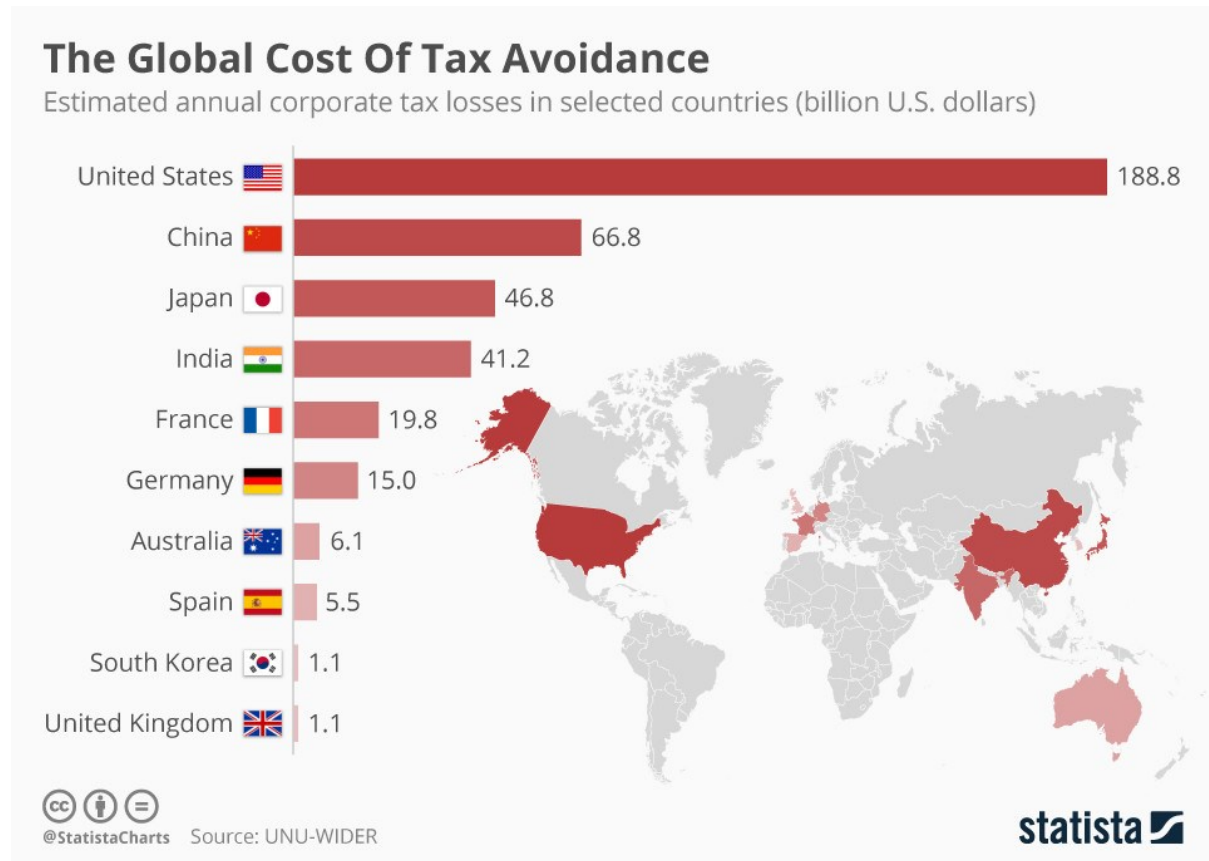
¹⁰⁰ Alex Cobham and Petr Jansky, "Global Distribution of Revenue Loss from Tax" United Nations University World Institute for Development Economics Research Working Paper 2017/55.

¹⁰¹ UNCTAD *supra* note 88 at 200.

¹⁰² *Ibid.*

¹⁰³ Statista, "The Global Cost of Tax Avoidance": www.statista.com/chart/8668/the-global-cost-of-tax-avoidance/ (last accessed 12 June 2017)

Figure 2: The Global Cost of Tax Avoidance



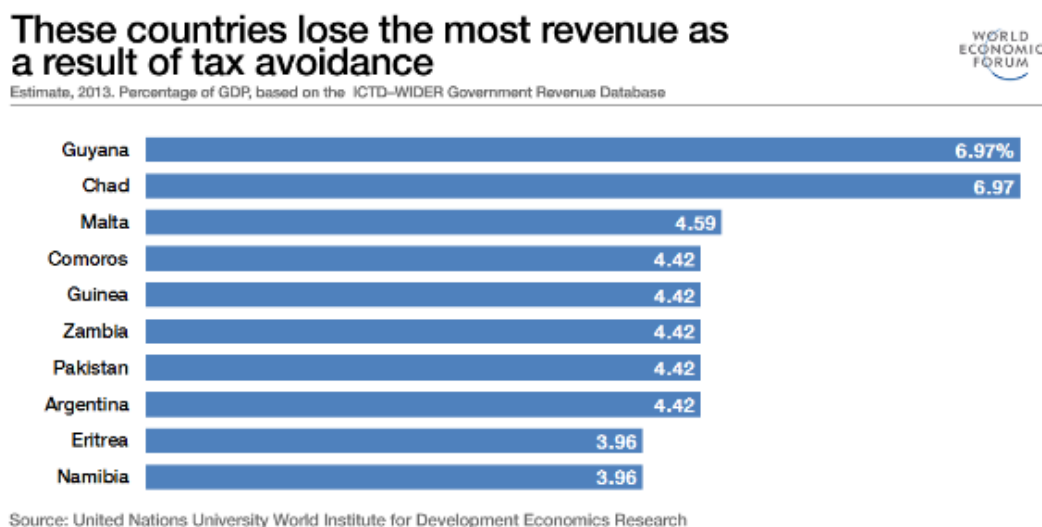
Source: Nial McCarthy, “The Global Cost of Tax Avoidance”, Statista (2014), online: <www.statista.com/chart/8668/the-global-cost-of-tax-avoidance/>

Although it appears that developed countries lose more revenue from BEPS, statistics show that lower income countries are affected worst when measured as a share of GDP. The IMF estimates that developing countries lose 1.3 per cent of their GDP to BEPS, compared to 1 per cent for developed countries.¹⁰⁴ According to an OECD official, Africa alone may be losing around \$250 billion each year to BEPS, estimated to be approximately 7 to 8 per cent of its GDP annually,

¹⁰⁴ Crivelli, Ruud De Mooij and Michael Keen, “Base Erosion, Profit Shifting and Developing Countries” (2015) IMF Working Paper WP/15/118 at 21.

through tax avoidance schemes.¹⁰⁵ Loss of revenue measured as a percentage of GDP reveals that low-income countries lose more from BEPS. The graph below illustrates this.

Figure 3: Countries that lose the Most Revenue as a Result of Tax Avoidance



Source: Joe Myers, “Which Countries are Worst Affected by Tax Avoidance”, World Economic Forum/United Nations World Institute for Development Economics Research, (2017), online: <www.weforum.org/agenda/2017/04/which-countries-are-worst-affected-by-tax-avoidance>

Overall, although the figures estimated to be the amount of revenue lost to BEPS in countries differ, the common ground is that both developed and developing countries lose revenue due them because of BEPS. However, because developing countries rely more on corporate income taxes, they are more affected by BEPS.¹⁰⁶

¹⁰⁵ Prem Sikka, “Smoke and Mirrors: Corporate Social Responsibility and Tax Avoidance” (2010) Centre for Global Accountability, University of Essex at 5-6 citing A statement by Jeffrey Owens (director of the Centre for Tax Policy Administration at the Organisation for Economic Cooperation and Development) on 28 November 2008; available at www.reuters.com/article/latestCrisis/idUSLS349361 (last accessed 12 June 2017)

¹⁰⁶ See UNCTAD *supra* note 88 at 183 for the analysis of corporate revenues to overall revenues for developed and developing countries.

2.5 Effect of BEPS on Fiscal Sovereignty

Sovereignty is an inalienable feature of statehood. One of its attributes is the state's ability to exercise control over its subjects.¹⁰⁷ There is a definite link between taxation and sovereignty. For instance, Michael Graetz observes: "No function is more at the core of government than its system of taxation".¹⁰⁸ Ring thinks tax sovereignty: "is a tool to achieve important missions of the democratic sovereign state: (1) the continued operation and existence of a functioning government (predicated on revenue and sustainable fiscal policy) and, (2) the accountability and legitimacy underpinning that democratic state".¹⁰⁹ Christians emphasizes that "to speak of tax sovereignty is generally to suggest that taxation is an inherent or essential component of sovereign status".¹¹⁰ Consequently, it is generally accepted that "sovereign status seems to include a right to tax in some form, so that infringing on the right of taxation is an infringement on sovereignty itself".¹¹¹

These affirmations of the importance of fiscal rights to states substantiate the international principle of "territorial integrity" contained in Article 2 of the Charter of the United Nations¹¹², particularly paragraph 4 which forbids states from undermining mutual "territorial integrity or

¹⁰⁷ See for instance the Island of Palmas case (Netherlands/U.S.A) : < http://legal.un.org/riaa/cases/vol_II/829-871.pdf> an arbitration award of the Tribunal of the League of Nations (now the United Nations) which involved a dispute between Netherlands and the U.S.A relating to claims of sovereignty over the Island of Palmas (or Miangas) by the two countries. The Tribunal at 838-839 held as follows: "Sovereignty in the relations between states signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other state, the functions of a state. Territorial sovereignty ...involves the exclusive right to display the activities of a state". see also Robert Jackson, "Sovereignty in World Politics: A Glance at the Conceptual and Historical Landscape", (1999) 47:431 POL. STUD. 431, 449-54 for a discussion of the importance of sovereignty as an indicium of statehood.

¹⁰⁸ Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies", (2001) Yale Law Faculty Scholarship Series Paper 261-336 at 277.

¹⁰⁹ Dianne Ring, "Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation" (2009) 9 Florida Tax Review 555-596 at 559.

¹¹⁰ Allison Christians "Sovereignty, Taxation and Social Contract" (2009) 18:1 MINN. J. INT'L L 99-153 at 104. See also Dianne Ring *ibid*.

¹¹¹ *Ibid* at 108.

¹¹² *Charter of the United Nations*, 26 June 1945, Can TS 1945 No 7.

political independence ... in any manner inconsistent with the purposes of the United Nations”. Thus, to the extent that BEPS prevents states from exercising their rights to levy taxes on profits derived within their jurisdictions, either as source or residence countries, it is safe to conclude that tax havens undermine the fiscal rights of states and, in this sense, their political independence as a function of entitlement to tax MNC profits that are generated within their jurisdiction. Put another way, tax havens infringe on the fiscal rights of states because they deny states with genuine links to MNC profits the right to tax them. This situation emasculates the desideratum that a tax system should have effective control over the various elements of its tax base.¹¹³ The fiscal rights of states are impeded when profits made within their jurisdictions, and ought to be taxed therein, are reported by another MNC entity located in tax havens with insignificant links to the activities which generated the profits in issue. The outcome is that states are unable to utilize fiscal policies to fulfil the goals of taxation, which are: to raise revenue to provide public goods and other government activities; to redistribute income and wealth according to the collective conception of justice; and to smooth the economic cycle or stabilize economic conditions.¹¹⁴

It bears re-emphasizing that to the extent that the activities of tax havens promote BEPS, they are inconsistent with the purposes of the United Nations. The United Nations Charter, in chapter 1, expresses its purposes and principles as the need for states to cooperatively promote and maintain international peace and to respect the fundamental rights of all people.¹¹⁵ The Charter identifies

¹¹³ Peter Dietsch & Thomas Rixen *supra* note 14 at 64.

¹¹⁴ Peter Dietsch, “Tax Competition and its Effects on Domestic and Global Justice” in Ayelet Banai, Miriam Ronzoni, and Christian Schemmel, eds, *Social Justice Global Dynamics: Theoretical and Empirical Perspectives* (New York: Routledge, 2011) 95 at 97; see also Peter Dietsch & Thomas Rixen “Redistribution, Globalisation, and Multi-Level Governance” *supra* note 14 at 63.

¹¹⁵ *Supra* note 112, see Article 1 generally.

that these goals can be reached through observing guiding principles of peace, justice, respect, cooperation and harmonization.¹¹⁶

Arguably, as a matter of international law, the duty of states to respect each other's rights extends to fiscal rights. The Arbitration Tribunal of the United Nations pointed this out when it held in the *Island of Palmas*¹¹⁷ case that: "Territorial integrity...has as a corollary duty: the obligation to protect within the territory the rights of other states, ... together with the rights which each state may claim for its nationals in foreign territory. Without manifesting its territorial sovereignty in a manner corresponding to circumstances, the state cannot fulfil this duty".¹¹⁸ These broad principles emphasize, in particular, reciprocal protection of sovereign interests. This obligation is directly violated by the activities of tax havens which encourage BEPS. Fiscal sovereignty transcends any justification for harmful tax competition practices. On the contrary, it demands fiscal coordination among states which can only be possible when states respect the fiscal policies of others.¹¹⁹ This form of coordination becomes possible through the unilateral implementation of the principles of peace, justice, respect, and harmonization, ideals established by the League of Nations as the hallmarks of statehood as far back as 1945.¹²⁰ The enjoyment of fiscal rights by each state requires mutual respect for sovereignty translated as mutual protection for the right of a state to tax or not to tax.¹²¹

Contrary to the foregoing, tax havens defend their BEPS policies and activities. They "resist efforts to change harmful tax practices on the ground that these practices are valuable from their sovereign

¹¹⁶ *Ibid.*

¹¹⁷ *Supra* note 107.

¹¹⁸ *Ibid.*

¹¹⁹ Peter Dietsch, "Rethinking Sovereignty in International Fiscal Policy" (2011) 37:5 *Review of International Studies Journal* 2107-2120 at 2118 See also Allison Christian *supra* 110 at 102.

¹²⁰ *Supra* note 112.

¹²¹ Allison Christians *supra* note 110 at 111.

perspective (even if potentially inefficient globally)".¹²² Ring tells us that: advocates for competition identify not only the potential benefits of broad competition by tax systems but also their inherent rights as sovereign states to design and utilize their tax systems to best support their state.¹²³ However, as argued earlier, the notion that states are independent and free to design their policies without considering the effects that they have on other states does not apply in international taxation. On this issue, Christians rightly observes that:

Thus if tax sovereignty means anything, perhaps it is the idea that governments have a non-exclusive right to decide through political means whether and how to tax whatever activity occurs within their territories and whomever can be considered to be their "people," and that they recognize a reciprocal right in all other states. This duty for states to respect the fiscal rights of others is embedded in the international law principle of comity and reciprocity.¹²⁴

Highlighting the importance of cooperation by all states as a necessary requirement in international taxation, Ring again notes that: "The stereotyped concept of a sovereign state as independent from all external forces and in complete control domestically, has been a fiction, and certainly is not theoretically required today".¹²⁵

In sum, BEPS poses a threat to the fundamental right of states to exercise their fiscal rights. Fiscal rights are what gives power to governments to fulfil their mandates, and can best be described as the core of governance. Undermining this mandate brings to the fore other consequences that BEPS produces. It is a major reason why states must collaborate to design an efficient and lasting framework to eradicate BEPS because no society can function well without effective governance founded on effective taxation as a core aspect of fiscal policy. The discussion in section 2.6

¹²² Dianne Ring *supra* note 109 at 574.

¹²³ *Ibid* at 575.

¹²⁴ Allison Christians *supra* note 110 at 110-111.

¹²⁵ Dianne Ring *supra* note 109 at 589.

discusses how BEPS infringes upon the need for fairness in taxation and revenue allocation between and across jurisdictions.

2.6 Effect of BEPS on the Notion of “Tax Justice”

The term “justice” has widespread usage. According to Rawls, “Justice is the first virtue of social institutions, as truth is of systems of thought”.¹²⁶ When seeking redress for a wrong done to their clients, lawyers seek justice in court, which, presumably, must administer the law to achieve justice. Citizens seek justice against repressive rule, so do they against discriminatory policies and laws.

International tax justice theorists argue against the injustice/unfairness attached to BEPS.¹²⁷ In terms of international taxation, the term “justice” can be used to describe the unfairness of international/national taxation rules which encourage the aggressive tax planning activities of MNCs and fiscal policies and activities of tax havens which promote BEPS. This unfairness/injustice creates two fundamental consequences. First is the erosion of revenue from source countries, which can be the country of residence of an MNC, or the country where the economic activities that produce the profits in question occurred, or both. Second is the unfairness which BEPS foists on other taxpayers who pay their fair share of taxes and must bear a greater tax burden to make up for the revenue that is lost to BEPS.

¹²⁶ John Rawls, *The Theory of Justice* (United States of America: Harvard University Press, 1999) at 1

¹²⁷ See for instance Zorka Milin, “Global Tax Justice and the Resource Curse: What do Corporations Owe” (2014) 1:1 *Moral Philosophy and Politics Journal*, 17-36; Gillian Brock and Thomas Pogge, “Global Tax Justice and Global Justice” (2014) 1:1 *MOPP* 1-15; Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (New York: Oxford University Press, 2015); Peter Dietsch and Thomas Rixen, “Redistribution, Globalization, and Multi-Level Governance” (2014) *MOPP* 1:1 61-81 (2014) 1:1 61-81.

2.6.1 The Injustice/Unfairness BEPS Creates for States

As discussed above, justice in international taxation translates to the ability of states to achieve policy goals by means of taxation,¹²⁸ that is, states that have invested their resources in ways that assist MNC profit generation being entitled to their due returns in the form of taxes. It is this situation that tax justice attacks. Tax justice does not imply that states be equally affluent, as Apeldoorn argues,¹²⁹ but that they can interact justly under certain conditions. As Apeldoorn says: “It does not require the global distribution of individual advantages to conform to some principle of distributive justice, but rather that all states have the capacity to secure a just distribution of advantages between their citizens.”¹³⁰

For the purposes of taxing MNC profits, states can only interact justly when they implement fiscal policies which respect the entitlements of source countries to tax MNC profits in deserving circumstances. These circumstances would be the existence of significant ties to the profits in question, specifically the fact that the economic activities which resulted in the profits being taxed occurred either wholly or partly within their jurisdictions. Dietsch uses the phrase “legitimate tax policy” to describe how the fiscal policies of states create unfairness/injustice for other states. He states: “A tax policy is legitimate if it does not produce a collectively suboptimal outcome. A collectively suboptimal outcome is here defined as one where the aggregate extent of fiscal self-determination of states is reduced”.¹³¹

¹²⁸ See Laurens Val Apeldoorn, “BEPS, Tax Sovereignty and Global Justice”, (2016) *Critical Review of International Social and Political Philosophy Journal* at 2.

¹²⁹ *Ibid* at 4.

¹³⁰ *Ibid* citing Ronzoni, M., 2009. “The global order: a case of background justice? A practice-dependent account” *Philosophy and public affairs*, 37 (3), 229–256; Ronzoni, M., 2012. “Two conceptions of state sovereignty and their implications for global institutional design” *Critical review of international social and political philosophy*, 15 (5), 573–591.

¹³¹ Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (New York: Oxford University Press, 2015) at 95.

The notion of inter-nation equity argues against BEPS in terms of the effect it has on states. The principle deals with international revenue sharing among states. Musgrave notes that “international revenue sharing, as an aspect of the taxation of foreign investment, is a matter of inter-nation equity...”¹³² Musgrave thinks that states can share this revenue as follows: “A country is expected to share in the gains of foreign-owned factors of production operating within its borders, gains that are generated in cooperation with its own inputs, whether they be natural resources, an educated or low-cost workforce, or proximity to a market.”¹³³ In her view, the equitable distribution of tax ensures that countries are able to claim tax revenue in proportion to the budgetary services and intermediate goods which they provide to the foreign investment.¹³⁴ This principle, as Musgrave explains, bears some relation to the benefit principle and will ensure that taxes are allocated to countries in proportion to the value added to the final product in each country.¹³⁵

Harmful tax competition, that is, the use of fiscal incentives by states to “lure” mobile capital that is derived in other jurisdictions, is therefore an infraction of the inter-nation equity principle.¹³⁶ On the international scene, injustice is perpetrated when countries which contribute to economic activities producing multinational profits are prevented from taxing them, while countries which

¹³² Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge: Law School of Harvard University, 1969) at 130

¹³³ Peggy Musgrave, “Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World,” in Inge Kaul and Pedro Conceicao, eds, *The New Public Finance Responding to Global Challenges* (Oxford University Press 2006) 167 at 192.

¹³⁴ Peggy B. Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (1963, John Hopkins Press, Baltimore) at 15.

¹³⁵ *Ibid* at 26-7.

¹³⁶ See Laurens Val Apeldoorn *supra* note 128 for a contrary view that harmful tax competition is the use of fiscal incentives to lure both FDI and mobile capital but see Peter Dietsch & Thomas Rixen *supra* note 13 at 73 where they state that competition for FDI, that is, “luring” MNCs to invest can only be considered illegitimate/ harmful if it is strategically motivated and leads to a reduction in the aggregate level of fiscal self-determination of other states.

contribute little or nothing to economic activities which generate such profits, namely, tax havens, can keep them as an exercise of their fiscal independence.

Lastly, taking into consideration the fact that developing countries suffer more from BEPS in terms of revenue loss, as established in section 2.4, it is safe to conclude that they are also the worst affected by the tax injustice associated with BEPS. This conclusion is reinforced by the substantial tax administration challenges that exist in developing countries which incapacitate them to detect and combat BEPS, unlike developed countries.¹³⁷ To crown it all, developing countries, in a bid to be part of the international taxation table, resort to the grant of tax incentives as a fall-back option to attract foreign direct investment. Even though they do this at a loss¹³⁸, they hold on to this approach as the only way to get a slice from the large chunk of multinational corporation profits.

2.6.2 The Injustice/Unfairness BEPS Creates for Taxpayers other than MNCs

Tax justice implies that appropriate taxes are paid on profits where they are earned and that states utilize the revenue collected to promote the conception of the scheme of social justice that has been chosen through their particular democratic processes.¹³⁹ Social justice includes, first, the obligation on all taxpayers, irrespective of their status, to pay their fair share of taxes in states where their profits/income are generated, and second, the ability to use taxation to achieve social objectives, such as balancing the gap between the rich and the poor for equality purposes.

¹³⁷ Peter Dietsch *supra* note 114 at 106-108.

¹³⁸ See for instance Action Aid Report, which states that three West African Countries, Ghana, Nigeria and Senegal are losing up to \$5.8 billion a year to corporate tax incentives “The West African Giveaway: Use & Abuse of Corporate Tax Incentives in ECOWAS” :

www.actionaid.org/sites/files/actionaid/the_west_african_giveaway_2.pdf> (last accessed 12 June 2017)

¹³⁹ Peter Dietsch and Thomas Rixen *supra* note 14 at 62.

The principle of “inter-individual equity” summarizes the expectation that taxpayers pay their fair share of taxes.¹⁴⁰ For source and residence countries, this principle states that taxpayers with equal income pay the same amount of tax, regardless of the source of their income.¹⁴¹ Also, this principle suggests that individuals who benefit equally from government, including non-residents, should contribute to the host country’s cost of governance.¹⁴² The inter-individual equity principle is used to determine the relative benefits and burdens of different individuals and groups in the society.¹⁴³ This principle can be equated to the principle of “horizontal equity” when MNCs are equally situated with other taxpayers. The fundamental taxation principle of “horizontal equity” requires that similarly situated taxpayers face similar tax burdens.¹⁴⁴ The avoidance of taxation by MNCs through BEPS activities is a violation of these two significant principles. Elkins argues that violation of the principle of “horizontal equity” is not fatal, but that it causes a serious flaw in any proposed tax arrangement. However, given that BEPS creates severe consequences in terms of revenue loss, and creates disparities between MNCs and other taxpayers when they are equally situated, Elkins’ view that horizontal inequity in taxation is not fatal is highly questionable. The OECD, evidenced in the graph below, exposes the distortions in national taxation occasioned by inappropriate taxes paid by MNCs on profits derived from their global activities:

¹⁴⁰ Nancy Kaufman, “Fairness and the Taxation of International Income” 29:2 *Law & Pol’y Int’l Bus.* 145 (1997-1998) pp.145-203 at 153.

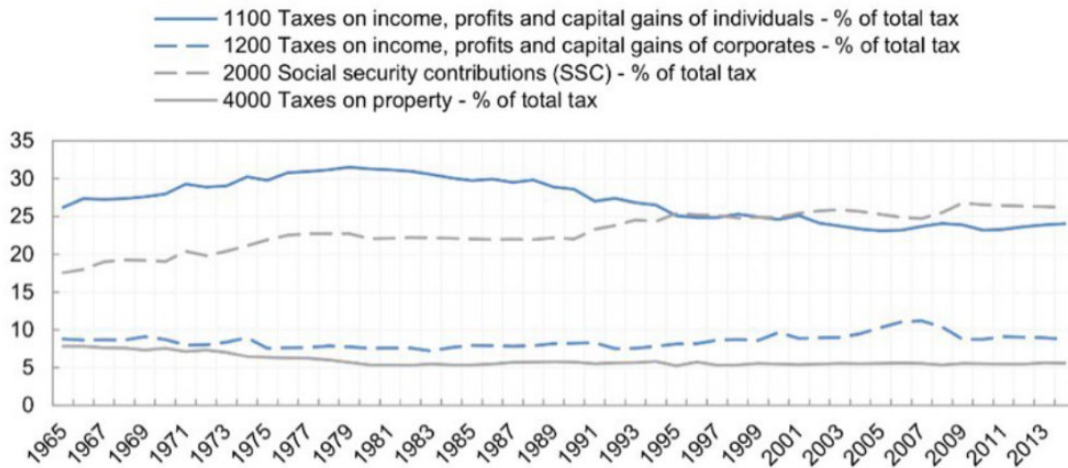
¹⁴¹ Peggy Musgrave *supra* note 132 at 170-1; see also See Jinyan Li, “Improving Inter-nation Equity” in Arthur J. Cockfield, ed, *Globalization and Its Tax Discontents: Tax Policy and International Investments* (London: University of Toronto Press, 2010) at 119.

¹⁴² *Ibid.*

¹⁴³ *Ibid.*

¹⁴⁴ David Elkins, “Horizontal Equity as a Principle of Tax Theory” (2006) 24:1 *Yale Law & Policy Review* 43-90 at 43.

Figure 4: OECD Revenue Statistics



Source: OECD Revenue Statistics 2016



Source: OECD (2016), Revenue Statistics 2016, OECD Publishing.

The graph reveals that there is imbalance in tax revenues as between private individual and corporate taxpayers, although there are no statistics showing that these sets of taxpayers are similarly situated. If they are, the outcome of this situation is regressive tax systems, the situation whereby states broaden their tax bases to make up for lost revenue by shifting focus from capital, which is capable of being moved offshore, to labour, which is immobile, and to indirect taxes, such as consumption tax. Dietsch submits that developed countries have been successful in stabilizing their economies through this approach, but not without the consequence of inequality which regressive tax systems foist on other taxpayers.¹⁴⁵ He concludes that one way to assess this development, “is to say that OECD countries have bought fiscal stability in terms of revenue at

¹⁴⁵ Peter Dietsch *supra* note 131 at 48 citing Organization for Economic Cooperation and Development (OECD), *Divided we Stand: Why Inequality Keep Rising* (Paris: OECD Publishing 2011).

the cost of a less redistributive system.”¹⁴⁶ In contrast, developing countries are unable to stabilize their economies through this approach because they lack the administrative resources to do so.¹⁴⁷

The fiscal rights of states entail their ability to rely on the redistributive functionality of fiscal policies to balance the circumstances of taxpayers to ensure that each one pays fair taxes, but not more than each ought to pay. Therefore, to the extent that BEPS impedes this national right, it threatens the redistributive functionality of taxation to achieve tax justice in each adversely affected state.

In sum, BEPS deprives countries which have legitimate claims over multinational profits the right to tax them, thus violating inter-nation equity. It also weakens the redistributive capacity of states by which to secure equality within their jurisdictions through fiscal policies which promote progressive tax systems. This latter consequence violates the inter-individual equity principle.

2.7 Conclusion

In conclusion, the discussion above reveals two important root causes of BEPS: transfer pricing by MNCs and the activities of tax havens. The discussion notes that to understand BEPS, a distinction must be made between “harmful tax competition” or “virtual tax competition” as the cause of BEPS, and “unharmful tax competition” or “actual tax competition” which states may use to attract foreign direct investment. The emphasis of the discussion is the severity of the consequences which BEPS causes to states, namely, huge revenue loss, infringement of their fundamental fiscal rights, and the injustice attached to the denial of tax revenue due them. Closely associated with this is the unfairness and increased tax burden which the BEPS activities of MNCs

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*

foist on other taxpayers. The phenomenon also has deleterious consequences for future national tax systems, given that developed countries shift towards regressive tax systems, and developing countries operate at a loss from the grant of fiscal incentives.

Having discussed the magnitude of the BEPS problem in this chapter, the next chapter examines the solutions that were earlier proposed by the OECD and the UN, namely, the OECD's Harmful Tax Competition Report of 1998 and the OECD and UN's Transfer Pricing Guidelines.

Chapter 3

The OECD and the UN's Anti-BEPS Initiatives: An Assessment

3.0 Introduction

The severity of the consequences attached to BEPS mainly because of the unhealthy fiscal practices by tax havens and transfer mispricing by some MNCs are explained in Chapter 2. Chapter 3 examines the gaps in the OECD harmful tax competition reports that hinder the global fight against BEPS, and transfer mispricing by MNCs. The issues pursued by this Chapter are premised on the understanding that MNCs leverage the integrated nature of their businesses to manipulate transfer prices, and to transfer profits from source countries to tax havens where they benefit from lax fiscal regimes. This Chapter examines the OECD's work on harmful tax competition through the three reports it issued in 1998¹, 2000² and 2004³ and the harmful tax practices in which states engage.

This Chapter also examines the efficiency of the arm's length principle, which is designed to regulate transfer prices fixed by MNC entities as contained under Article 9 of both the Organization for Economic Co-operation and Development (OECD)⁴ and the United Nations (UN) Double Taxation Conventions.⁵ Altogether, this Chapter examines the potential of the OECD Reports on harmful tax practices to proscribe harmful tax practices and the arm's length principle to counteract transfer mispricing by MNCs. The conclusion the discussion draws is that these two

¹ OECD (1998), *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing, Paris.

² OECD (2000) *Towards Global Tax Co-operation*, Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices.

³ OECD (2004) *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report*.

⁴ OECD (2015), *OECD Double Taxation Convention on Income and on Capital 2014*, OECD Publishing, Paris.

⁵ *UN Model Double Taxation Convention between Developed and Developing Countries, 2011*.

initiatives are flawed, which explains why harmful tax practices and transfer mispricing remain a challenge to states.

This chapter is broadly divided into two sections. The first section covering 3.1 and 3.2 reviews the OECD's efforts to control harmful tax practices that states engage in and which encourage BEPS. The second section, covering 3.3 to 3.6 examines the activities of the League of Nations, the OECD and the UN regarding the arm's length principle as a regulatory mechanism for transfer pricing. More specifically, Sections 3.1 and 3.2 assess the OECD's work on harmful tax competition. Section 3.1 reviews the 1998, 2000 and 2004 OECD reports on harmful tax practices by tax havens and preferential tax regimes, and Section 3.2 assesses the core provisions of these reports as per the OECD's objective to proscribe harmful tax practices. The assessment establishes that the OECD's work on harmful tax practices is fraught with significant inadequacies and this explains why states still engage in harmful tax practices. Section 3.3 discusses the evolution of the arm's length principle through the work of the League on the separate entity principle. Section 3.4 reviews the development of the arm's length principle under the OECD's Double Taxation Convention, and Section 3.5 examines the arm's length principle under the UN Model Double Taxation Convention. The overall assessment of the principle in Section 3.6 highlights its gaps that leave opportunities for transfer mispricing. In conclusion, Section 3.7 highlights the findings of the discussion, in particular, that the efforts of the OECD and the UN have failed to ameliorate BEPS.

The arm's length principle emerged from national efforts to harmonize fiscal laws bordering on taxation of MNCs. This harmonization began in the 20th century through the work of the League of Nations (the League). The League's work focused on the allocation rules to govern how states

share the profits from cross-border trade activities for tax purposes.⁶ The objective of the harmonization was to divide MNC profits among states so as to prevent international double taxation and to encourage free flow of capital.⁷ This approach led to the adoption of the “separate entity principle”, which determines the yardstick for the allocation of taxing rights among states summarized under the broader principle of “economic allegiance”.⁸ The principle of economic allegiance embodies the right of source countries to levy income taxes on the profits of affiliates or permanent establishments of non-resident MNCs produced in their jurisdictions.⁹

In 1933, the separate entity principle was extended by the League to address issues surrounding how the combined profits of an MNC may be apportioned to PEs and affiliates and how states were to tax such profits.¹⁰ It is this separate entity principle that the OECD modified and included in Article 9 of its Double Taxation Convention, first adopted in 1963. The principle was subsequently revised in 1977, 2010 and 2014¹¹ as the “arm’s length principle” and designed to regulate transfer prices fixed by non-arm’s length parties. In 1979, the UN copied the OECD’s arm’s length principle and included it in Article 9 of its Double Taxation Convention.¹² Both Double Taxation Conventions, and nearly all double taxation treaties, maintain the arm’s length principle as the standard by which to regulate transfer prices for transactions by non-arm’s length

⁶ See generally Sol Piccotio, *International Business Taxation: A Study in the Internationalization of Business Regulation* (United Kingdom: Cambridge University Press, 2013) at 1- 37 for the history of harmonization of national fiscal laws.

⁷ See the Report on Double Taxation submitted by Professors Bruins, Einaudi, Seligman and Adams (the four experts tasked by the League of Nations in 1921 to study and report on the economic consequences of international double taxation) to the Financial Committee Economic and Financial Commission of the League of Nations by the Experts, Document E.F.S.73. F.19 (April 5th 1923) — Volume 4 Section 1: League of Nations report of the Fiscal Committee of the League of Nations: www.adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;collection=:database=:query=:brand=default (last accessed July 12 2017).

⁸ *Ibid* at 20-29.

⁹ *Ibid* at 24-25.

¹⁰ League of Nations: Fiscal Committee (1933) Report to the Council on the Fourth Session of the Committee *infra* note 54.

¹¹ *Supra* note 4.

¹² *Supra* note 5.

parties to prevent transfer pricing manipulation or abusive transfer pricing.¹³ In addition, both the OECD and the UN have issued guidance on transfer pricing.¹⁴ This is intended to guide MNCs when they fix transfer prices, and tax administrators when they examine the appropriateness of the transfer prices fixed by MNCs.

3.1 The OECD and Harmful Tax Competition

The OECD's work on harmful tax competition focuses on curbing BEPS promotion through the fiscal policies and laws of member and non-member countries. In 1998, the OECD issued a Report titled "Harmful Tax Competition: An Emerging Global Issue."¹⁵ It classified harmful tax competition into two categories: tax havens and preferential tax regimes.¹⁶ Tax havens are defined as states with the following features: no or nominal income taxes and at least one of three characteristics: lack of effective exchange of information, lack of transparency, and lack of substantial activities by taxpayers.¹⁷ It identified preferential tax regimes as states with the following features: a no or low tax rate and at least one of the following: ring fencing, lack of transparency, and lack of effective exchange of information.¹⁸ The Report provides a distinction between tax havens and harmful tax preferential regimes. It points out that tax havens are "countries that are able to finance their public services with no or nominal income taxes, and that offer themselves as places to be used by non-residents to escape tax in their countries of

¹³ Michael Lang, *Introduction to the Law of Double Taxation Conventions*, 2nd ed. (The Netherlands: IBFD, 2013) at 146.

¹⁴ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris; United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, Department of Social Affairs, United Nations, New York, 2017.

¹⁵ *Supra* note 1.

¹⁶ *Ibid.*

¹⁷ *Ibid* at 22-3.

¹⁸ *Ibid* at 26-8.

residence”.¹⁹ It describes potentially harmful preferential tax regimes as “countries that raise significant revenues from their income tax but whose tax system has features constituting harmful tax competition”.²⁰ Although the report did create a distinction between tax havens and preferential tax regimes, the common denominator between these two is the presence of harmful tax practices that erode the tax base of other countries.

The Report focused on how harmful tax practices within states, in relation to geographically mobile activities such as financial and other service activities, that erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and generally broad social acceptance of tax systems.²¹ Throughout the report, the OECD identified the role that transparency and tax information exchange between member countries would play in fighting BEPS.

In 2000, the OECD released a list of forty-seven member countries with harmful tax practices, which it planned to include in its list of uncooperative tax havens unless they agreed to eliminate harmful features from their laws.²² The OECD also listed thirty countries as tax havens in its 2000 report.²³ Eventually, it included just seven countries in its list of uncooperative tax havens in 2002 because other countries that it initially identified as preferential tax regimes had given political commitments to eliminate harmful tax practices within their jurisdictions.²⁴ The OECD’s list of tax havens had shrunk to three countries by 2009 when they were eventually removed because of their political commitments to implement the OECD standards of transparency and effective

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ *Ibid* at 8 paragraph 4.

²² OECD *supra* note 2.

²³ *Ibid.*

²⁴ OECD, List of Uncooperative Tax Havens: www.oecd.org/countries/monaco/listofunco-operativetaxhavens.htm (last accessed 13 July 2017).

exchange of information²⁵ The OECD's Global Forum on Transparency and Exchange of Information continues to build on these reports to monitor the extent to which member states abide by their commitments to eliminate harmful tax practices.²⁶ The 1998 Report, on the provisions of which subsequent reports on harmful tax competition are based, is now considered more fully.

3.2 The OECD's 1998 Report on Harmful Tax Competition

Attempts by the OECD to prevent harmful tax practices by states ought to be commended, however, its efforts carry some fundamental defects. The Report is flawed on two grounds: internally, for ambiguity, and externally on the grounds of legitimacy, objectivity, and misplaced priorities.

First, the Report does not clearly describe tax havens, nor does it provide guidance on indicators it gave concerning the activities of states deemed to be tax havens.²⁷ For instance, although the Report mentioned "no substantial activity" as a qualifier of tax havens, the degree of such activity is not prescribed.²⁸ The same applies to "nominal tax rate", one of the features of tax havens highlighted by the OECD in its description of the activities of tax havens.²⁹ As well, the OECD does not specify the degree of the "sufficient amount of revenue" that a country is to receive from income tax that would qualify it as a preferential tax regime instead of a tax haven or even qualify that state as a preferential tax regime in the first instance.³⁰ These gaps lead one to conclude that the OECD's lists of tax havens and preferential tax regimes are, at best, subjective.³¹ They leave

²⁵ *Ibid.*

²⁶ OECD, Global Forum on Transparency and Exchange of Information: www.oecd.org/tax/transparency/ (last accessed 13 July 2017)

²⁷ *Supra* note 18.

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ Alexander Townsend, Jr, "The Global Schoolyard Bully: The Organisation for Economic Co-operation and

the credibility of the Report in doubt in terms of its objective commitment to curbing harmful tax practices.

More importantly is the issue of legitimacy of the OECD in its effort to eradicate BEPS globally. From a legal perspective, the OECD's efforts to proscribe the harmful tax practices of tax havens over-reach its powers.³² The Report asks states to proscribe the fiscal regimes of others. This undermines international comity, as such matters are normally handled through taxation treaties.³³ The coercive nature of the report is evident in the sanctions declared to follow upon a country ignoring its recommendations.³⁴ Townsend declares that the absence of negotiation in the processes that culminated in the Report usurps the fiscal right of states.³⁵ Although the harmful tax practices of tax havens are, in themselves, a breach of the fiscal right of other states, those practices cannot be counteracted by issuing prescriptive norms and coercing states to design their fiscal regimes as recommended.³⁶ Overall, the OECD's approach via its earlier reports contradicts relevant principles of international law. Cooperation is essential when it comes to harmonization of fiscal laws. This factor is also strong enough to nullify the OECD's earlier work on harmful tax competition.

Development's Coercive Efforts to Control Tax Competition (2001) *Fordham International Law Journal* 25:1 at 256; see also Javier G. Salinas, "The OECD Tax Competition Initiative: A Critique of its Merits in the Global Market Place" (2003) 25:3 *Houston Journal of International Law* at 555.

³² See generally Diane M. Ring. "Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation." (2009) *Florida Tax Review* 9, 555-596 for a discussion of the importance of cooperation in harmonization of fiscal laws.

³³ Eyal Benvenisti, "*Exit and Voice in the Age of Globalization*", (1999) 98 *MICH. L. REV.* 167, 167-68; see also Townsend *supra* note 31 at 251; Javier G. Salinas, *supra* note 31 at 555.

³⁴ See the 1998 Report note 1 at 158-61; and the 2000 Report *supra* note 2 at 36.

³⁵ Townsend *supra* note 31 at 252-4.

³⁶ Rutsel Silvestre J. Martha, *The Jurisdiction to Tax in International Theory and Practice of Legislative Fiscal Jurisdiction* (United States: Kluwer Law and Taxation Publishers, 1989)

Also, given the nature of BEPS, as discussed in Chapter 2, and the fact that it affects developing countries more than it does developed countries³⁷, one might think that the OECD is not a suitable regulatory body for harmful tax competition. When the reports were issued, the OECD consisted mainly of developed countries, save for Mexico and Turkey.³⁸ However, given that BEPS is a global problem, more so because it affects developing countries more severely, the question is the legitimacy of leaving developing countries out of the fight against harmful tax practices/BEPS. That not all states are included in this fight strongly suggests that the OECD might, after all, just be protecting the interests of its members. Melo declares that the OECD's work on harmful tax competition is a technique to keep its monopolistic dominance in international trade by proscribing the lax fiscal regimes in tax havens which may weaken its dominance.³⁹ Well and Lowell also provide insight into the original intention of the OECD when it was designing the allocation rules and its aggressiveness in attempting to fix the BEPS problem.⁴⁰ They maintain that the OECD's original intention was to strip source countries of the revenue accruing from the operations of non-residents; hence the over-allocation of revenue to residence countries under the allocation rules in the OECD Model Taxation Convention.⁴¹ They further explain that BEPS exists because the operations of tax havens break the tie between source and residence countries and, instead of MNCs transferring profits from source countries to residence countries, they now have an

³⁷ See Section 2.4 of Chapter 2.

³⁸ OECD 1998 Report *supra* note 1.

³⁹ George M. Melo, "Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty?" (2000) 12 PACE INT'L Law Review at 205; see also Karen B. Brown, "Harmful Tax Competition: The OECD View" (1999) 32 GEO. WASH. J. INT'L L. & ECON. 314-5; Mitchell B. Weiss, "International Tax Competition: An Efficient or Inefficient Phenomenon?" (2001) 16 AKRON Tax Journal, 126-28.

⁴⁰ Bret Wells & Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin" (2012) 65 Tax Law Review at 599.

⁴¹ *Ibid.*

alternative, tax havens, which offer incentives that match their objective to reduce global costs and maximize global profits.⁴²

From a moral perspective, the OECD's effort, reflected in the Report, fails the objectivity test. First, some of its members engage in harmful tax practices and, over time, have shown their disinterest in the OECD's policy reforms.⁴³ In addition, the OECD rules on allocation of profits between source and residence countries contribute to BEPS in source countries.⁴⁴ The rules can apply to strip the income of non-resident MNCs from source countries to residence countries. This happens, for example, because the rules proscribe the taxation of non-residents' income if their activities do not qualify as permanent establishments.⁴⁵

Lastly, the Report leaves out the primary cause of harmful tax practices: transfer pricing manipulation by MNCs. It is my contention that unless the primary cause of BEPS is addressed, harmonization of fiscal laws by the OECD, even if it passes the legitimacy and objectivity tests, would not yield practically beneficial results. It is important to note that the harmful tax practices of states are a continuation of the BEPS activities of MNCs. MNCs erode the tax base of countries first before the profits eroded are transferred to tax havens. It, therefore, follows that the most effective way to address harmful tax practices of states is tackle the factors that make it possible for MNCs to erode the tax base of countries in the first place. Chapter 2 illustrated that transfer pricing is the tool most utilized by MNCs to erode the tax base of source countries. As such, the gaps inherent in the arm's length principle that make it possible for transfer mispricing must be

⁴² *Ibid.*

⁴³ See for instance Switzerland and Luxembourg's abstentions from the OECD's work on harmful tax competition *supra* note 1 at 65.

⁴⁴ See Section 7 of the OECD Double Taxation Convention *supra* note 4.

⁴⁵ Peggy Musgrave, "Combining Fiscal Sovereignty and Co-ordination: National Taxation in a Globalizing World" in Inge Kaul and Pedro Conceicao, ed., *The New Public Finance Responding to Global Challenges* (Oxford University Press 2006) 167 at 168.

critically examined. My analysis of these gaps in sections 3.6.1 and 3.6.2 below make it safe to conclude that the principle is not suited for effective taxation of the integrated transactions of MNCs.

Overall, the OECD's work on harmful tax competition is yielding little or no positive results, especially in light of the severe consequences attached to BEPS, as discussed in Chapter 2. As well, the OECD admits that more work is needed in the aspect of harmful tax practices.⁴⁶ Tax competition simpliciter is unarmful. But it becomes harmful when states, in a bid to fulfil their fiscal interests, rob other states of taxable revenue due them.⁴⁷ Tax havens engage in harmful tax competition because they welcome income accruing from the activities of MNCs in other jurisdictions (source countries). By this, they deprive source countries of their rights to tax these profits.⁴⁸ Harmful competition is a cause of BEPS and this is what the OECD sought to address in its report. Harmful competition occurs when profits are displaced through the distortions MNCs create when they transfer the majority of their revenues to tax havens from source countries.

3.3 Tracing the Evolution of the Arm's Length Principle

As indicated in the introduction, the League of Nations began work harmonizing national fiscal rules governing taxation of MNC profits with the aim to prevent international double taxation of MNCs early in the 20th century. The goal was to prevent international double taxation in order to promote cross-border trade.⁴⁹ By this time, corporate businesses had transcended national borders and there was need for coordination of the national fiscal laws of the different states where MNCs

⁴⁶ See for instance the OECD, OECD's Reports Progress in Fighting Offshore Tax Evasion, but Says More Are Needed: www.oecd.org/general/oecdreportsprogressinfightingoffshoretaxevasionbutsaysmoreeffortsareneeded.htm (last accessed 13 July 2017).

⁴⁷ See section 2.6.1 of Chapter 2 for a detailed discussion about harmful tax competition.

⁴⁸ *Ibid.*

⁴⁹ *Supra* note 6.

operated.⁵⁰ For example, Picciotto records how British corporations which were, at this time, the largest global investors of funds, took on, portfolio investment in the United States, Spain, South Africa, and subsequently, delved into foreign direct investment in jurisdictions where minerals or raw materials production took place prior to the first World War.⁵¹ He also notes the involvement of US corporations in foreign direct investment in the automobile industry beginning in 1920.⁵²

The interaction of states' laws through these transnational transactions creates room for double taxation of MNCs. The only way out of this, according to the League, was for states to treat MNC entities separately for taxation purposes.⁵³ This principle of separate treatment shaped the content of subsequent reports by the League's Fiscal Committee. For instance, in addressing the question whether a non-resident entity should be taxed at source, the League restricted the taxing powers of source countries to situations where the non-resident entity has a PE in the country, that is, an entity operating in source countries with activities of a fixed nature.⁵⁴

The arm's length principle is an offshoot of the "separate entity principle", traceable to the work of the subcommittee of the Fiscal Committee of the League headed by Mitchell B. Carroll. The subcommittee was set up in 1931 to consider and report on the allocation of profits to permanent establishments.⁵⁵ The subcommittee based its report on practices in jurisdictions such as the British Commonwealth of Nations which consisted of the United Kingdom, the Irish Free State, British India and South Africa; the United States of America; Canada⁵⁶; Germany; and France and their

⁵⁰ *Ibid* at 2.

⁵¹ *Ibid* at 9.

⁵² *Ibid* at 3.

⁵³ *Supra* note 7.

⁵⁴ League of Nations, *Taxation of Foreign and National Enterprises (Volume IV) Methods of Allocating Taxable Income* by Mitchell B. Carroll, Fiscal Comm., Doc. C. 399.M.204.1933.II.A, Geneva: League of Nations, 1933.

⁵⁵ *Ibid*.

⁵⁶ See for instance section 23 of the Canadian *Income War Tax Act*, chapter 97, R.S.C. 1927, as amended *supra* note 54 at 110 which provided as follows: "where any corporation carrying on business in Canada purchases any

declared preference for this method.⁵⁷ The subcommittee also examined alternatives to the separate accounting method: the empirical, and the fractional apportionment methods which these jurisdictions reported they resort to when the separate accounting method fails.⁵⁸ In the end, the fiscal committee adopted the separate accounting method as the primary method of allocating profits to the various countries in which an enterprise has permanent establishments.⁵⁹

The empirical method was rejected as a primary method and was only to be employed when the accounts of a permanent establishment being assessed are insufficient, or when no such accounts are maintained at all.⁶⁰ The same goes for the fractional apportionment method even in the face of Spain's proposal in support of it.⁶¹ The empirical approach is similar to the separate entity principle but relies heavily on statistics. The Committee notes that in most instances, the empirical method utilized is the percentage of turnover obtained through a comparison of percentage of net profit to gross receipts of similar enterprises, or the percentage of gross profit to gross receipts from which the expenses incurred by the affiliate or permanent establishment are deducted.⁶² The fractional apportionment approach is a radical change from the arm's length principle because it involves the division of the general profits of an enterprise or two or more of its subsidiaries, and assignment of taxable profits to a permanent establishment or affiliate based on the division.⁶³ As a guide, the committee prescribed that the weighted factor of these three economic activities be utilized: sales,

commodity from a parent, subsidiary or associated corporation at a price in excess of the fair market price, or where it sells any commodity to such a corporation at a price less than the fair market price, the Minister may, for the purpose of determining the income of such corporation, determine the fair price at which such purchase or sale shall be taken into the accounts of such corporation."

⁵⁷ *Supra* note 54 at pages 88-90.

⁵⁸ *Supra* note 54 at 47-54.

⁵⁹ *Supra* note 54 at 189.

⁶⁰ *Supra* note 54 at 91.

⁶¹ *Supra* note 54 at 94.

⁶² *Supra* note 54 at 54-8.

⁶³ *Supra* note 54 at 58-87.

tangible property, and working hours.⁶⁴ To formalize the recommendations of the 1933 Fiscal Committee, the League incorporated recommendations of the subcommittee into Article III of the 1935 Draft Convention for the Allocation of Business Income Between States.⁶⁵

All through the revisions to the work of the League in 1940, 1943, and 1946 up until 1954 when the League became defunct, the separate entity approach was preserved as the general principle for allocation and taxation of MNC profits. Rules which divide MNC profits among states were relegated to lesser status, such as the provisions of the 1928 treaty between Hungary and Poland, which provided for fractional apportionment.⁶⁶

Even though the League adopted the separate entity method as the primary method for allocating taxable income to affiliates or permanent establishments, it gave no guidance on its applicability. The League left this issue unresolved because of “conflicting viewpoints as to what is a fair transfer price, charge or evaluation”.⁶⁷ The League admitted that those issues are the exclusive preserve of the enterprises rather than the tax authorities.⁶⁸

Guidance on the application of the separate entity approach began in 1968 when the US released four methods by which it could be applied.⁶⁹ The methods proposed by the US were: comparable uncontrolled pricing (the CUP); the resale profit; the cost-plus method; and, as a last resort, an

⁶⁴ *Ibid.*

⁶⁵ League of Nations, Fiscal Committee: Report to the Council on the Fourth Session of the Committee: <http://biblio-archive.unog.ch/Dateien/CouncilMSD/C-399-M-204-1933-II-A_EN.pdf> (last accessed 12 June 2017)

⁶⁶ *Supra* note 54 at 59.

⁶⁷ *Supra* note 54 at 129.

⁶⁸ *Ibid.*

⁶⁹ Bret Wells & Cym Lowell *supra* note 40 at 580.

unspecified “fourth method”.⁷⁰ Well and Lowell say that these methods represent a continuation of the work of the Fiscal Committee from 1933.⁷¹

3.4 Developing the Arm’s Length Principle: The OECD Double Taxation Convention

3.4.1 The Development of the OECD’s Double Taxation Convention

After World War II, the Organization for European Economic Co-operation (OEEC) was formed in 1947 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe.⁷² Engendering market reforms in the European Community⁷³ was a focal point under the mandate of the OEEC. As such, the OEEC was concerned about the problem of international double taxation. To this end, the Fiscal Committee of the OEEC produced three reports containing measures that would solve the problem of international double taxation.⁷⁴ In 1961, the OEEC became the Organization for Economic Co-operation and Development (OECD). The latter was tasked with a much wider mandate, adopting some of the work of the then-defunct League of Nations, including the mandate to develop policies to enhance the economic development of member states and the world at large.⁷⁵ In 1963, the fiscal committee presented its final report to the OECD. The report was commended to member states for adoption and implementation, and

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² OECD, History: www.oecd.org/about/history/ (last accessed 12 June 2017).

⁷³ The European Economic Community (the EEC) was created by the Treaty of Rome in 1957 and renamed as the “European Community” upon the formation of the European Union in 2003. The EEC later ceased to exist upon its absorption into the present day European Union in 2009, see *ibid.*

⁷⁴ *Ibid.*

⁷⁵ *Supra* note 72.

was mutually agreed to by the OECD member countries as the Draft Convention for the Avoidance of Double Taxation Convention.⁷⁶

The draft Convention has undergone a series of revisions over the years, incorporating amendments to the Convention as they are being made. The objective of these revisions is to harmonize national fiscal laws to prevent international double taxation and fiscal evasion.⁷⁷ In all the revisions, the OECD followed the approach of the League and the US on the separate treatment of associated entities of MNCs by adopting the arm's length principle as the standard to be applied for assessing their taxable profits.⁷⁸ The following section examines what the arm's length principle under the OECD's Double Taxation Convention on Income and Capital look like.

3.4.2 Overview of the Arm's Length Principle Under the OECD's Double Taxation Convention on Income and Capital, 2014

Article 9 of the OECD's Convention provides that the arm's length principle must be the norm for allocation of taxable profits among associated entities:

Where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.⁷⁹

To emphasize the principle as the norm for allocating profits among associated entities, the OECD, in 1977, produced a report on it. This report was revised in 1995 into specific guidelines on the application of the arm's length principle by tax administrators.⁸⁰ The Guidelines have undergone

⁷⁶ OECD, *Draft Double Taxation Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital*, June 30, 1963, reprinted in Walter H. Diamond & Dorothy B. Diamond, *International Tax Treaties of all Nations* 7, 9-10 (1976).

⁷⁷ *Ibid* at I-5 para. 16.

⁷⁸ See *Ibid*, Article 9 of the OECD Convention at M-25.

⁷⁹ *Ibid*.

⁸⁰ See the OECD, (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2017, OECD Publishing, Paris for a history of the OECD transfer pricing guidelines.

many revisions over the years, the most recent being the 2017 amendments. The guidelines copy the hierarchy of methods for applying the principle as set out in the US Corporate Income Tax Regulations of 1968.⁸¹ This hierarchy is the preference for traditional transfer pricing methods, which revolve around comparability between transfer prices fixed by MNC entities, and open market prices.

The transfer pricing methods in the OECD's Guidelines are broadly classified into two categories: the traditional approaches, namely, the Comparable Uncontrolled Price (CUP) method; the Resale Price Method; and the Cost-Plus Method; and the transactional approaches, which are the Transactional Net Margin Method and the Transactional Profit Split Method.⁸² The OECD notes that the use of any of these methods should be premised on its appropriateness in light of the circumstances of the transaction being assessed.⁸³ But it also advises that the methods are only to be utilized in a manner that approximates arm's length pricing.⁸⁴ It then endorsed the CUP as the appropriate method for establishing the arm's length price for physical goods.⁸⁵ The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.⁸⁶ The OECD, however, recognizes the possibility of circumstances where the arm's length price for functions performed by related entities resulting in the physical good, rather than the physical good as a whole may be ascertained. In these circumstances, the OECD advises the use of either the resale or the cost-plus methods.⁸⁷

⁸¹ *Supra* note 69.

⁸² *Supra* note 80 at 101-145.

⁸³ *Supra* note 80 at 97 paragraph 2.2.

⁸⁴ *Supra* note 80 at 98 paragraph 2.6.

⁸⁵ *Supra* note 80 at 102 paragraph 2.18.

⁸⁶ *Supra* note 80 at 101.

⁸⁷ *Supra* note 80 at 107 at paragraph 2.32.

The resale method is a function-based method which uses the gross margin on functions performed in related-party transactions to arrive at arm's length prices for such transactions.⁸⁸ This method is applied to adjust the profits from goods purchased from related entities, considering the functions performed by them.⁸⁹ The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price of the original transfer of property between the associated enterprises.⁹⁰

The second traditional alternative to the CUP method is the cost-plus method. This method aims to ascertain what independent enterprises would agree to as cost of goods/services supplied to an MNC entity by an affiliate. The OECD describes it as a transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction.⁹¹ An appropriate mark-up is added to this cost to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the mark-up may be regarded as an arm's length price of the original controlled transaction.⁹²

Transactional transfer pricing methods differ from the traditional methods because they rely more on the functions performed by MNC entities that result into the profits being assessed.⁹³ The OECD's Guidelines contain two transactional methods: transactional net margin, and the transactional profit split methods.⁹⁴ The transactional net margin method examines the net profit

⁸⁸ *Supra* note 80 at 105-6.

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

⁹¹ *Supra* note 80 at 111.

⁹² *Ibid.*

⁹³ *Supra* note 80 at 117.

⁹⁴ *Ibid.*

margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realises from a controlled transaction or from transactions that it is appropriate to aggregate under the principles of comparability under chapter III of the Guidelines.⁹⁵

The transactional profit method is a radical departure from the separate entity principle in that it involves a profit split of the “combined profits”⁹⁶ among related entities.⁹⁷ The OECD advises that the split be in alignment with the principles of comparability under paragraphs 3.9-3.12 of the Guidelines.⁹⁸ Where comparable uncontrolled transactions of sufficient reliability are unavailable, the OECD proposes that tax authorities resort to internal data.⁹⁹

The inclusion of the transactional methods evidences the significant weaknesses of the arm’s length principle in the allocation of taxable income among associated entities. The proponents of the separate entity principle, which metamorphosed into the arm’s length principle, would be displeased to see the increasing modifications that have been incorporated into the principle, most especially through the transactional profit method. Although the OECD gives a blanket suggestion that all the methods be applied in alignment with the notion of “comparability”, that is, with what independent enterprises would do under comparable circumstances¹⁰⁰, the transactional profit method allows tax authorities to dispense with the comparability test where there are no comparable uncontrolled transactions of sufficient reliability, especially for transactions involving intangibles.¹⁰¹

⁹⁵ *Supra* note 80 at 117-8.

⁹⁶ The OECD defined it as the profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged.

⁹⁷ *Supra* note 80 at 133.

⁹⁸ *Ibid.*

⁹⁹ *Supra* note 80 at 143 at para 2.147.

¹⁰⁰ *Supra* note 85.

¹⁰¹ *Ibid.* See also the OECD (2014), *Practical Guidance on Transfer Pricing Aspects of Intangibles*, OECD/G20 BEPS Project, OECD Publishing at 46-49.

3.5 The Arm's Length Principle in the UN Model Double Taxation Convention between Developed and Developing Countries

The UN joined the OECD in designing international taxation rules but with attention to the peculiar interests of developing countries. In designing these rules, the UN's aim was to strengthen the inflow of foreign trade from developed to developing countries. To this end, it recognized the role that rules governing the taxation of MNCs would play.¹⁰² The UN sought to influence the provisions of double taxation treaties between developed and developing countries in order to create attractive investment climates in developing countries as source countries.¹⁰³ It published its Model Double Taxation Convention in 1979, which it subsequently revised in 1999 and 2011.¹⁰⁴

The UN retained the arm's length principle in its Article 9, just as the OECD did.¹⁰⁵ It subsequently released its version of a transfer pricing manual for developing countries in 2013, as amended in 2017.¹⁰⁶ The UN Guidelines contain transfer pricing methods that mirror the OECD's but go a step further to discuss how emerging economies, such as Brazil, China, India and South Africa, could apply the arm's length principle.¹⁰⁷ These countries recount their experiences with the arm's length principle as they discuss some challenges they face in applying the principle, such as lack of comparables, lack of information about the global businesses of MNCs and, broadly, lack of sophisticated mechanisms for the effective application of the principle, unlike the developed countries have. The OECD and UN Double Taxation Conventions provisions on transfer mispricing create a composite framework of common elements. It is now considered how, together, they give effect to the arm's length principle.

¹⁰² Origin of the United Nations Model Convention *Supra* note 2 at vi-xiii.

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Supra* note 5 at 15-6.

¹⁰⁶ United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, Department of Social Affairs, United Nations, New York, 2017.

¹⁰⁷ *Ibid* at 357-409.

3.6 The Arm's Length Principle under the UN and OECD Regimes

The nagging consequences attached to transfer pricing as discussed in Chapter 2, and the unavailing efforts by the OECD and the UN, as examined above, compels an assessment of the arm's length principle. This assessment considers the nature of the principle, and its application to the transfer pricing methods that it generates.

3.6.1 The Nature of the Arm's Length Principle

Scholars have critiqued the nature of the arm's length principle as it applies to MNCs.¹⁰⁸ The common denominator in the concerns raised against the principle relate to the challenges involved in applying it to MNCs, given the structure of MNCs and how they transact.¹⁰⁹ Scholars note that the integrated structure of MNCs is responsible for the challenges associated with the application of the arm's length principle as an effective means to deter BEPS. For instance, Picciotto, writing on the problem of BEPS and the OECD's BEPS Report, notes that the issues with the arm's length principle are intractable:

These problems result from a deep structural flaw in the international tax system. This flaw is the failure to treat TNCs according to the economic reality that they operate as integrated firms under central direction... Instead, a principle has become gradually entrenched that they should be taxed as if they were separate enterprises in each country dealing independently with each other.... This not merely allows but encourage TNCs to organize

¹⁰⁸ See for instance R.S. Avi-Yonah & I. Benshalom, "Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3 *World Tax Journal* 376; Standard to Multinational Banks based on a Comparability Analysis", (2004) 58:2 *Bull. Intl. Taxn*; Sol Picciotto, "Towards Unitary Taxation" In Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness*. (United Kingdom: Oxford University Press, 2016); Sol Picciotto, "*International Business Taxation: A Study in the Internationalization of Business Regulation*" (United Kingdom: Cambridge University Press, 2013 Electronic Edition); Reuven S. Avi-Yonah, Kimberly Clausing, & Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 *Florida Tax review* 497; Bret Wells & Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin" (2012) 65 *Tax Law Review*.

¹⁰⁹ *Ibid.*

their affairs by forming entities in suitable jurisdictions to reduce their overall effective tax rate, by a variety of means.¹¹⁰

As these scholars argue, the inadequacy of the arm's length principle as a deterrent to BEPS comes from not recognizing that even though an MNC consists of a parent company and several affiliates located across multiple jurisdictions, they are linked, and as such, all entities, wherever they are located, operate to achieve the same goal, which is to maximize global profits.¹¹¹ Consequently, in light of the obvious realities of trade between and among MNC entities, which leaves room for transfer pricing manipulation, it is not a wise decision if the combined profits of MNCs are apportioned to affiliates and PEs based on their separate accounts in line with the arm's length principle. Wilkie explains the practical factors that shape transactions within an MNC as follows: "Neither in a transfer pricing context nor with reference to other notions of tax jurisdiction do global "firms" conduct business as a collection of autonomous actors. They see themselves as single economic enterprises, or "firms", with equally singular or unitary profits..."¹¹²

The arm's length principle bears a striking resemblance to the doctrine of separate personality under corporate law as established in *Salomon v. Salomon & Co Ltd.*¹¹³ This case established that a company is a separate entity different from its owners, and imbued with the legal rights of corporate personality, which include the right to sue and be sued; own and be able to transfer property; and enter into contracts; and other rights incidental thereto. The framers of the arm's length principle basically imported this principle into international taxation to say that although

¹¹⁰ Sol Picciotto, "Towards Unitary Taxation" In Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness*. (United Kingdom: Oxford University Press, 2016) at 222.

¹¹¹ Sol Picciotto, "*International Business Taxation: A Study in the Internationalization of Business Regulation*" (United Kingdom: Cambridge University Press, 2013 Electronic Edition) at 309.

¹¹² J. Scott Wilkie, "Reflecting on the Arm's Length Principle": What is the "Principle"? Where Next? In W. Schon and K.A. Konrad (eds.), *Fundamentals of International Transfer Pricing in Law and Economics*, MPI Studies in Tax Law and Public Finance Volume 1 (United States: Springer, 2012) at 150.

¹¹³ [1896] UKHL 1, [1897] AC 22.

MNC entities may be related, they are distinct from one another. The principle of corporate personality, however, should not be imported into international taxation given the notion of “common ownership” that influences cross-border trade among MNC entities. The synergistic nature of the relationship between MNC entities cannot be separated from the fixing of transfer prices and, consequently, the profits declared in the jurisdictions in which these entities operate. These entities enjoy competitive advantages of internalization to reduce production and transaction costs.¹¹⁴ Since tax is seen as a cost, they consider the fiscal regimes of states in fixing their transfer prices. For these obvious reasons, the arm’s length principle, to the extent that it regards MNC entities as separate entities, is inherently flawed.

As noted, the arm’s length principle is fundamental to the application of the transfer pricing methods. The mechanics and implications of this exercise are examined next.

3.6.2 The Arm’s Length Principle and Transfer Pricing Methods

The transfer pricing methods identified above are designed to regulate the arbitrary transfer prices fixed by MNCs. In principle, they are meant to serve as a check on the taxable profits of an MNC entity in source countries through a requirement that the profits declared by such an entity conform to profits that an independent enterprise would have declared under similar circumstances. This principle requires tax administrations to answer the “what would independent enterprises do” question.¹¹⁵ For MNCs, the expectation is that they would transact as independent corporate entities and, to this end, prices fixed on intra-firm goods and services would reflect market prices.

¹¹⁴ Picciotto supra note 111 at 224-225; see also Mehafdi, M, “The Ethics of International Transfer Pricing”. *Journal of Business Ethics* (2000) 28: 365.

¹¹⁵ Lorraine Eden, “The Arm’s Length Standard: making it Work in a 21st Century World of Multinationals and Nation States” in Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness*. (United Kingdom: Oxford University Press, 2016) at 155.

In the event that they do not, tax authorities may seek to adjust the profits, using recognised transfer pricing methods to adjust prices to conform to arm's length prices.¹¹⁶

The fundamental flaw with this principle inheres in the assumption that there are arm's length prices for goods and services internally supplied within MNCs. Different from the requirements of this principle, the continuous use of transfer pricing by MNCs to engender BEPS and the challenges that countries face while applying the arm's length principle to adjust transfer prices point to the fact that comparables rarely exist.¹¹⁷ No such independent enterprise is able to transact the way MNCs do because, apart from the way MNCs leverage upon the benefits of internalization to maximize profits, some profits are more "insidiously unavoidable because they inhere in association".¹¹⁸ As regards the flaws of the arm's length principle through the application of the transfer pricing methods, Wilkie explains as follows:

The expectation of transfer pricing is that through a variety of methodological simulations, the relative equivalence...devoid of the taint of "association" can reliably be discerned. However, a "firm" is an economic unity despite its operating manifestation as various legal "bits". It is the direct antithesis of the taxpayers to which the "arm's length principle" is meant to apply. Its internal organs and appendages have no more intrinsic significance than the organs and limbs of the human body each on its own apart from the human "being" of which it is a component. A "firm" is an economic "being". Its existence, and the inherent value it captures by its existence is uniquely self-interested; it is not merely the sum of the values ascribed to its bits as if they had the same functionality and significance apart from that economic being.¹¹⁹

The inadequacy of the arm's length principle is seen through the perception that arm's length prices can be found for non-arm's length relationships. The arm's length principle might have been easy to ascertain in the early years of trade when trade was restricted to physical goods. However, in a

¹¹⁶ See Articles 9 of both the OECD and UN Double Taxation Conventions *supra* notes 4 and 5.

¹¹⁷ Wilkie *supra* note 112 at 143

¹¹⁸ *Supra* note 112 at 141.

¹¹⁹ *Supra* note 112 at 143.

globalized age where business entities transact in intangibles with unique features and even without necessarily being required to maintain physical presence, the search for comparables can become endless.¹²⁰

The deficiencies of the arm's length principle are brought to light when tax authorities deal with transfer prices fixed on intangibles. Given that intangibles create rights that are peculiar to the MNCs that developed them, the subjection of transfer prices fixed for intangibles to "comparable circumstances" does not make the valuation easier.¹²¹ This is because the arm's length principle leaves out the real factors that ought to be considered in allocating profits to affiliates and PEs, that is, economic factors that resulted in the profits from intangibles.¹²² Intangibles are important because they add significant value to MNC business.¹²³ Avi-Yonah points out that intangibles are "central among the necessary conditions for the successful operation of MNEs"¹²⁴ Consequently, the inability to evaluate the transfer prices for intangibles with the aim to prevent transfer pricing manipulation constitutes a huge gap in international taxation, and explains why BEPS remains a challenge.

Recognizing the difficulties involved in valuing intangibles, the OECD released guidance on valuing intangibles.¹²⁵ This guidance forms one of the first sets of deliverables on Action Plans 8-

¹²⁰ Vann, Richard J., Reflections on Business Profits and the Arm's-Length Principle (November 17, 2010). THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES, pp. 133-169, B.J. Arnold, J. Sasseville, E.M. Zolt, eds., Canadian Tax Foundation, 2003; Sydney Law School Research Paper No. 10/127. Available at SSRN: <https://ssrn.com/abstract=1710945>; see also Amir Pichhadze, "The Arm's Length Comparable in Transfer Pricing: A Search for an "Actual" or a "Hypothetical" Transaction?" (2015) World Tax Journal, 2015 (Volume 7), No. 3.

¹²¹ Yariv Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes", (2008) 28 Virginia Tax Rev 79:28 at 94.

¹²² *Ibid.*

¹²³ Vann *Supra* note 120 at 141.

¹²⁴ *Supra* note 121 at 93.

¹²⁵ *Supra* note 102. The provisions of this guidance on intangibles are amendments to Chapter VI of the OECD Guidelines on Transfer Pricing *supra* note 80 at 247-313.

10 of the OECD's BEPS Action Plan.¹²⁶ In this guidance, the OECD proposes that states pay attention to the economic factors that shape the development and use of intangibles by performing a functional analysis of the following factors: functions performed, use of assets, and assumption of risks by MNC entities in the development, enhancement, maintenance and protection of intangibles.¹²⁷

This appears to be a step forward in transfer pricing of intangibles, but for the subjection of the functional analysis to the comparability test under Article 9 of the OECD Convention.¹²⁸ It is safe to conclude that, notwithstanding the OECD's inclusion of transactional transfer pricing methods, the arm's length principle remains the heart, spirit and the foundation of the international transfer pricing regime.¹²⁹ This is why all the transfer pricing methods and guidance on their applicability echo the dominance of the comparability test, rejecting a complete functional analysis of the economic activities of MNCs.

In a bid to apply the arm's length principle more effectively, countries like Brazil, Argentina, Uruguay and Ecuador adopt a "sixth method" of valuing non-arm's length transactions.¹³⁰ Although these countries claim they are applying the arm's length principle via this sixth method, the method differs from the OECD's transfer pricing methods and guidelines. The sixth method allows tax authorities in the different countries where it is utilized to ignore the transfer pricing arrangements made by related entities and to use the quoted price¹³¹ if it is greater than the transfer

¹²⁶ *Ibid.*

¹²⁷ *Ibid.*

¹²⁸ *Ibid* at 247.

¹²⁹ *Supra* note 121 at 96.

¹³⁰ PwC, "'Sixth method' raises Transfer Pricing Concerns in Developing Countries", online: (2013) PKN Alert <www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-global-sixth-method-developing-countries.pdf> (last accessed 13 July 2017).

¹³¹ Quoted price is defined in the OECD Transfer Pricing Guidelines *supra* note 49 at 102 as the "price of the commodity in the relevant period obtained in an international or domestic commodity exchange market...it also

prices.¹³² The extent to which the arm's length principle is being stretched is also seen in the application of fixed margins (average of 20%) for gross profits and mark-up in Brazil for the Cost-plus and Resale Transfer Price Methods.¹³³ These alternative methods create uncertainty and enough room for arbitrary tax assessments across these jurisdictions.

The interpretation of the arm's length principle is another area where its inadequacy comes to the fore. For instance, section 247(2) of the Canada's *Income Tax Act*,¹³⁴ in providing the Canada Revenue Agency (the CRA) with power to adjust non-arm's length transactions to reflect arm's length prices, itemizes the requirements that the CRA should take into consideration. One of these is that "the terms or conditions made or imposed, in respect of the transaction or series, between any of the participants in the transaction or series differ from those that would have been made between persons dealing at arm's length".¹³⁵ This requirement was interpreted by the Supreme Court of Canada in *Her Majesty The Queen v. GlaxoSmithKline Inc.*¹³⁶ The Supreme Court said that this clause, which was also in section 69(2) in the 1985 Income Tax Act, obligated the CRA to have regard to the "economically relevant circumstances" of the transactions as advised by the OECD transfer pricing guidelines. By a joint reading of Section 69(2) of the 1985 Income Tax Act, now Section 247(2), and the advice by the OECD to consider "economically relevant circumstances" while ascertaining transfer prices of related entities, the Supreme Court justified the inflated price paid to Glaxo Group by Glaxo Canada for the purchase of a drug, ranitidine. The

includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them.

¹³² *Ibid.*

¹³³ United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, Department of Social Affairs, United Nations, New York, 2013.

¹³⁴ Income Tax Act R.S.C., 1985, c. 1 (5th Supp.)

¹³⁵ Section 247(2)(a) of the Income Tax Act *Ibid.*

¹³⁶ *Her Majesty The Queen v. GlaxoSmithKline Inc.*, 2012 SCC 52.

Court justified this price on the ground that a separate agreement (licence agreement) between Glaxo World and Glaxo Canada explained the reason behind the inflated price. According to the Court, Glaxo Canada did not just pay for the purchase of the product, but also compensated Glaxo World for its secondary manufacturing and marketing functions as per the terms of the licence agreement between Glaxo Canada and Glaxo World.¹³⁷ The court held thus: “Considering the License Agreement and the Supply Agreement together offers a realistic picture of the profits of Glaxo Canada”.¹³⁸

This case exemplifies the extent to which the arm’s length principle can be extended through the interpretation given it to justify an apparent transfer pricing manipulation by which profit was eroded from Canada by Glaxo Canada. It is apparent that the Supreme Court, in this case, went beyond the scope of section 69(2), now 247(2), by digging into the internal transactions of Glaxo Canada. One might wonder if the drafters of Section 69(2) could have contemplated this situation, which shows the extent to which the principle can be stretched even to the point of justifying an apparent case of abusive transfer pricing.

The continuous revisions of the transfer pricing guidelines illustrate the inadequacies of the principle as a rule by which BEPS can be deterred. The OECD published its newest version of the Transfer Pricing Guidelines on 10 July 2017.¹³⁹ They provide more guidance on how the arm’s length principle may be applied by source countries to promote transfer pricing outcomes that align with value creation. The recommendations reflect the OECD’s work on Action plans 8-10, Aligning Transfer Pricing Outcomes with Value Creation, and Action Plan 13, Transfer Pricing

¹³⁷ *Ibid* at paragraphs 45-7.

¹³⁸ *Ibid* at paragraph 52.

¹³⁹ OECD releases latest updates to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations: <www.oecd.org/tax/transfer-pricing/oecd-releases-latest-updates-to-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm> (last accessed 13 July 2017)

Documentation and Country-by-Country Reporting.¹⁴⁰ The revisions focus on the need for tax authorities, while applying the arm's length principle, to understand the nature of MNC transactions and apply appropriate transfer pricing methods.¹⁴¹

Also, novel mechanisms like Advance Pricing Agreements between taxpayers and tax authorities, and Safe Harbour rules, have found their way into domestic tax laws to save both taxpayers and states the time and resources that go into the assessment procedure under the arm's length principle.¹⁴² Advance Pricing Agreements are concluded between taxpayers and one or more tax authorities, usually for about five years, regarding the taxpayer's transfer prices.¹⁴³ Safe Harbour rules relieve smaller taxpayers from complying with domestic transfer pricing rules. The OECD says it is "a trade-off between strict compliance with the arm's length principle and administrability".¹⁴⁴ By the provisions of the safe harbour rules, taxpayers' transfer prices would attract little or no scrutiny.¹⁴⁵ Notwithstanding these administrative mechanisms, the applicability of the arm's length principle remains a challenge. For instance, in India, there are backlogs of transfer pricing disputes yet to be solved across jurisdictions and, more so, these disputes have been said to involve complex transactions.¹⁴⁶

Modification to the arm's length principle in the face of its apparent flaws, especially its inapplicability to the integrated nature of the activities of MNCs, further reveals the failed attempts by the OECD and the UN to regulate MNC transfer pricing. In chapter 5, this thesis recommends

¹⁴⁰ *Ibid.*

¹⁴¹ *Ibid.*

¹⁴² See Chapter IV of the OECD Guidelines *supra* note 80 at 204-224 on guidance on APAs and Safe harbour rules.

¹⁴³ Marc M. Levey & Stephen C. Wrappe, *Transfer Pricing Rules, Compliance and Controversy*, 4th ed. (United States: Wolters Kluwer, 2013) at 424 paragraph 1410.01.

¹⁴⁴ *Supra* note 142 at 208 paragraph 4.112.

¹⁴⁵ *Ibid.*

¹⁴⁶ PWC, "India Publishes its First APA Annual Report" (2017): www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-india-apa-statistics.pdf (last accessed 13 July 2013)

the formulary apportionment (FA) approach to replace the arm's length principle. The FA approach obviates the need for comparables which, in most instances, are non-existent. The FA approach divides the combined profits of an MNC and allocate these profits to states based on the level of economic activity within their jurisdictions which generated the profits. In the next section, I examine the OECD's efforts to curb unhealthy fiscal policies of tax havens that engender BEPS.

3.7 Conclusion

BEPS will continue, so long as states retain the arm's length principle and tax havens continue to exist. As shown, the arm's length principle ignores the realities of trade between non-arm's length parties. The arm's length principle, if anything, brings to the fore the inappropriateness of comparing related-party transactions with that of independent enterprises in "comparable circumstances". Although there has been a shift from traditional to transactional methods, the arm's length principle still expects tax authorities to apply transactional transfer pricing methods using the "comparability test". As discussed above, the search for comparables can be an endless one.

It cannot be denied that it is the sovereign right of states to design their tax systems howsoever they choose. This is a major reason why, despite political commitments, states still engage in harmful tax practices that encourage BEPS. An efficient structure for regulating the fiscal policies of states must appreciate this factor; otherwise, it is bound to fail. I have discussed above that the OECD's reports on harmful tax competition leave out this factor among others. The other factors which affect the prospect of success in the OECD's "war" against harmful tax practices are the ambiguity of the definition of tax havens and preferential tax regimes; the non-inclusion of non-OECD member countries in the process; the OECD's lack of control over its own members that

engage in harmful tax practices; the OECD's allocation rules which engender BEPS in source countries; and the inability of the arm's length principle to prevent transfer pricing manipulation.

This thesis advocates, as an alternative to the arm's length principle, the formulary apportionment approach. This obviates the need for comparability, and it is based on a functional assessment of the activities of MNC entities across the various jurisdictions in which they operate. An effective functional analysis would require MNCs to publish their consolidated books of account reflecting the functions performed by each member of the group, profits made and consequent taxable profits accrued and paid in each country.

Considering the need for combined reporting by MNC entities as the starting point for the alternative approach which this thesis proposes, the next chapter examines one of the revisions to the OECD's transfer pricing guidelines: Country-by-Country Reporting Rules (the CBCR Rules) contained in chapter V of the OECD Guidelines. The OECD proposed the CBCR Rules as additions to the arm's length principle. The next chapter discusses the gaps in the rules as tools to fight against BEPS on a global scale.

Chapter 4

The OECD and the Country-By-Country Reporting Mechanism: An Assessment

4.0 Introduction

This Chapter assesses the potency of the Country-by-Country Reporting (CBCR) Rules as an addition to transfer pricing rules based on the arm's length principle, designed to solve the problem of lack of adequate information about the global activities of MNCs. This chapter assesses the CBCR Rules and highlights some of their fundamental weaknesses that are likely to impede the global fight against BEPS. These weaknesses are ingrained in three clauses in the OECD's Guidance on the implementation of the CBCR Rules, which define the operation and use of the CBCR. As such, the Rules determine, largely, the success of a global fight against BEPS. The rest of this Chapter is structured as follows: Section 4.1 reviews pertinent aspects of the OECD's 2013 BEPS project that led to the enactment of the CBCR Rules. It discusses the OECD's optimism as to the viability of the CBCR Rules as a tool that can be used to assist in eliminating BEPS globally. Section 4.2 discusses the evolution of the CBCR mechanism. It reviews the development of the CBCR mechanism, which is birthed in the advocacy of tax activists for increased transparency in corporate governance for the benefit of everyone affected by the global activities of MNCs. Section 4.3 examines the text of the OECD's CBCR Rules and highlights their key provisions, namely, the threshold, confidentiality, and 'appropriate use' clauses. This Section highlights the differences between the OECD's CBCR Rules and the CBCR mechanism designed by tax activists. Section 4.4 assesses the key clauses of the OECD's CBCR Rules, and concludes against the OECD's optimism regarding the viability of the Rules as a tool by which BEPS can be eliminated globally. This Chapter concludes in Section 4.5, reiterating that only an amendment of the key clauses of the CBCR Rules can make for a viable mechanism by which BEPS can be eliminated globally through their provisions.

4.1 The OECD's BEPS Project

As discussed in Chapters 1 and 3, in 2013, the G20 tasked the Committee of Fiscal Affairs (the CFA) arm of the OECD to develop solutions to BEPS.¹ Later in the year, the OECD through the CFA produced 15 Action Plans tagged “BEPS Action Plans”, to be worked on and refined as proposals to deter profit shifting.² The OECD, through the BEPS Project, proposed a multilateral approach to tackle profit shifting, and invited both developed and developing countries to provide input into its design. According to the OECD, “[t]he global economy requires countries to collaborate on tax matters in order to be able to protect their tax sovereignty”.³ This multilateral approach was purportedly adopted by the G20 Leaders in Saint Petersburg, Russia, in September 2013. There they declared that: “Despite the challenges we all face domestically, we have agreed that multilateralism is of even greater importance in the current climate, and remains our best asset to resolve the global economy’s difficulties”.⁴

The objective of the OECD BEPS Action Plans is to enact rules that would promote taxation that is aligned with value creation, which is poor due in large part to the transfer pricing policies of the MNCs. The OECD highlighted the severity of the consequences of BEPS for governments, individual taxpayers and businesses.⁵ It also noted the gaps in international taxation rules that advance BEPS, and proposed a unified approach to tackle the problems associated with profit shifting, such as bilateral treaty abuse, under-capitalization, and mispricing of property by MNCs especially for intangibles.⁶ With respect to transfer pricing, the OECD noted that tax

¹ G20 Meeting of Finance Ministers and Central Bank Governors , Moscow, July 20, 2013: www.g20.utoronto.ca/2013/2013-0720-finance.html (last accessed 31 July 2017)

² OECD, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, (2013).

³ *Ibid* at 9.

⁴ OECD: G20 Summit, Saint Petersburg, Russian Federation, online: www.oecd.org/g20/summits/saint-petersburg/.

⁵ *Supra* note 2 at 8.

⁶ See Action plans 6 & 8-10 of the OECD BEPS Action Plans *supra* note 2 at 19-21.

administrators' lack of access to information about the global activities of MNC entities that informed the taxable profits declared by them is a major cause of BEPS. The OECD describes this challenge in the following words:

In many countries, tax administrations have little capability of developing a “big picture” view of a taxpayer’s global value chain...In this respect, it is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services and other transactions is made available to the tax administration.⁷

The OECD highlights other factors that promote transfer mispricing by MNCs, such as the challenges of the digital economy that make it difficult for tax administrations to effectively evaluate transfer prices on intangibles, and in general, the synergistic nature of relationships that exist between MNC entities that allow transfers of risks and capital, providing inappropriate returns to them.⁸ Regarding transparency of the activities of MNC entities, the OECD notes that transfer pricing documentation filed by MNCs with tax administrations fails to provide comprehensive information about their activities.⁹ Although such information, as the OECD notes, may become available while conducting an audit, they leave gaps for early detection of aggressive tax planning techniques/strategies of MNCs.¹⁰ The OECD, therefore, recognizes the need to design uniform rules that would require MNCs to provide information about their global activities at the time of the transaction or, no later than the time of filing a tax return for the fiscal year in which the transaction took place. The OECD listed this as action plan 13 in its Action Plans. It compels the OECD to take action in order to:

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be

⁷ *Supra* note 2 at 22.

⁸ See Action plans 8, 9, and 10 of the OECD’s Action Plans *supra* note 2 at 20-1.

⁹ See OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris at 229-231.

¹⁰ *Ibid.*

developed will include a requirement that MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.¹¹

Through this action plan, the OECD desires to balance the competing interests of states and MNCs, that is, provision of adequate information about the global activities of MNCs to tax administrations where they operate, and managing the cost of compliance for business. The need for comprehensive information to be filed by MNCs, according to the OECD, is because of the studies that show that there is an increased disconnection between value-creating activities of MNCs and allocation of profits.¹² Therefore, the OECD sees the expansive information to be filed as a viable way for tax administrators to detect the tax planning activities of MNCs that engender BEPS. It, therefore, seeks to address gaps in international taxation rules that allow the BEPS-related activities of MNCs to be shielded from scrutiny by tax administrators. Currently, the individual transfer pricing documentation filed by MNC entities with tax administrators of the different countries where they operate covers only the entities' activities in that jurisdiction.¹³ The OECD says that this situation opens up windows of opportunity for MNCs to engage in BEPS-related activities unknown to tax administrations.¹⁴ The OECD notes that the impact inheres in the challenges faced by tax administrators in effectively assessing the appropriateness of the transfer prices declared by MNC entities in the context of other functions performed by related entities. The OECD summarized this as appropriate value-chain analyses.¹⁵ The OECD therefore maintains that enhancing transparency for tax administrations, through the reform of its transfer pricing guidelines to require the disclosure of information about the global activities of MNCs, will

¹¹ *Supra* note 2 at 23.

¹² *Supra* note 2 at 21.

¹³ See Action Plan 12 *supra* note 2 at 22.

¹⁴ *Ibid.*

¹⁵ *Supra* note 2 at 22.

provide tax administrations with the information necessary to help them assess high-level transfer pricing and other BEPS-related risks.

The OECD's recent call for the reform of its guidelines on transfer pricing documentation was borne out of the weaknesses of its initial guidelines that it adopted in 1995. Transfer pricing documentation under the OECD's former transfer pricing guidelines centred on the notion of "reasonability".¹⁶ This obligated MNCs to file documentation on their determined transfer prices based only on "information reasonably available at the time of the determination of their transfer prices and, overall, information sufficient to allow tax administrations to determine, approximately, which taxpayers need further examination".¹⁷ The Guidelines left out the specific nature of the required documentation. They also left out the type of information sufficient for this exercise. Prior to the reform of the OECD transfer pricing guidelines, the emphasis was on the impact that detailed transfer pricing documentation might have on MNCs.¹⁸ According to the OECD, "it would be unreasonable to require the taxpayer to submit documents with the tax return specifically demonstrating the appropriateness of all transfer price determinations. The result could impede international trade and foreign investment".¹⁹

The inadequacies of the documentation required under the OECD's former transfer pricing guidelines led to national regulations with which MNCs were obligated to comply. Because transfer prices are important aspects of MNC transactions, some states enacted detailed rules requiring MNC entities to file information about all of their transfer pricing determinations. These rules require disclosure about the particulars of the transactions being assessed, circumstances

¹⁶ Chapter 5, *OECD Transfer Pricing Guidelines supra* note 9 at 229.

¹⁷ *Ibid.*

¹⁸ *Ibid.*

¹⁹ Chapter 5, OECD (2010), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010, OECD Publishing Paris at 185, paragraph 5.5.

surrounding the transfer prices, and comparability analysis in consonance with the arm's length principle.²⁰ Even with the detailed transfer pricing regulations introduced by states, the restrictiveness of the transfer pricing documentation filed is of limited assistance to tax administrations in recognizing the BEPS-related activities of the MNC more broadly. This is because the documentation required to be filed covers only the transactions of the entities being assessed. Closing this gap is the reason the OECD proposed an expansion to the documentation filed by MNCs through the CBCR Rules to require MNCs to report to tax administrations in every state in which they operate their global activities, including their transfer pricing strategies.

4.2 Evolution of the Country-by-Country-Reporting Rules

Before proceeding to discuss and assess the key provisions of the OECD's CBCR Rules as a mechanism designed for the elimination of BEPS, which is the focal point of the discussion in this Chapter, it is important to set out, first, the evolution of the CBCR, to explain the rationale behind its design and the objective that it was designed to achieve. The CBCR mechanism is the outcome of the advocacy of tax activists for increased transparency in corporate governance through the disclosure of comprehensive information about the global activities of MNCs.²¹ The first group to fight for this cause was the Global Witness Group.²² Over the years, other non-governmental organizations have joined the cause, including Global Financial Integrity, Christian Aid, Global Witness, Tax Justice Network, Oxfam, ActionAid UK, Eurodad and Transparency International.²³ CBCR was first suggested by Richard Murphy in 2003²⁴ as a new international accounting

²⁰ See for instance, Subdivision 284-E of Schedule 1 to the Australia's Taxation Administration Act 1953; Section 247 of Canada's *Income Tax Act*.

²¹ Allison Christians, "Tax Activists and the Global Movement for Development through Transparency" in Brauner & Miranda Stewart, eds, *Tax, Law and Development* (United Kingdom: Edward Elgar Publishing, 2012) at 291.

²² *Ibid* at 290.

²³ *Ibid*.

²⁴ Richard Murphy, "A Proposed International Accounting Standard: Reporting Turnover and

standard requiring MNCs to disclose information about their global activities.²⁵ Murphy comments on the nature of CBCR as a mechanism designed for the use of everyone affected by the activities of MNCs thus:

...it is stressed that tax was by no means the only concern in suggesting what should be disclosed: issues relating to governance, geopolitical and economic risk, corporate social responsibility and exposure to potential corruption were all as significant when demanding initial geographic data. The accounting data was also clearly designed to meet a variety of other needs as well. Employment data, for example, also assists trade unions and those interested in employment related issues whilst also permitting a range of productivity related ratios to be calculated. Combining profit and capital ratios also indicates to investors how effective management might be at allocating the capital entrusted to their care. The significance of country-by-country reporting for these interest groups should not be ignored.²⁶

After Murphy designed the CBCR and encouraged states to adopt it as an accounting standard, a good number of the non-governmental organizations identified above embraced it.²⁷ The argument for the inclusion of the CBCR mechanism by Murphy and tax activist groups shows that the CBCR was not designed only solely for tax administrators. It is said to be beneficial to all stakeholders involved. Stakeholders include “employees, suppliers, customers, governments, regulatory agencies, civil society, trade unions, and ordinary citizens”.²⁸ Murphy argues that MNCs owe these people and agencies a duty of care because they provide MNCs with their “licence to operate”.²⁹

Tax by Location” (2003) Essex: Association for Accountancy and Business Affairs. Available at: <visar.csustan.edu/aaba/ProposedAccstd.pdf>. (last accessed 25 July 2017)

²⁵ *Ibid.*

²⁶ Richard Murphy, “Country-by-country Reporting: An exploration of the data potential for Tax Authorities”, (2017) CIYPERC Working Paper Series 2017/02 at 2.

²⁷ See for instance the GFI, “GFI Urges G20 Action on Anonymous Companies, Country-by-Country Reporting at Brisbane Summit”: www.gfintegritty.org/press-release/gfi-urges-g20-action-anonymous-companies-country-country-reporting-brisbane-summit/, see also Oxfam, “Opening the Vaults: The Use of tax Havens by Europe’s Biggest Banks”: www.oxfam.org/en/research/opening-vaults where GFI and Oxfam argued for public disclosure of CBCR by all multinational corporations.

²⁸ Murphy *supra* note 22 at 1, see also Eurodad, “Exposing the Lost Billions: How Financial Transparency by Multinationals on a Country-by-Country Basis Can Aid Development” : www.eurodad.org/files/pdf/4720-exposing-the-lost-billions-how-financial-transparency-by-multinationals-on-a-country-by-country-basis-can-aid-development-.pdf

²⁹ Richard Murphy, “Country-by-Country Reporting: Holding Multinational Corporations to Account Wherever they are” (2009) Task Force on Financial Integrity and Economic Development at 11, see also Richard Murphy, “Country-

To this end, he says all stakeholders deserve to know about the transnational trade activities of MNCs. He argues that although MNCs prepare consolidated accounts by which they indicate the global trade activities of constituent entities, the information only reveals the business outlook and investment trends of the MNC group as a whole for the benefit of shareholders.³⁰ As such, information about intra-firm transactions, like the underlying profit shifting mechanisms utilized by MNCs are not included in the consolidated financial accounts filed by MNCs.³¹ Given that consolidated accounts are prepared for the benefits of shareholders, they, therefore, do not provide an avenue by which other groups and agencies affected by the activities of MNCs can hold them accountable for what they do.

Through their campaign for transparency, advocates for CBCR emphasize the importance of transparency and accountability for MNCs in the jurisdictions where they operate, not just to tax administrations but to members of the public. Murphy explains the objective of the CBCR as follows:

The basic concept is to require the inclusion in annual audited financial statements of a profit and loss account for each jurisdiction in which a multinational corporation had operations during the year. These profit and loss accounts would include disclosure of both third party and intra-group transactions, which for these purposes are those trades that take place across national boundaries but between companies under common ownership or control. They would be required to be reconciled with the overall group results.³²

by-Country Reporting: Accounting for Globalisation Locally” Tax Justice Network, 2012: www.taxresearch.org.uk/Documents/CBC2012.pdf at 2.

³⁰ Richard Murphy, “Country-by-Country Reporting: Accounting for Globalisation Locally” *Ibid* at 61.

³¹ Maria Theresia Evers, Ina Meier & Christoph Spengel, “Transparency in Financial Reporting: Is Country-by-Country Reporting Suitable to Combat International Profit Shifting?” (2014) *Bulletin for International Taxation* at 298-9.

³² Richard Murphy, “The Benefits of Country-by-Country Reporting”, (2012) *Association of Concerned African Scholars* at 42.

The discussion and assessment of the OECD's CBCR in this section is from this standpoint; that is, to assess whether the provisions of the OECD's CBCR Rules align with the original intention for CBCR, and whether it provides a viable framework for a global fight against BEPS.³³

4.3 The OECD's CBCR Mechanism: Introduction

The OECD demonstrated its commitment to the cause of tax activists regarding increased transparency for MNCs by including the CBCR mechanism in its first set of deliverables of the BEPS Project in 2014.³⁴ Later in September 2014, the OECD released the Country-by-Country Implementation Package.³⁵ The Implementation Package contains comprehensive information about the CBCR Rules. The content of the CBCR documentation is summarized by the OECD as follows:

The country-by-country report requires multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs 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 engages in.³⁶

The OECD's guidance on CBCR Rules demonstrates its desire to balance the competing interests of tax administrators and MNCs. The Guidance contains rules allowing tax administrations to have access to detailed information about the transfer prices of MNCs at an early stage, while allowing for the performance of transfer pricing risk assessments to determine if the prices fixed on transactions being assessed warrant in-depth review in the form of an audit.³⁷ At the same time,

³³ Christians *supra* note 21 at 293.

³⁴ OECD (2014), *Explanatory Statement*, OECD/G20 Base Erosion and Profit Shifting Project, OECD.

³⁵ OECD, *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, 2014.

³⁶ *Ibid* at 11.

³⁷ *Ibid* at 14.

the Guidance attempts to create a cost-effective mechanism for filing transfer pricing documentation by MNCs, as it requires that MNC entities file the same set of documentation in jurisdictions where they operate.³⁸ The OECD introduced three new sets of documentation that expand the filing obligations of MNCs namely: a master file, a local file and a Country-by-Country Report.³⁹

The master file is designed to provide information about the general overview of an MNC business group, including the nature of its business, overall transfer pricing policies, and global allocation of income and economic activity. The OECD says the import of the master file is to contain information providing a “blueprint of the MNE group”. The local file, on the other hand, provides information about the transaction being assessed in the context of the domestic country’s tax system. According to the rules, such information includes relevant financial information about the specific transaction, a comparability analysis and the selection and application of the most appropriate transfer pricing method.

The CBCR that is the subject of this chapter of the thesis consolidates the information in both the master and local files. It provides information relating to the tax implications of activities conducted by all constituent entities of an MNC, locations of such activities, allocation of global profits, and taxes paid. According to the OECD, CBCRs will be useful to tax administrations for high-level transfer pricing risk assessment purposes, for BEPS related risks, and where appropriate, for economic and statistical analysis.⁴⁰ Information disclosure by MNCs is expected to have a huge impact on transfer pricing risk assessments and audits by tax administrations.

³⁸ *Ibid.*

³⁹ *Supra* note 35 at 17-9.

⁴⁰ *Supra* note 35 at 19.

The OECD is largely positive about the potential for states' use of the CBCR to fight against BEPS.

It expressed its optimism thus:

This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments.⁴¹

In February 2015, the OECD released further Guidance on CBCR (the Guidance),⁴² focusing more on the Implementation of the CBCR Rules. The Guidance sets out in detail the types of MNCs required to file CBCR, the suggested timing for filing CBCR, the mechanisms for exchange of CBCR between countries, and the conditions that should govern the obtaining and use of CBCR documentation.⁴³

According to the Guidance, CBCRs are required to be filed only by MNC groups with consolidated revenue of not less than €750 million or its equivalent in local currency as at January 2015, or during the fiscal year immediately preceding the reporting fiscal year.⁴⁴ Also, the obligation to file CBCR is primarily on the ultimate parent entity of an MNC or, if unable to file, a surrogate entity may be appointed by the MNC group to file.⁴⁵ An ultimate parent entity is defined as one that owns directly or indirectly a sufficient interest in one or more other constituent entities of the MNC group, as a result of which it is required to prepare consolidated financial statements.⁴⁶ A surrogate parent entity is appointed by an MNC group not only when CBCR is not filed by the ultimate parent entity, but also in situations where an ultimate parent entity files CBCR with its country of residence but the country fails to share CBCR with other countries under the following

⁴¹ *Supra* note 35 at 9-10.

⁴² OECD/G20 Base Erosion and Profit Shifting Project Action 13, *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting*, February 2015.

⁴³ *Ibid* at 4.

⁴⁴ *Ibid*.

⁴⁵ Action 13: Country-by-Country Reporting Implementation Package OECD OECD/G20 Base Erosion and Profit Shifting Project, 2015 at 9-12.

⁴⁶ *Ibid*.

circumstances: where the ultimate parent entity has no obligation to file CBCR under the laws of its country of residence; or where the country of residence of the ultimate parent entity, though party to the OECD's International Agreement on CBCR, yet has no agreement with specific countries regarding exchange of CBCR (the Qualifying Competent Authority Agreement (QCAA)). A surrogate parent entity is appointed also if a systemic failure occurs, that is, where the country of residence of an ultimate parent entity has a QCAA in place, but fails to exchange CBCR with other signatories.⁴⁷ For timing, the Guidance proposes that reporting must begin in the fiscal year beginning on January 1, 2016. However, the recommendation of the September 2014 Guidance on CBCR was that MNCs be given one additional year to prepare for the filings. In view of this, the OECD recommended the start date to be December 31, 2017.⁴⁸

According to the OECD, the use of CBCR is limited to assessment of high-level transfer pricing risks and other base erosion and profit shifting related risks, including the risk of non-compliance by members of the MNC group with applicable transfer pricing rules. Where appropriate for economic and statistical analysis, the CBCR may also be reviewed.⁴⁹ The OECD specifically notes that transfer pricing adjustments should not be based on CBCRs filed.⁵⁰ Also, tax administrations are under the duty to keep information derived from CBCR confidential. This is similar to their obligations under tax information exchange agreements or other bilateral agreements for the exchange of information and confidentiality obligations under domestic legislation. Thus, the OECD proscribes exchange of CBCR with non-signatories to its mechanism for exchange, namely,

⁴⁷ *Ibid.*

⁴⁸ *Supra* note 39.

⁴⁹ *Supra* note 35 at 5.

⁵⁰ *Ibid.*

the *Multilateral Competent Authority Agreement*⁵¹, Double Tax Conventions and Tax Information Exchange Agreements.⁵²

Annexes III & IV to chapter V of the OECD transfer pricing guidelines consolidate all of the OECD reports on CBCR.⁵³ There, the OECD declares that the CBCR is to serve three key purposes, namely: to ensure that MNCs give appropriate consideration to transfer pricing requirements in establishing their transfer prices; and to provide tax administrations with adequate information about the activities of MNCs to conduct an informed transfer pricing risk assessment; to provide tax administrations with adequate information necessary to conduct an audit of the transfer pricing activities of MNCs.⁵⁴

Annex III contains a template for CBCR. This template provides information about the constituent entities of an MNC for a fiscal year, namely: the tax jurisdictions that the entities operate from; total profits derived from related and unrelated entities; profits/loss before tax; income tax paid; income tax accrued; stated capital; accumulated earnings; number of employees; and tangible assets other than cash and cash equivalents. An additional template provides information about the tax jurisdiction of constituent entities of MNCs, and the nature of activities carried out by the entities. Constituent entities are defined to include those included in an MNC group's financial statements, or entities excluded on size or materiality grounds, and permanent establishments. With regard to permanent establishments, the OECD warns that the taxpayer should reflect their operation (source) countries and not the country of residence of the business group. Also,

⁵¹ *Infra* note 55.

⁵² *Ibid.*

⁵³ OECD, *OECD Transfer Pricing Guidelines supra* note 9.

⁵⁴ *Ibid* at 235, para 5.5.

information filed should indicate the countries of residence of entities, or jurisdiction of incorporation where this is different.

Annex IV to Chapter V contains information about the implementation and exchange of CBCR. Guidance in Annex IV mirrors the provisions in the OECD's *Convention on Mutual Administrative Assistance in Tax Matters*⁵⁵, which is the principal legislation on CBCR. It contains eight articles covering definition of terms, provisions on filing obligations, provisions on the duty of an MNC entity to give notification of the details of the reporting entity to its local tax administration, summary of the content of CBCR, time for filing, terms governing use of CBCR and the obligation on tax administration to keep the content of CBCR confidential, room for tax administrations to insert penalty provisions in their local laws if they choose to and, lastly the effective date. The detailed guidance on CBCR is to ensure that the OECD's desire for consistency and uniformity in the filing and use of CBCR is met.⁵⁶ In the next section, this Chapter assesses the viability of the OECD's CBCR mechanism through the three key clauses, namely: the threshold, confidentiality, and appropriate use clause.

4. 4 Viability of the OECD' CBCR in the Global Fight against BEPS: A Weak Regime

Three clauses structure the OECD's regime on the operation of the CBCR apparatus. In light of the fight against BEPS, this mechanism is well intentioned but does not carry the bite for an effective campaign against BEPS. An evaluation of the threshold clause, the confidentiality clause, and the appropriate use clause reveals how unlikely it is that the OECD's approach to CBCR Rules will assist in the fight against BEPS. The CBCR Rules do not apply to MNCs with an annual

⁵⁵ OECD and Council of Europe (2011), *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol*, OECD Publishing.

⁵⁶ *Supra* note 42 at 5.

consolidated revenue of less than €750 million by the provisions of the threshold clause. The confidentiality clause prevents the opportunity to expose legal and institutional structures that advance BEPS. The appropriate use clause forbids the use of information contained in CBCR filed to adjust the tax liabilities of MNCs.

4.4.1 The Threshold Clause

The threshold clause is fundamental to an assessment of the viability of the Rules as a mechanism designed to help fight against BEPS globally. This clause restricts the operation of the rules to MNCs with an annual consolidated revenue of not less than €750 million in the year preceding the time of filing the report. This restriction obviously weakens the OECD's declared intent to eliminate BEPS globally. Although there are statistics showing that MNCs engage in BEPS-related activities, as discussed in Chapter 2, none show the types of MNCs that engage in these activities. Therefore, without statistics demonstrating that only the MNCs that meet the prescribed threshold engage in BEPS, the prescribed threshold lacks merit. What this does is to focus on the very large MNCs, leaving out the smaller ones which also engage in BEPS-related activities. This situation likely leaves a substantial amount of BEPS activity unexposed. It supports continued aggressive tax planning by some MNCs. The number of MNCs left out of this laudable ideal of increased transparency is a cause for worry in terms of how far the goal to eliminate BEPS globally can be pursued. The MNCs which qualify for CBCR, as estimated by the OECD, represents 10-15 per cent of the total number of MNCs.⁵⁷

⁵⁷ *Supra* note 42 at 5.

This situation is worse for developing countries, which have fewer MNCs. Statistics reveal that the headquarters of top MNCs are predominantly in developed countries.⁵⁸ The parent companies of majority of the 500 top MNCs that meet the OECD's threshold, as listed by Fortune Global, are based in developed countries, with China, Brazil, India, Russia, Mexico, India, Malaysia, Thailand, Singapore, Indonesia, Saudi Arabia and Turkey, the emerging economies, as the exceptions.⁵⁹ The implication is that other countries with smaller MNCs that are interested in eliminating BEPS may be prevented from doing so if the MNCs that operate in their jurisdictions do not meet the OECD's threshold.

Surprisingly, the threshold also affects developed countries. For instance, according to statistics on the number of MNCs with parent entities resident in Canada in 2006, as of December 16th, 2013, more than 1400 corporations would escape the web of CBCR just by the prescribed threshold.⁶⁰ If these corporations are exempt from filing CBCR in a developed country like Canada, one might wonder what the figures would be in developing countries, and the least developed countries that have even fewer MNCs.

By way of recommendation, it is suggested that states incorporating the OECD's CBCR Rules into their local laws should modify this clause to prescribe a more feasible threshold that would ensure that CBCRs are filed by MNCs that are subject to their tax laws. Since there are no statistics showing the category of MNCs that engage in BEPS, it is difficult to prescribe a threshold.

⁵⁸ See, Fortune Global 500 for the list of top 500 MNCs and their country of residence: www.fortune.com/global500/list/filtered?non-us-cos-y-n=true

⁵⁹ *Ibid.*

⁶⁰ The Canadian Encyclopaedia: Multinational Corporation, online: www.thecanadianencyclopedia.ca (last accessed 28 July 2017).

Notwithstanding, there appears to be no justification for the exemption of some MNCs from the CBCR obligation without evidence to back this up.

4.4.2 The Confidentiality Clause

This clause also demonstrates the inadequacy of the OECD's CBCR Rules because it proscribes the disclosure of information contained in the CBCR filed by MNCs to non-signatories and members of the public. The concern this clause raises goes to the seriousness of the OECD's declared fight against BEPS. Compelling confidentiality excludes states that have not subscribed to the OECD's mechanism, as well as individual members of the public who are interested in knowing about the earnings of MNCs within their jurisdictions and the amount of taxes they pay on their profits. The implications of this clause on the global fight against BEPS are two-fold, as discussed seriatim.

First, the confidentiality clause requires that signatories to the OECD's Multilateral Competent Authority Agreement on The Exchange of Country-by-Country Reports (CBC MCAA) can share CBCR filed by entities of MNCs within their jurisdictions only with other countries that have other MNC entities within their jurisdictions, provided the latter are, simultaneously, signatories to the CBC MCAA. The problem with this clause flows from the fact that not all countries are signatories to the OECD's CBC MCAA. As at 22 June 2017, out of the 196 countries of the world, only 64, that is, less than half, have subscribed to the OECD's mechanism.⁶¹ This clause therefore denies other countries useful information needed to help them to combat BEPS within their territories. The confidentiality clause makes it impossible for countries which are interested in deterring BEPS within their jurisdictions and, obviously, need the information contained in the CBCR but do not

⁶¹ Signatories of The Multilateral Competent Authority Agreement on The Exchange of Country-by-Country Reports (CBC MCAA) and Signing Dates: www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf (last accessed 29 July 2017)

have the resources to commit to the OECD's CBCR mechanism, to have access to CBCR filed by MNCs. The majority of the signatories to the OECD's exchange mechanism are developed countries. In discussing the revenue consequences attached to BEPS in Chapter 2, it was highlighted that BEPS affects developing countries more than it does developed countries. Therefore, one would have thought that a mechanism designed to address BEPS on a global scale would accommodate as many countries as possible. Clearly, the confidentiality clause fails to create a framework necessary to eliminate BEPS globally.

Second, the confidentiality clause prevents the public from accessing CBCR filed by MNCs. It is arguable that the fight against BEPS is incomplete without an opportunity for the public to assess the information filed by MNCs, and to have the opportunity to consider how tax administrations assess the tax liabilities of MNCs. These two conditions provide a 'third-party opinion' about how MNCs carry on their businesses and how countries treat them, an exercise that is necessary to evaluate the activities of MNCs and national responses to them. Public scrutiny helps to assess the extent to which MNCs and tax administrators incorporate transparency and accountability into their activities. Public disclosure of CBCR is not just for 'public shaming' of MNCs that engage in BEPS. It is also to expose legal and institutional agencies in states that permit BEPS, whether deliberately as acts of corruption, or unintentionally when laws require MNC entities to only publish limited information and, as such, offers them a platform to hide their BEPS-related activities.⁶² My normative claim is, however, subject to some privacy concerns examined below.

As the Task Force on Financial Integrity and Economic Development put it, public disclosure would enable "local stakeholders to know the real identity of the companies with which they are

⁶² Richard Murphy, "Country-by-Country Reporting: Holding Multinational Corporations to Account Wherever they are" *supra* note 29.

engaging”.⁶³ This information is the starting point for making MNCs accountable for what they do across jurisdictions. First, it offers a mechanism by which the public can compare the level of profit recorded in these different jurisdictions with the amount of taxes paid on them. The public can then query the amount of profits recorded in their jurisdictions if these are not commensurate with the level of economic activities carried on within the jurisdictions. As discussed in Chapter 2, the detrimental consequences of BEPS affect individual taxpayers. Therefore, individual taxpayers should also qualify as “stakeholders” to join in the fight against BEPS. They can, however, only do so if provided with information contained in the CBCR as a premise to challenge MNCs for their BEPS-related activities.

Another advantage of public disclosure of CBCR is making it possible to query the amount of taxes collected by tax administrations on profits declared by MNCs, as well as the use of these resources by governments. In this sense, CBCR would be a useful tool to challenge under-payment of taxes by MNCs, as those reports would assist in assessing whether MNCs had not been paying their appropriate share of taxes like other domestic taxpayers.⁶⁴ Public disclosure of CBCR also opens the door for public accountability because there would be publicly available information on how much taxes government collects from MNCs, and how government uses these resources for the public good. The Extractive Industries Transparency Initiative (EITI)⁶⁵ is geared to increase transparency between governments and the public, but only in the extractive industry sector. The possibility of public disclosure of CBCR stands out as a major reason why tax activists support the CBCR. They rightly see BEPS as the combination of aggressive tax planning activities of MNCs and inadequacies in the legal and institutional structures regulating how MNCs are taxed. If public

⁶³ Richard Murphy *supra* note 29 at 14.

⁶⁴ Richard Murphy *supra* note 29 at 15.

⁶⁵ Extractive Industries Transparency Initiative: www.eiti.org/ (last accessed 29 July 2017)

disclosure of CBCR is allowed, it will give room for transparency to cut across sectors. It is this encompassing framework that is needed to eliminate BEPS globally.

It is pertinent here to examine what the law requires in terms of protecting the privacy of corporations. This is necessary to ascertain if the OECD's CBCR Rules, in light of the confidentiality clause, confers on MNCs a privilege that is non-existent in laws regulating the transnational activities of corporations. The right to privacy is a fundamental right respected and protected in nearly all nations by constitutional provisions, legislation, or common law rules.⁶⁶ This right, however, is usually interpreted only in relation to the protection it confers on individuals rather than on corporate entities.⁶⁷ The issue of the right to privacy of corporate taxpayers has not attracted much academic and policy attention.⁶⁸ Cockfield and McArthur explain this situation in the following words: "...substantive privacy rights are generally associated with individuals. The nature of these privacy rights devolves from the potential for intimate harm (for example, kidnapping) that could result from the disclosure of an individual's personal information. Such concerns are less evident in the case of corporate taxpayers..."⁶⁹

In cases relating to corporate entities where a right to privacy comes up for determination, the Courts have emphasized that this right is guaranteed by constitutions to individuals only. For instance, the Court of Appeal of Kentucky in *Maysville Transit Co. v. Ort*⁷⁰ held: "...if the case at bar turned upon the violation of a right of privacy, then the company's cause would fail because such a right is designed primarily to protect the feelings and sensibilities of human beings, rather

⁶⁶ See Canadian Charter of human rights and freedoms, CQLR c C-12, sections 7 and 8, See also Section 37 of Nigeria's Constitution.

⁶⁷ Arthur J. Cockfield and Carl D. MacArthur, "Country-by-Country Reporting and Commercial Confidentiality" (2015) 63:3 Canadian Tax Journal 627 at 653.

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

⁷⁰ *Maysville Transit Co. v. Ort*, 177 SW 2d 369, at 370 (1944).

than to safeguard property, business or other pecuniary interests.”⁷¹ More directly, the US Supreme Court in *California Bankers Association v. Shultz*⁷² held that corporations do not enjoy the right to privacy. The Court said:

While they may and should have protection from unlawful demands made in the name of public investigation, corporations can claim no equality with individuals in the enjoyment of the right to privacy. They are endowed with public attributes. They have a collective impact upon society, from which they derive the privilege of acting as artificial entities.

Reuven S. Avi-Yonah argues that in the US, corporate privacy is an oxymoron. He says the right to privacy applies only to individuals because only individuals have the kind of feelings that are affected by invasions of privacy.⁷³ In sum, therefore, the right to privacy should not apply to corporations. As such, MNCs can be required by law to publicly disclose CBCR.

It is important to stress at this point that the argument for public disclosure of CBCR is for MNCs, not tax administrators, and it is because public disclosure is necessary in the broad context of the economic and social implications that BEPS creates for members of the public, as discussed in Chapter 2. As MNCs owe a duty to tax administrators to report the activities that generate their profits, they also owe members of the public a duty of care which is fulfilled when members of the public are informed about their global activities.⁷⁴ This duty does not depend on the duty of confidentiality that tax administrations owe MNCs that is protected under domestic statutes. For instance, section 241(1) of Canada’s *Income Tax Act*⁷⁵ guarantees the right of non-disclosure of taxpayer information to third parties. It provides thus:

⁷¹ *Ibid.*

⁷² *California Bankers Association v. Shultz* 416 U.S. 21, 65-66 (1974).

⁷³ Reuven S. Avi-Yonah, “Country-by-Country Reporting and Corporate Privacy: Some Unanswered Questions” (2016) 8:1 Colum. J. Tax Matters at 1.

⁷⁴ *Supra* note 63.

⁷⁵ *Income Tax Act*, RSC 1985, c. 1 (5th Supp), s 241(1)(a) & (b) (c), see also Jinyan Li, “Taxpayers’ Rights in Canada” (1997) 7:1 Revenue Law Journal at 172, Allison Christians, “Taxpayer Rights in Canada” in César Alejandro Ruiz

Except as authorized by this section, no official or other representative of a government entity shall

(a) Knowingly provide, or knowingly allow to be provided, to any person any taxpayer information;

(b) Knowingly allow any person to have access to any taxpayer information; or

(c) Knowingly use any taxpayer information otherwise than in the course of the administration or enforcement of this Act, the Canada Pension Plan, the Unemployment Insurance Act or the Employment Insurance Act or for the purpose for which it was provided under this section.

The requirement for public disclosure of CBCR that this Chapter proposes does not conflict with the duty of confidentiality which the law imposes on tax administrations discussed above. It must be noted that there are existing initiatives promoting public disclosure of global activities. For instance, Section 1504 of the Dodd-Frank Act in the US requires listed US corporations operating in the extractive sector to publish payments made to the United States or a foreign government.⁷⁶ Also, by virtue of the proposed amendment to the UK Finance Act 2016, MNCs operating in the UK, domestic corporations, general and limited liability partnerships, LLPs with consolidated revenue of €750 million or more, may be required by the Treasury to publish CBCR.⁷⁷ A similar provision exists in the EU's Directive for EU corporations.⁷⁸ Specifically, financial institutions in the European Union are obligated to publish CBCR by virtue of the provisions of Section 77 of the European Union (Capital Requirements) Regulation.⁷⁹ Section 77(1) provides thus:

Jiménez, ed. *Derecho Tributario Y Derechos Humanos/tax Law and Human Rights* (2016). Available at SSRN: <https://ssrn.com/abstract=2797381>

⁷⁶ Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

⁷⁷ The amendment is the inclusion of this clause to Schedule 19 of the Finance Act, 2016. It provides that "A group tax strategy of a qualifying group which is a MNE group must also include a country-by-country report", Online: www.publications.parliament.uk/pa/bills/cbill/2016-2017/0001/amend/finance_rm_cwh_0608.pdf (last accessed 29 July 2017).

⁷⁸ European Commission, Company Reporting: www.ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting_en (last accessed 29 July 2017)

⁷⁹ Regulation (Eu) No 575/2013 Of the European Parliament And of The Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012: www.eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=en

Subject to paragraph (2), each institution shall, from 1 January 2015, disclose annually, specifying by Member State and by third country in which it has an establishment, the following information on a consolidated basis for the financial year:

- (a) name, nature of activities and geographical location;
- (b) turnover;
- (c) number of employees on a full time equivalent basis;
- (d) profit or loss before tax;
- (e) tax on profit or loss;
- (f) public subsidies received.

These mechanisms, though laudable, are insufficient to combat BEPS on a global basis. The reasons are, first, they apply to only extractive industries and financial institutions in the European Union. Second, they exempt some categories of MNCs by the threshold fixed on the categories of MNCs required to file CBCR. More importantly, these initiatives do not require disclosure on every relevant aspect of MNC activities. For instance, none of the rules requires publication on tangible assets of concerned MNCs.⁸⁰ The Dodd-Frank Act enacted pursuant to the Extractive Industries Transparency Initiative (EITI) is even worse because it does not require publication of information about the activities of the filing corporations, nor the revenue made, profit/loss before tax, and the number of employees.⁸¹ The OECD's CBCR template has all the relevant information necessary to evaluate the activities of MNCs. If the OECD's confidentiality clause is expunged, the OECD's CBCR will serve as a more suitable platform by which the activities of MNCs in all industries can be subject to a higher level of transparency through public disclosure.

The crux of the arguments raised against public disclosure of CBCR is that MNCs might lose some competitive advantages if they disclose confidential information about their global activities, such

⁸⁰ KPMG, Country-by-Country Reporting: An Overview and Comparison of Initiatives, 2016 at 18. www.kpmg.com/content/dam/kpmg/pdf/2016/07/cbcr-kpmg-cbcr-overview-and-comparison-of-initiatives-15042016.pdf (last accessed 2 August 2017).

⁸¹ *Ibid.*

as trade secrets.⁸² This is a serious concern that is recognized even by the OECD prior to the adoption of the CBCR Rules. It is to cater to this concern that Article 26(3) of the OECD Model Double Tax Convention⁸³ provides for the right of a tax administration to refuse to share the information of a taxpayer if it is satisfied that doing so would violate the taxpayer's right to maintain commercial and trade secrecy. Given that confidentiality is such a serious issue, rules should be enacted in such a way that compliance with them do not harm MNCs in the way they conduct their businesses. Even so, it is important to assess whether public disclosure of CBCR might lead to loss of competitive advantages and/or profits by MNCs. Cockfield argues that statistics on this issue are polarised.⁸⁴ Some note that MNCs are not eager to publicly disclose information about their activities because they want to avoid scrutiny from investors on their allocation of global resources. Others argue that the lack of interest in public disclosure is because MNCs might incur some proprietary costs as a result.⁸⁵ Cockfield further points to empirical research that reveals that MNCs withhold information on their global activities because they want to hide the fact that they shift profits from high-tax jurisdictions to low-tax jurisdictions from tax administrations and members of the public.⁸⁶ Amidst the inconsistent findings on whether public disclosure of CBCR would harm businesses or not, Transparency International (EU) based on its

⁸² Cockfield & McArthur *supra* note 67 at 655-7.

⁸³ OECD (2012), Model, Tax Convention on Income and on Capital 2010 (updated 2010), OECD Publishing.

⁸⁴ Cockfield & McArthur *supra* note 67 at 647-50

⁸⁵ *Ibid.*

⁸⁶ Cockfield & McArthur *supra* note 67 at 649 citing Ole-Kristian Hope, Mark Ma, and Wayne B. Thomas, "Tax Avoidance and Geographic Earnings Disclosure" (2013) 56: 2-3 *Journal of Accounting and Economics* 170-89. Herita T. Akamah, Ole-Kristian Hope, and Wayne B. Thomas, Tax Havens and Disclosure Aggregation, Rotman School of Management Working Paper no. 2419573 (Toronto: University of Toronto, Rotman School of Management, November 2014).

2016 research found that rather than for CBCR to reduce MNCs' competitiveness, 43 per cent of EU CBCR reporters maintained or increased their competitiveness.⁸⁷ It reports as follows:

In fact, the research shows that 43 per cent of the European companies that already publicly report on a country-by-country basis improved or maintained their revenue performance. Similarly, more than 90 per cent of the assessed Indian companies that report on subsidiary-by-subsi-dary basis had a revenue growth comparable or higher than an average of other international companies in a similar sector...companies can no longer say public country-by-country reporting puts them at a competitive disadvantage. The research does not back them up...⁸⁸

Given the fundamental nature of the BEPS problem, together with the detrimental consequences that it continues to have in various countries, the absence of rules protecting MNCs from publicly disclosing their global activities, in light of the empirical evidence disclosure maintains and even enhances their competitiveness, the clear conclusion to draw is that the confidentiality clause of the OECD's CBCR Rules is not the right tactic to adopt. Does the 'appropriate use clause' provide any better hope for the fight against BEPS?

4.4.3 Appropriate use

The restricted purposes for which the CBCR reports filed by MNCs can be used, as provided under the CBCR Rules, is another major weakness of the Rules, and this will likely impede a global fight against BEPS. This clause circumscribes the use of the CBCR Reports filed to transfer pricing assessments and economic and statistical analysis. The OECD declares as follows:

The country-by-country report will be helpful for high-level transfer pricing risk assessment purposes. It may also be used by tax administrations in evaluating other BEPS related risks and where appropriate for economic and statistical analysis. However, the information in the country-by-country report should not be used as a substitute for a

⁸⁷ Transparency International, "Do corporate claims on public disclosure stack up? Impact of public reporting on corporate competitiveness" www.transparencyinternational.eu/wpcontent/uploads/2016/07/Factsheet-impact-public-reporting-competitiveness.pdf

⁸⁸ Transparency International, "Press Release: New Research Shows Transparency Does Not Negatively Affect Business Competitiveness", 13 July 2016, online: www.transparencyinternational.eu/2016/07/press-release-new-research-shows-transparency-does-not-negatively-affect-business-competitiveness/.

detailed transfer pricing analysis of individual transactions and prices based on a fully functional analysis and a full comparability analysis.⁸⁹

The above quote confirms that the OECD designed the CBCR mechanism only as a source of information to tax administrations for risk assessment. The problem with this arrangement is that the rules do not improve the application of transfer pricing rules based on the arm's length principle in any significant way. The fundamental weakness of the arm's length principle, as discussed in Chapter 3 is the inability to apply it to efficiently tax MNC profits derived from the synergistic relationships that exist between MNC entities. This creates a gap because tax administrations are unable to ascertain the appropriateness of transfer prices declared by MNC entities. One would have thought that an addition to the arm's length principle, such as the CBCR Rules, would be designed to improve the application of the principle with the aim to deter BEPS.

Given this implication, it is obvious that the restriction of the use of CBCR to assessment of high-level transfer pricing and other BEPS-related risks is unhelpful to the application of the arm's length principle. This is because the Rules proscribe re-adjustment of MNC profits based on information contained in the CBCR.⁹⁰ This outcome undermines the fact that the relevance of the CBCR as a tool to crack down on BEPS must lie in its practical usefulness as a source of information that can be utilized to adjust the profits of MNCs if these are found to be inappropriate. Knowledge about the BEPS-related activities of MNCs without the ability of tax administrators to correct such activities impedes a global fight against BEPS.

The restricted use of the CBCR even goes against how states currently apply the arm's length principle. By the transfer pricing rules of states which reproduce the provisions of Articles 9(1)

⁸⁹ OECD Transfer Pricing Guidelines *supra* note 9 at 235, para 5.25.

⁹⁰ Sol Picciotto, "Towards Unitary Taxation: Combined Reporting and Formulary Apportionment" in Thomas Pogge & Krishen Metha eds. *Global Tax Fairness* (United States of America: Oxford Press, 2016) at 228.

and 9(2) of the OECD and UN Model Tax Conventions respectively, tax administrations are empowered to adjust or even recharacterize the transfer prices of MNCs if these are found to be non-arm's length.⁹¹ To this end, the CBCR Rules do not support the tenets of the arm's length principle, and so they cannot be seen as an improvement on the principle's effectiveness. Since the OECD has declared its intention to retain the arm's length principle, and only to amend it in a way that it can be effectively used to combat BEPS⁹², one would expect any reform of the principle to align with the objectives behind it. To the contrary, the "appropriate use" clause falls short of advancing the objectives of the arm's length principle.

4.5 Conclusion

Overall, the assessment of the threshold, confidentiality, and the 'appropriate use' clauses in this Chapter reveals the inadequacies of the OECD's objective to provide a framework, through the CBCR, by which BEPS can be eliminated globally. To summarize the flaws discussed above, the CBCR Rules exempt 85-90 per cent of MNCs from participating; it shields the information contained in CBCR from non-signatories to the OECD's mechanism for exchange of CBCR, and from members of the public; and it forbids the use of CBCR for transfer pricing adjustments.

These fundamental flaws limit the viability of the OECD's CBCR Rules as an addition to international taxation rules for eliminating BEPS globally. More importantly, the fundamental weakness of the arm's length principle, as discussed in Chapter 3, is the reason this thesis recommends an alternative approach - unitary taxation (formulary apportionment) - in place of the arm's length principle. The formulary apportionment (FA) approach, unlike the arm's length

⁹¹ See for instance, Section 247(2)(a) & (c) and 247(2)(b) & (d) of Canada's *Income Tax Act* *supra* note 76 for the CRA's power to adjust and recharacterize transfer prices of MNCs respectively.

⁹² OECD Transfer Pricing Guidelines *supra* note 9 at 35-8.

principle, provides a better platform for the use of information contained in CBCR, and in this way, would help in the global fight against BEPS. The unitary taxation approach ensures that the profits of MNCs will be allocated to states based on the level of economic activities within their jurisdictions from which those profits are generated. The indicia for allocation would be the key indicators of the economic activities of MNCs provided in the CBCR filed, namely, assets, labour and sales. The FA approach consolidates the global profits of an MNC enterprise, examines the economic activities that occurs in various states, and appropriates taxable profits to states based on the level of those activities that occur in each state.

Chapter 5: Conclusion

5.0 The Formulary Apportionment Approach: A Better Complement to the OECD's Country-By-Country Reporting Rules?

Chapters 1 and 2 of this thesis explained that MNCs fix transfer prices strategically to maximize their global profits. It was also established that tax havens attract mobile capital through their aggressive fiscal policies. Chapter 3 discussed the inadequacies of transfer pricing rules based on the arm's length principle that is, otherwise, supposed to enable tax administrators to eliminate BEPS activities, including their lack of access to information about the global activities of MNCs.

The crux of the argument in this Chapter is that effective taxation of MNCs can only begin when states adopt the Formulary Apportionment (FA) approach to replace the arm's length principle. The OECD recognizes the inadequacies of the arm's length principle in combatting BEPS, but has decided to reform rather than abandon it. This Chapter argues for the abandonment of the arm's length principle. What is needed is a complete overhaul of international taxation rules governing how MNCs are taxed. This is the approach that would eliminate the opportunities that MNCs capitalize on to erode taxes from source countries, and neutralize the harmful tax competition practices that tax havens and preferential tax regimes engage in. I draw from and agree with the approach advocated by Sol Picciotto. Lamenting the efficacy of both the arm's length principle and its projected reform proposals, he asserts:

The issue now facing us is how to establish international tax rules on a sounder basis. Applying further patches to existing rules seems futile. What is clearly needed is to reorient the rules so as to treat TNCs as single firms, instead of being based on the unrealistic fiction that they are a loose collection of separate and independent entities in each country.¹

¹ Sol Picciotto, "Towards Unitary Taxation: Combined Reporting and Formulary Apportionment" in Thomas Pogge & Krishen Metha eds. *Global Tax Fairness* (United States of America: Oxford Press, 2016) at 225.

The inadequacies of the arm's length principle as discussed in Chapter 3 inform Picciotto's assertion in the quote above. In this regard, this thesis endorses the switch to the formulary apportionment (FA) approach in place of the arm's length principle. The FA approach will ensure that MNCs are taxed in jurisdictions where they operate, by ensuring that profits are allocated to states on the basis of the level of economic activities, measured by objective factors, carried on in each state.

One of the reforms proposed to current international taxation rules by the OECD is the mechanism introduced pursuant to the Country-by-Country Reporting (CBCR) Rules. Although the objective of the CBCR regime is to provide information to tax administrations about the global activities of MNCs, the gaps identified in its structure, as fully discussed in Chapter 4, stand to impede the global fight against BEPS. Chapter 4 suggested amending the Rules to recast CBCR, to make it a viable mechanism in the effort to eliminate BEPS globally. The argument of this Chapter buttresses this argument by adding that once the amendments suggested in Chapter 4 are incorporated, the adoption of the FA would help to make the composite regime a more potent tool for eliminating, or at least, minimizing the incidence and adverse impacts of BEPS. The rest of this Chapter is structured as follows: Section 5.1 discusses the emergence of the FA approach and its operational form. Section 5.2 explains the workings of the FA approach and Section 5.3 shows how the CBCR can work in combination with the FA approach to eliminate BEPS globally. The Concluding Section 5.4 sums up the discussion, emphasizing that a switch to the FA approach in the place of the arm's length principle, in combination with the CBCR when amended according to the suggestions in Chapter 4, holds the potential for eliminating BEPS globally.

5.1 The Formulary Apportionment Approach: Background and Nature

The FA approach is not an entirely new concept. As far back as 1933, the Subcommittee of the Fiscal Committee of the League of Nations, while weighing alternatives to the arm's length principle, considered the fractional apportionment approach, an approach like the FA approach. Fractional apportionment, like FA, begins with the total net income of an MNC regardless of the sources from which they come, divided in a prescribed ratio and allocated to states based on the level of economic activities that took place within their jurisdictions.² The Subcommittee found that states resorted to the fractional apportionment approach when the income of non-resident entities of MNCs could not be ascertained through the particular accounts filed.³ International consensus at that time centred on the separate treatment of MNC entities. However, there was evidence of the use of the fractional apportionment approach by states. Despite this, the League failed to design rules to regulate its use. This rejection did not, however, bring an end to the use of the approach by individual states in taxing MNCs.

For instance, the US modified its transfer pricing regulations in 1994 by including two transactional transfer pricing methods to assess the economic functions performed by MNC entities that resulted in the profits being assessed.⁴ The two methods the US utilized were the comparable profit method (CPM) and the profit split method. The CPM is defined as “as a type of formula designed to ensure that the profits of the related party do not fall outside a reasonable

² League of Nations, *Taxation of Foreign and National Enterprises (Volume IV) Methods of Allocating Taxable Income* by Mitchell B. Carroll, Fiscal Comm., Doc. C. 399.M.204.1933.II.A, Geneva: League of Nations, 1933 at 58-90.

³ *Ibid* at 59.

⁴ The 1994 final regulations that incorporated these two methods is a product of series of debate as contained in the 1988 white paper, 1992 proposed regulations, 1993 temporary regulations and the 1994 final regulations under Section 482 of the Internal Revenue Code, US, see Reuven S. Avi-Yonah, “The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation”, (2006) 9 *Finance and Tax Law Review* 310 at 318.

range of profit margins earned by other corporations which are not truly comparable with the related party”.⁵ The profit split method is even closer to the FA approach than the CPM. It is the “...end of the transfer pricing continuum, because it starts with the enterprise as a whole and allocates the profits in a formulary fashion”.⁶ By this move, the US departed from the internationally recognised straight-jacket means of taxing MNCs through the arm’s length principle.⁷

The US initiative was borne out of the recognition and admission that the arm’s length principle was inadequate as a mechanism by which to effectively tax MNC profits, given the synergistic nature of the relationships that exist between MNC entities and the inability to verify the accuracy of the transfer prices they declare. Notwithstanding the inclusion of elements of the FA approach by the US through these two new methods, the US still titled the two methods the ‘basic arm’s length return method’ (BALRM). Avi-Yonah wonders:

It is difficult to see in what way the BALRM can meaningfully be called an ALS method in the traditional sense. First, since BALRM by definition can only be applied in the absence of comparables, it falls outside the traditional definition of the ALS, which relies on comparables. Thus, BALRM can only be called an "arm's length method" if the definition of what constitutes "arm's length methods" is expanded to include any method that reaches results that are the same as those that would have been reached by unrelated parties. If this is the definition, then “arm’s length” includes the entire transfer pricing continuum, including formulary apportionment, because even pure formulary apportionment may, in appropriate cases, reach the same results as would have been reached by unrelated parties dealing at arm’s length.⁸

Avi-Yonah’s comments about the difference between the BALRM and other transfer pricing methods under the US transfer pricing regulations are insightful. However, his argument that the

⁵ Reuven S. Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation” 2003-2007, Law & Economics Working Papers Archive at 2.

⁶ *Ibid.*

⁷ Reuven S. Avi-Yonah, “Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation”, (2010) World Tax Journal 13 at 17.

⁸ Avi-Yonah *supra* note 5 at 19.

CPM and profit split methods can only be termed an arm's length method if it is admitted that an arm's length method includes the FA approach is flawed. This is because the FA approach is a stand-alone approach, and differs from arm's length methods. For instance, while the arm's length methods including the BALRM under the US transfer pricing regulations require a comparative analysis, the FA approach does not. The conclusion that can be drawn from the introduction of the BALRM is that the US recognizes the inadequacies of the comparative analysis under the arm's length methods. It also appreciates the strength of functional analysis of MNC transactions under the BALRM, by allowing the US Treasury to depart from a comparability analysis under the arm's length principle, and to analyse functions performed by MNC entities and their subsequent allocation of profits to states by a formula.⁹ It, however, failed to embrace the FA approach in its entirety by restricting the use of the CPM and the profit split methods to instances when comparables cannot be found.

The OECD followed the US initiative by incorporating the CPM and profit split methods into its transfer pricing guidelines.¹⁰ As well, like the US, the OECD failed to admit its departure from the international consensus on the arm's length principle and to admit they have adopted elements of the FA approach. The OECD tried to block all avenues that may show partial abandonment of the arm's length principle. It did this, first, by, renaming the CPM as the transactional net margin method. Second, it reiterated that the arm's length principle was still the general principle that states should adopt.¹¹ The substance of the methods, especially the profit split method, however,

⁹ By virtue of the 1994 amendments to Section 482 of the US Internal Revenue Code.

¹⁰ OECD, (1995) *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, Paris.

¹¹ OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris; United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, Department of Social Affairs, United Nations, New York, 2017 at 38.

displaces any formal declaration by both the US and the OECD against the adoption of the FA approach. This Chapter argues that the FA approach sits comfortably in the OECD's profit split method, though in a restricted form, and this can be expanded.

The profit split method as described in the OECD transfer pricing guidelines divides the combined profits of MNC entities and allocates them to states based on a formula. The OECD provides two means by which tax administrators can use this method. First is the contribution analysis, that is, allocation of profits to states based on the level of economic activities performed by MNC entities in these states. The second approach suggested is the residual analysis approach. The residual approach is a two-sided transfer pricing approach. First is the assessment of the taxable profits of MNC entities based on the traditional transfer pricing approach, that is, comparability, in order to arrive at what the guidelines term the 'routine' profits of an entity. The second stage involves the use of an allocation formula to divide the residual profits to entities based on their level of contribution to the activities that produced the profits. The OECD prescribed the profit split approach for the division of profits accruing from unique intangibles. According to the OECD, this method is reserved for instances when comparables cannot be found, and allows tax administrators to divide the combined profits of MNCs among constituent entities based on the division of functions performed by individual entities. Functions to be measured are assets used and risks assumed by the different entities.¹²

Additional evidence that the FA approach is not entirely new is that some federal states, namely, the United States and Canada, use it to allocate profits to states/provinces.¹³ In the US, some states

¹² *OECD Transfer Pricing Guidelines* *ibid* at 134, para 2.117.

¹³ Kimberly Clausing, "Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment" (2014). www.ssrn.com/abstract=2359724 (last accessed 10 August 2017) at 7.

have adopted the FA approach to allocate corporate profits based on a formula founded on the provisions of the Uniform Division of Income for Tax Purposes Act¹⁴, and subject to the Federal Commerce Clause and the supremacy clause.¹⁵ These clauses prevent taxation that discriminates between interstate commerce which, otherwise, creates a risk of double or multiple taxation for foreign commerce. In Canada also, corporate profits are allocated to provinces based on the provisions of Part IV of the Regulations to the Income Tax Act¹⁶, which allows the allocation of the taxable income of a corporation to provinces in alignment with its level of economic activities in those provinces.

The FA approach proposed here would expand how these states apply the FA approach nationally to include the division of the worldwide profits of MNCs. To this end, the implications of the FA approach, what it entails, and how it would work when adopted by tax administrations globally, are discussed next.

5.2 The Workings of the FA Approach

The FA approach proposed here as an alternative to the arm's length principle is a one-sided approach, in the sense that it requires only a functional analysis of the global activities of MNCs. It is different from the arm's length principle which requires both a functional and a comparative analysis. The FA approach involves the allocation of the combined/unitary profits of MNCs to their constituent entities using an allocation key/formula. The combined profits to be split are the

¹⁴ Uniform Division of Income for Tax Purposes Act: < www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf (last accessed 10 August 2017)

¹⁵ See Jean-Gabriel, Castel, "Unitary Taxation in the United States of America." Canadian Yearbook of International Law 25 (1987): 369 at 373 citing Foreign Commerce Clause, US Constitution. Art. I, s. 8, cl.3, Due Process Clause, US Constitution 14th Amendment, para. 1.

¹⁶ Part IV of the Regulations to the Income Tax Act, RSC 1985, c. 1 (5th Supp).

profits from each business activity of a MNC group.¹⁷ An activity is “a group of functions related to the conduct of a particular trade or business to which two or more related parties contribute, determined at the largest level of aggregation of functions performed that will permit reliable identification of such related parties' respective contributions to the functions comprising an activity”.¹⁸ In arriving at the combined taxable profits of an MNC group before it is allocated, the FA approach requires the deduction of allowable expenses by a common accounting standard.¹⁹ The final stage involved in applying the FA is the division of the net income and its allocation to entities based on the allocation formula.

It is suggested that the weighted average of three economic activities- physical assets, labour, and sales- be used. This formula is similar to the one used in EU's Common Consolidated Corporate Base proposal.²⁰ The choice of these three factors is to enable the capture of essential economic activities in the various jurisdictions where they take place without discrimination. The limitation to physical assets is deliberate, as intangibles are hard to value.²¹ Picciotto suggests that labour should be based on a 50:50 weighting of payroll and headcount because of global wage differences.²² He also suggests that sales should be based on the location of the consumers for physical products and for intangibles, to be ascertained through the billing address of the consumer.²³ Based on these formulae, tax jurisdictions would receive a fair portion of global MNC

¹⁷ Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, “Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split” (2009) 9:5 Fla. Tax Rev. 497 at 501.

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ European Commission, Proposal for a Common Consolidated Corporate Tax Base (CCCTB) : www.ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf (last accessed 8 August 2017).

²¹ *Ibid.*

²² Sol Picciotto, “Towards Unitary Taxation” in Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness* (United States: Oxford Press, 2016) at 230.

²³ *Ibid.*

profits *via* an appropriate fraction of the whole, based on the level of real economic activities that occurred in each contributing jurisdiction.

On the choice of these three factors, Murphy notes:

“There is good reason for choosing these three “allocation keys” for determining whether or not the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes: companies cannot make profits without sales and they cannot make sales without employing people and physical assets, many of which will be linked to the production process”.²⁴

Emphasis is placed on the equal weighting of the three factors because concentration on one or two factors would jettison the contributions of some states to the worldwide profits of MNCs, a situation that would eventually bring about BEPS in the countries left out.

The experience in the US, where some states resort to a formula that has higher or exclusive weight on sales, shows the need to give equal consideration to each of the factors involved in the FA approach.²⁵ Commenting on the heavy concentration on the sales factor in the US, Clausing notes that it introduced unhealthy tax competition there, and engendered what she termed ‘beggar-my-neighbour policy choices’. In other words, harmful tax competition is likely to result where distinct formulas are chosen.²⁶ Therefore, to prevent a re-introduction of BEPS, this work argues for equal weighting of the three factors identified above to determine and allocate MNC global profits.

The FA approach proposed here is different from the profit split method endorsed in the OECD’s transfer pricing guidelines. The profit split method is a two-sided transfer pricing approach that, first, requires a comparability analysis for routine profits before the apportionment of residual

²⁴ Richard Murphy, Country-by-Country Reporting in Thomas Pogge & Krishen Metha (ed.) *Global Tax Fairness* (United States: Oxford Press, 2016) at 106.

²⁵ Kimberly Clausing *supra* note 13 at 25.

²⁶ *Ibid.*

profits to relevant tax jurisdictions using a formula.²⁷ The inadequacies of the ‘comparability’ test have been admitted by the OECD itself. In sum, since the integrated functions performed by MNC entities make it difficult to determine arm’s length prices for the activities that they engage in, there is no reason why the arm’s length principle should be retained. Discussing the value in abandoning the arm’s length principle for a functional assessment of the economic activities engaged in by MNC entities, the OECD says:

The profit split method offers flexibility by taking into account specific, possibly, unique facts and circumstances of the associated enterprises that are not present in independent enterprises while still constituting an arm’s length approach to the extent that it reflects what independent enterprises would have done if faced with the same circumstances... it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated.²⁸

Integrated entities like MNCs can only be effectively taxed through a mechanism that recognizes and admits the peculiar contributions of their constituent entities and the impossibility of effectively taxing them through a subsection of the transfer prices they declare to a comparability test. Resort to profit split as a fall-back method would give room for BEPS because the arm’s length principle, as discussed in Chapter 3, is ineffective in allocating profits from the synergistic relationships that exist among MNC entities. The OECD understands this fundamental fact, but still formally rejects the FA approach as a stand-alone method.

My contention is that there seems to be no justification for the retention of the arm’s length principle and regarding the profit-split method as a fall-back option, especially considering the inadequacies of the principle. In this sense, the arguments for reinvigoration of transfer pricing rules is displaced. On this point, Lorraine Eden argues that the phenomenon of BEPS is not a

²⁷ Avi-Yonah & ors. *Supra* note 17.

²⁸ OECD Transfer Pricing Guidelines *supra* note 11 at 134-5 at para 2.118-9.

transfer pricing problem but an international tax regime design problem that is best handled by fixing the source and residence rules in the international tax regime.²⁹ To this end, she recommends that residence countries should tax the worldwide profits of resident MNCs (including unrepatriated profits), while extending credits for foreign taxes paid. Alternatively, a regime with stronger anti-abuse (e.g., CFC rules) should be considered to end the BEPS problem.³⁰

Contrary to Eden's arguments, it should be reiterated that the problem of BEPS begins with transfer mispricing/transfer pricing manipulation by MNCs. Although the tax rules of states may encourage profit shifting, the fundamental cause of BEPS is transfer mispricing/manipulation by MNCs. Therefore, the solution to BEPS should first address the opportunities that the arm's length principle affords MNCs to manipulate transfer prices. BEPS can only be eliminated when states replace the rules governing the formal attribution of profits to source and residence countries and focus on the level of economic activities carried on by MNC entities in various jurisdictions. The FA approach is perfect to achieve this objective. In support, Picciotto declares "...this approach does not seek to attribute profit, since it assumes that the profits of an integrated firm result from its overall synergies and economies of scale and scope. It allocates profits according to the measurable physical presence of the firm in each country".³¹

My proposed FA approach would not completely resolve the problem of BEPS. For instance, Dharmapala cites instances where the FA approach may give rise to other efficiency costs, such as the introduction of 'reselling strategies' where firms sell goods to arm's length parties in low-tax

²⁹ Lorraine Eden "The Arm's Length Standard: Making it Work in a 21st Century World of Multinationals and Nation States" in Thomas Pogge & Krishen Metha ed, *Global Tax Fairness* (United Kingdom: Oxford University Press, 2016) at 157.

³⁰ *Ibid.*

³¹ Picciotto *supra* note 1 at 231.

jurisdictions, and in turn, they resell them in high-tax jurisdictions.³² It is not clear what states can do to control this. It is also conceded that the FA approach may not be the perfect means to eliminate BEPS globally. But as Picciotto notes, "...aligning tax rules more closely to the economic reality of integrated firms operating in liberalized world markets would make taxation of MNCs simpler and more effective".³³ In this context, how would the CBCR required to be filed by MNCs assist states to fight against BEPS globally? This issue is considered next.

5.3 The Value of CBCR under the Formulary Apportionment Approach

The analysis of Chapter 4 exposed the gaping holes in the OECD's CBCR Rules, the ultimate point of which is that the Rules cannot, as they are, help a global fight against BEPS. Consequently, it was recommended that there must be amendments to the threshold, confidentiality and the appropriate use clauses that frame the legal character and operational efficacy of the CBCR. It was stressed that without the changes, the OECD's declared intention to end BEPS globally would not be assisted by the implementation of the CBCR Rules. In sum, MNCs that do not meet the annual consolidated threshold revenue of €750 million or more are not required to file CBCR. Nor can this information be shared with non-signatories to the mechanism or the public. As well, CBCR information, where this is filed, cannot be used to adjust the profits of MNCs that filed them. As argued in Chapter 4, only the removal of these restrictions would allow the CBCR to become an asset in the effort to eliminate BEPS.

The argument here is that the OECD's proposed CBCR holds the potential to be such a weapon against BEPS under the FA approach. The CBCR required to be filed by MNCs would reveal the

³² Dharmapala, Dhammika, "The Economics of Corporate and Business Tax Reform" (2016). University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 757. www.ssrn.com/abstract=2737444 at 23

³³ Picciotto *supra* note 1 at 231-2.

global activities of MNCs, such as research and development, the holding or managing of intellectual property, and purchasing or procurement.³⁴ This provides an opportunity to introduce rules that promote transparency and accountability on the part of MNCs. In practice, this serves to ensure that the activities of MNCs in various jurisdictions, and globally, are available to tax administrators, making it easy to effectively assess and tax them under the FA approach. This possibility exists because all the relevant factors needed for the application of the FA approach are captured in the CBCR. All that would be left is the allocation of profits using the prescribed formula based on the economic activities disclosed.³⁵ Otherwise, tax administrators would be unable to maximize the use of the information disclosed in CBCR by the arm's length principle. For instance, if the information in the CBCR shows that profits were shifted to tax havens where little or no economic activities that generated the profits being assessed occurred, tax administrators cannot adjust the transfer prices without having the comparables that the arm's length principle demands. But under the FA approach, all that tax administrators have to do is adjust the transfer prices fixed and re-allocate profits to states based on the level of economic activities that took place in their jurisdictions.

It is admitted that the FA approach would introduce a paradigm shift into the taxation of MNCs, because it goes against the separate treatment of MNC entities, a fundamental principle that shaped the design of international taxation rules as far back as 1928.³⁶ Even so, the severe consequences attached to BEPS, in the face of the weaknesses of the arm's length principle, makes this change more than worthwhile. Global adoption of the FA approach would upend the formal structures put

³⁴ OECD Transfer Pricing Guidelines *supra* note 11 at 511.

³⁵ Sol Picciotto, Towards Unitary Taxation *supra* note 1 at 227, see also Richard Murphy, Country-by-Country Reporting *supra* note 24 at 107.

³⁶ See Chapter 2 for a detailed discussion of the history of the development of the arm's length principle.

in place by MNCs to conveniently engage in BEPS, and holds the potential to allocate the profits of an integrated firm according to the measurable presence of the firm in each country.³⁷ The challenge that remains, therefore, is to persuade the international tax community to dispense with the current international taxation rules that allow states to tax only MNC entities present within their jurisdictions in the face of the challenges in enforcing the arm's-length principle.³⁸

5.4 Conclusion

The theme of this thesis is that the OECD's Country-by-Country Reporting (CBCR) Rules as part of the OECD's BEPS project are insufficient to eliminate BEPS globally. The discussion highlighted that BEPS is the unsavoury fruit of two fundamental factors, namely, transfer mispricing/manipulation and harmful tax competition. It was pointed out that this phenomenon undermines the fiscal rights of states, the notion of tax justice between states, and justice between taxpayers within each state. In sum, the discussion established that BEPS severely undermines national economies of tax revenue and development opportunity, and deepens the chasm and mistrust between developed and developing states in terms of global economic equity.

It was explained that the OECD and the UN have sought to curb BEPS prior to the OECD's proposal for the adoption of the CBCR Rules. They did this *via* transfer pricing guidelines based on the arm's length principle and the OECD's reports on harmful tax competition. It was shown that by their increasingly sophisticated means of doing business, MNCs got around the arm's length principle under which their transfer pricing was regulated. The flaws of the principle are evident in MNCs' continuous use of transfer pricing to engender BEPS, though both the OECD

³⁷ Picciotto, *supra* note 1 at 231.

³⁸ Castel *supra* note 15 at 370.

and the UN sought to improve the effectiveness of the arm's length principle by the introduction of alternative transfer pricing methods. The chief failure of the arm's length principle is the subjection of MNC profits to a comparability analysis of 'what similar enterprises would do in comparable circumstances'. Similarly, the objective of the OECD to eliminate the unhealthy tax policies of tax havens through the prescriptions of its Harmful Tax Competition Report of 1998, together with subsequent reports issued by the OECD pursuant to the 1998 Report, has not been achieved. The clearest evidence for this is the continuing existence of tax havens and preferential tax regimes. Among other observations, it was stressed that the OECD's effort had little chance of success because, as an institution, it cannot compel sovereigns to observe its fiscal rules. This is even more so when some OECD members are themselves tax havens tax havens and preferential tax regimes.

The OECD's effort, at this point, to push for a more globally acceptable and effective solution to BEPS comes in the CBCR Rules. The discussion established that the nature and operational implications of its three-legged framework or structure, namely, the threshold, confidentiality and the appropriate use clauses, cumulatively, ensure that: MNCs with annual consolidated revenue of less than €750 million are exempt from filing CBCR; non-signatory states and the public would have no access to the information filed by the MNCs that report under the Rules; and information contained in the CBCR filed by MNCs cannot be used to adjust their income for tax purposes. The conclusion reached is that, these features of the CBCR Rules disable the regime it spawns from being an effective asset in any global effort to minimize or eliminate BEPS.

Given this hapless outcome, this thesis argues for the adoption, promotion and implementation of the FA approach to international taxation in order to curb BEPS through the elimination of tax

havens and preferential tax regimes. This approach aggregates the global income of MNCs as collated by the contributory profits of their constituent entities. The tax imposed on this aggregate income is distributed equitably to each jurisdiction in which an activity took place in light of the extent of the contribution of that activity to the MNC's global income. It is urged that this can be done unless the global community is unwilling to do it.

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