

January 1994

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Recommended Citation

H. David Rosenbloom, *Sovereignty and the Regulation of International Business in the Tax Area*, 20 Can.-U.S. L.J. 267 (1994)
Available at: <https://scholarlycommons.law.case.edu/cuslj/vol20/iss/30>

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Sovereignty and the Regulation of International Business in the Tax Area

*H. David Rosenbloom**

It is a great pleasure to return here to Cleveland and to the Institute. I always particularly enjoy conferences that deal with a variety of legal areas, of which tax is but one, because I know I can safely start by observing that whatever you have heard about other subjects over the past day or so, and whatever you will hear for the next day or so, are completely divorced from this area of law. Tax people live in their own cocoon. I am going to try today to make some generalizations about the issues we face, and their relationship to sovereignty, and I will try to avoid being too technical.

There is a tremendous history of international cooperation in the tax area — probably greater than in any other legal area. The current rules and principles, which enjoy a remarkable level of international agreement, trace back directly to work done by the League of Nations in the 1920s. There are several modern institutions that have brought these principles forward, among which the Organisation for Economic Cooperation and Development in Paris is preeminent. The OECD Committee on Fiscal Affairs does a fine job of maintaining a high level of international understanding in the tax area. So we have long-standing institutions. We have a long history of cooperation. We have many unique things in the tax area that bear on today's topic.

On the other hand, the short-term outlook is for some fairly painful conflict, which is likely to mean dollars-and-cents cost to cross-border investment. I do not think anyone knows quite what to do about it. Nor am I confident that anyone is in a position to do anything is giving sufficient thought to the potential for that conflict.

Let me explain. No area of law is closer to the subject of sovereignty than taxation. When the Soviet Union imploded several years ago, and the world was faced with fifteen or so newly independent jurisdictions, one of the first manifestations on the world scene, if not in the world press, was the development of fifteen new tax systems. There still exists a state of considerable tax-related activity in many of those countries, accompanied by tax treaty negotiations on an impressive scale. And there is a great deal of international work being done in support of these developments.

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Despite the worldwide consensus on the principles of international taxation, it is fair to say that nations are quite reluctant to surrender their autonomy in this area. Other legal areas could be cited, but feelings seem to be more extreme in the tax area. Evidence for this statement can be found in many quarters. For example, common law countries, such as both the United States and Canada, are unwilling to enforce the tax judgments of other countries in their courts, even when they stand prepared to enforce other kinds of judgments. In a modern, interconnected world this unwillingness borders on the inexplicable.

The Organization for Economic Cooperation and Development has been a godfather, if you will, to the development of a network of four to five hundred tax treaties throughout the world, published in numerous volumes by the International Bureau of Fiscal Development in Amsterdam. However, the OECD has been unsuccessful in translating these bilateral agreements into anything resembling a multilateral treaty. Although there is near unanimity at the level of principle, in practice and administration it is virtually impossible to pass beyond the bilateral level. I do not believe anyone knowledgeable about the tax area would suggest that we are likely to see anything resembling GATT or NAFTA in this area any time soon. We are only barely able to cope with the network of agreements that presently exist.

Most international tax conventions, commonly called tax treaties, establish a dispute resolution mechanism, the Mutual Agreement Procedure. Some of us think that is the heart of a tax treaty, and that everything else is just guidance on how particularized disputes should be resolved. A taxpayer, of course, is concerned about how its case will be concluded, not general principles. So the Mutual Agreement Procedure is a very important aspect of the tax treaty network. Each tax treaty has a provision defining the Mutual Agreement Procedure, by which representatives of the two countries, the competent authorities, are authorized to sort out disputes.

There has been considerable debate in recent years about whether countries will accept an arbitration mechanism in the Mutual Agreement Procedure. And there has been extreme reluctance on the part of most countries, particularly the United States, to do that in a meaningful way. There have been some small moves in the direction of arbitration in the recent U.S. treaties with the Netherlands and Germany but, by and large, the United States (like most other countries) has insisted on retaining its autonomy in the tax area.

As a final example of the degree to which countries insist upon sovereignty in tax matters, I would point to the problems and issues that have arisen within the United States, where states have invoked their freedom under the Constitution to develop their own tax systems virtually without constraints from the federal government. According to my understanding, the same phenomenon is also found in Canada. In

fact, one of the things we were able to agree on in negotiating the U.S.-Canada Tax Treaty was that neither country had an appetite for putting constraints on its subnational jurisdictions.

So there is considerable evidence, I think, that tax and sovereignty go hand in hand. At the same time, I do not have to remind this group that developments in international commerce are placing unprecedented strains upon national tax systems, as well as the network of bilateral tax agreements. And nowhere is that issue any sharper than in the area generally referred to as "transfer pricing." Contrary to what some have implied, transfer pricing is not an inherently evil thing. It is not something we should wish to do away with, much less something that we can do away with. Transfer pricing refers simply to the fact that related parties transferring value, that is to say goods and services, between them must set a price. The price they set is called the transfer price. It is the price at which the value is transferred. There is nothing objectionable about that and, in fact, transfer pricing is inevitable in a world of separate legal entities under common control. However, there has been a growing and very sharp focus in the last ten years or so on testing the prices set by controlled parties against an objective standard. That is the heart of the current international tax conflict. It is not the only manifestation of such conflict, but it is one good example of where we may be headed for some real problems.

Most countries, of course, police the price at which their taxpayers buy from or sell to related parties, and most countries of the world do so with a view to preventing abuse. They take a fairly tolerant attitude of the relationship between parties under common control. They will step in to adjust prices, but only when things are badly out of harmony. That has not, however, been the approach of the United States. Instead of viewing transfer pricing as an area where rules are needed for the purpose of preventing egregious practices, the United States has increasingly taken the position that a set of rules can be developed that will yield the "right" answer in any given case.

Perhaps I evince some slight professional bias in suggesting that this tendency has been prompted by the economics profession, which seems to believe that right answers are achievable in individual cases. The result has been a stream of new rules in the United States that increasingly define economic responses, economic approaches, to testing transfer prices between related parties under the "arm's-length" method.

Within the borders of the United States, the debate is not of any practical importance because most related companies — and we are, of course, talking mostly about corporate taxation here — file consolidated returns. Therefore, within our borders the increasing sophistication of the transfer pricing rules has relatively little import, because one company's deduction is another's income. It all washes out when a

return is filed covering all companies in the affiliated group.

However, foreign related parties are not included in consolidated tax returns. They appear in consolidated financial reporting, but not in consolidated tax reporting. And so, transactions between related parties that cross borders do implicate the transfer pricing rules, and it is possible, and in the view of some even common, for taxpayers to use transfer pricing to shift income or deductions into or out of the United States. It has been this concern, and the added concern that the United States has lost revenues in recent years, that has led Congress to attack the transfer pricing problem. This began with the 1986 Tax Act, but gained strength and momentum in the late 1980s with a particular focus, it is fair to observe, on inbound investment from Japan.

There have been repeated hearings in Congress on this subject and a great deal of rhetoric. Contributing to the problem is the very substantial delay in tax administration in the United States, by comparison with other countries. In my own work, I am only just approaching the mid-1980s in terms of the years under audit that are coming up for review. The 1986 Tax Act was a very major piece of legislation, and I have not yet begun a case involving 1987 or subsequent years. My suspicion is that Canada and most other countries are more current.

We also have an independent court system, but one that is heavily document-oriented, in which litigation of a single case can easily take three, four, five, or up to eight or even ten years. The cases are very fact intensive, with warring experts on both sides fighting over the proper transfer price for transactions that took place many years previously.

We do not accord much discretion to our tax administrators in the United States. And thus we have come to believe that, if we are going to change anything, we must change the rules. The net effect, as I am sure some of you know, is that we now have a two-volume Internal Revenue Code and six volumes of regulations.

In sum, the transfer pricing area exhibits very detailed regulations which have taken a highly sophisticated economic view of how to test prices. In addition, we have placed upon taxpayers for the year 1994 and thereafter the burden, a new burden, of documenting their transfer prices in advance so that, when they are examined, they will have to show that their prices follow some methodology. This is opposed to developing a justification long after the fact when the examiner appears on the doorstep.

All of this has given rise to international upheaval. The regulations put out by the Treasury Department, first in proposed and then in temporary and final form, have been the subject of review by the OECD, which is writing its own report on transfer pricing. In addition, various countries have offered comments and criticisms of the United States' position.

Nor are these developments at the federal level the only pertinent ones. You will recall that our states are substantially independent in the tax field. While all of the above-described matters have been taking place, there has been a simmering fifteen- or twenty-year controversy involving a number of U.S. states, but principally California, on a related question. In the mid-1970s California despaired of the possibility of testing transfer prices on an item-by-item arm's-length basis. To me a lot of what they said makes sense. They said, first, it is too time consuming. Second, testing on a transactional basis involves tremendous resources. And the correct or "right" transfer price is inherently unknowable. At what price would a controlled party have sold to another controlled party if the parties had not been related? This is a hypothetical question, an inherently unknowable kind of question, with an unknowable approach to resolution, which invites very complex, very fact-oriented controversies and has very little that is objective about it.

California threw up its hands as early as the 1970s and said, we will not look at the transaction between the related parties. Instead, we will determine how much income has been earned by the related parties in the aggregate, and we will develop a formula to split that profit between the related parties, a so-called formulary approach to transfer pricing. On the merits, this has some appeal. Unfortunately, it has virtually no appeal when the federal government is simultaneously taking a transactional approach to the same issues.

This has caused much international consternation and produced a raft of litigation, of which the most recent manifestation is the famous *Barclays* case, just decided by the Supreme Court. The case had previously been decided against Barclays twice. The Supreme Court granted discretionary review and has just decided against the taxpayer for a third time.

Many people are talking about this subject, and it is highly controversial; a lot of companies are concerned about it. However, I believe the more immediate subject to be concerned about, in a conference on sovereignty, is not the threat of formulary taxation but refinements of the arm's-length method at the federal level. The increasing sophistication infusing the transactional method may not be proceeding in a desirable direction.

Other countries have reacted adversely to U.S. transfer pricing developments. For example, Canada: On January 7, 1994 the Finance Department and the Department of National Revenue issued a joint news release endorsing the arm's-length method and referring to difficulties that may arise when a jurisdiction adopts another method. They focus primarily on the so-called comparable profits method, by which profits of comparable companies are used to "back into," or impute, a transfer price. The release said that if companies adopted the comparable profits method to accord with the U.S. regulations, Canada would

“not be able” to provide relief under the U.S.-Canada Income Tax Treaty.

In recent weeks there have been reports that the Japanese have taken a similar position. In addition, they have done something else that had been widely predicted: They have begun assessing transfer pricing adjustments against U.S. companies, the most recent of which being an approximately \$150 million assessment against Coca-Cola®.

It seems to me that all this debate and ferment are hidden from the public to a large extent because the subject is highly technical. It finds its way only occasionally into the press, for example when a politician says something foolish on a related subject. However, what seems to be going on here is the building of an international tax conflict of unprecedented dimensions.

The United States seems determined to follow its new, highly sophisticated rules. Canada and the other OECD countries seem determined not to give relief when adjustments using those rules are made. And taxpayers, especially those operating across borders, are in the middle. Given the attitudes borne of sovereignty considerations that nations bring to the tax area, it is hard to predict where these developments will lead. Conceivably, if the new transfer pricing rules prove impractical, or inadequate from the perspective of Congress, the world may find itself in another acrimonious debate over the formulary alternative.