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# THE FUTURE OF SOURCE-BASED TAXATION OF THE INCOME OF MULTINATIONAL ENTERPRISES

*Robert A. Green†*

One of the functions of the corporate income tax is to raise revenue from foreign persons who earn income domestically through corporate intermediaries. This function is problematical because the tax base is mobile. Multinational enterprises can avoid one country's corporate income tax by moving their investment to another country. More significantly, the current international tax system allows multinationals considerable latitude to leave their investment in place but to shift the reported source of income. Multinationals can accomplish this by manipulating the prices that their affiliates charge one another in intercompany transactions or by strategically arranging their financial structures.

Congress and the Treasury Department have long been concerned that multinationals might avoid U.S. taxes by manipulating transfer prices.<sup>1</sup> This concern has increased in recent years, initially because of the Internal Revenue Service's (IRS) lack of success in applying transfer pricing rules<sup>2</sup> to U.S.-based multinationals that transfer intangible property to foreign affiliates.<sup>3</sup> More recently, the concern has been fueled by statistical evidence indicating that U.S. subsidiaries of foreign-based multinationals, as a group, report strikingly less tax-

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<sup>1</sup> See U.S. TREASURY DEPARTMENT, A STUDY OF INTERCOMPANY PRICING 6-12 (1988) (discussing history of U.S. transfer pricing law and regulations) [hereinafter WHITE PAPER], reprinted in 75 Stand. Fed. Tax Rep. (CCH) No. 53, at 1 (Oct. 20, 1988).

<sup>2</sup> The statutory source of the Internal Revenue Service's (IRS) authority to adjust transfer prices is § 482 of the Internal Revenue Code (the "Code"), which authorizes the Secretary of the Treasury to allocate income and deductions among commonly controlled businesses "in order to prevent evasion of taxes or clearly to reflect the income" of such businesses. I.R.C. § 482 (West 1988). Treasury regulations under § 482 set forth the applicable standards and methodologies for adjusting transfer prices. Treas. Reg. §§ 1.482-1A to -2A (as amended in 1993); Temp. Treas. Reg. §§ 1.482-0T to -7T (1993).

<sup>3</sup> See STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 1011-18 (Comm. Print 1987) [hereinafter 1986 BLUE BOOK] (discussing efforts to limit multinationals' ability to avoid or defer tax by transferring intangible property).

ble income than comparable domestically-owned firms.<sup>4</sup> In the last decade, Congress has conducted two hearings on tax underpayments by U.S. subsidiaries of foreign corporations<sup>5</sup> and has mandated several Treasury, IRS, and General Accounting Office (GAO) studies of the effectiveness of the United States' transfer pricing rules.<sup>6</sup> Recent efforts to solve the problem of transfer price manipulation have proceeded along two lines. First, the Treasury has developed new methodologies for determining whether intercompany prices satisfy the "arm's length" standard.<sup>7</sup> Second, Congress has enacted, and the

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<sup>4</sup> See generally Harry Grubert et al., *Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States* (1991) (concluding that IRS statistics provide indirect evidence that many foreign-based multinationals reduce U.S. taxable income by manipulating transfer prices), available in LEXIS, Fedtax Library, TNI File No. 92 TNI 26-35 (June 24, 1992).

<sup>5</sup> See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 101st Cong., 2d Sess. (1990) [hereinafter *1990 Hearings*]. The Subcommittee held further hearings on the same subject on April 9, 1992. See Opening Statement, Hon. J.J. Pickle, Chairman, Subcommittee on Oversight, Committee on Ways and Means (Apr. 9, 1992), available in LEXIS, Fedtax Library, TNT File No. 92 TNT 77-22 (Apr. 10, 1992).

<sup>6</sup> The Conference Committee Report on the Tax Reform Act of 1986 recommended that the Treasury make a comprehensive study of the § 482 regulations, giving consideration to whether these regulations should be modified. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-638 (1986), reprinted in 1986 U.S.C.C.A.N. 4075. In response, the Treasury and IRS reexamined the theory and administration of § 482, with particular attention to transfers of intangible property, and released their study on October 18, 1988. WHITE PAPER, *supra* note 1.

In 1990, Congress directed the IRS to examine the effect of recent legislation aimed at increasing compliance with § 482 and to recommend further legislative or administrative changes relating to § 482. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11316, 104 Stat. 1388, 1388-458. The IRS released its report on April 9, 1992. IRS, REPORT ON THE APPLICATION AND ADMINISTRATION OF SECTION 482 (1992) [hereinafter *IRS REPORT*], available in LEXIS, Fedtax Library, TNT File No. 92 TNT 77-19 (Apr. 10, 1992).

Responding to a request from Senator Jessie Helms, the ranking minority member of the Senate Committee on Foreign Relations, the U.S. General Accounting Office (GAO) prepared a report on the IRS's administration of § 482, which it released on June 15, 1992. U.S. GENERAL ACCOUNTING OFFICE, INTERNATIONAL TAXATION: PROBLEMS PERSIST IN DETERMINING TAX EFFECTS OF INTERCOMPANY PRICES (1992) [hereinafter *GAO, INTERNATIONAL TAXATION*].

<sup>7</sup> Since 1935, Treasury regulations have called for use of the arm's length standard in applying § 482. Treas. Reg. 86, § 45-1(b) (1935) (interpreting § 45 of the Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791, 806, the direct predecessor of current § 482); Treas. Reg. § 1.482-1A(b)(1) (as amended in 1993) (interpreting current § 482); Temp. Treas. Reg. § 1.482-1T(b)(1) (1993) (same). Under this standard, the IRS may adjust the transfer price charged in a transaction between related firms to match the price that unrelated firms would have charged had they engaged in the same transaction. *Id.* The United States' bilateral income tax treaties also call for use of the arm's length standard in allocating income among related parties. See MODEL INCOME TAX TREATY OF JUNE 16, 1981 art. 9 (U.S. Dep't of the Treasury 1981) [hereinafter *U.S. MODEL TREATY*] (allocation of income between "associated enterprises"), reprinted in 1 *Tax Treaties* (CCH) ¶ 211 (1990), withdrawn by Treasury Dep't News Release NB-1990 (July 17, 1992), 1992-13 Stand. Fed. Tax Rep. (CCH) ¶ 46,416; see also *id.* art. 7(2) (allocation of income between an enterprise in one country and its branch ("permanent establishment") in another country). The arm's length standard has become the nominal international norm for making such allocations,

Treasury Department and the IRS have implemented, new enforcement and penalty measures.<sup>8</sup>

Congress has devoted much less attention to the possibility that multinationals minimize U.S. taxes by strategically arranging their capital structures. This financial maneuvering tends to be much less visible than transfer price manipulation and is generally regarded with less disapproval. In its recent and limited attack on financial maneuvering, Congress has again relied on the arm's length standard.<sup>9</sup>

These approaches to combatting the tax minimization strategies of multinationals are based on a short-term and national perspective, which views the erosion of our country's corporate income tax base as the primary concern. From a long-term and international perspective, by contrast, the fundamental concern might be seen as the inher-

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although the meaning of the standard is often a matter of controversy. See WHITE PAPER, *supra* note 1, at 56-58.

In the *White Paper*, the Treasury proposed a new methodology, known as the "arm's length return method," for implementing the arm's length standard. *Id.* at 94-102. In 1992, the Treasury issued proposed new regulations under § 482, which introduced a modified version of the arm's length return method, known as the "comparable profit method," for implementing the arm's length standard. Prop. Treas. Reg. § 1.482-2(d)-(f), 57 Fed. Reg. 3571 (1992), *withdrawn by* INTL-401-88, 1993-10 I.R.B. 60. In 1993, the Treasury issued new temporary regulations under § 482, which prescribe a second modified version of the arm's length return method, known as the "comparable profits method." Temp. Treas. Reg. § 1.482-5T (1993).

<sup>8</sup> For example, in 1989, Congress imposed new reporting and record-keeping requirements on certain foreign-controlled corporations. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7403, 103 Stat. 2106, 2358-61 (amending I.R.C. § 6038A). Congress expanded these requirements in 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11314, 11315, 104 Stat. 1388, 1388-455 to 1388-458 (amending I.R.C. § 6038A and adding I.R.C. § 6038C). Congress also for the first time enacted penalties for transfer price misstatements. *Id.* § 11312(a), (b), 104 Stat. at 1388-454 to 1388-455 (amending I.R.C. § 6662(b)(3), (e), (h)(2)(A)). In addition, Congress increased the IRS's ability to obtain information relevant to § 482 investigations. *Id.* § 11311, 104 Stat. at 1388-453 (enacting I.R.C. § 6503(k)). In 1991, Congress increased the IRS's ability to hire outside experts for examinations and litigation in response to concern that the IRS was "outgunned" by the experts hired by the multinationals. Treasury, Postal Service and General Government Appropriations Act of 1991, Pub. L. No. 101-509, § 532, 104 Stat. 1389, 1470 (enacting 41 U.S.C. § 261). In 1993, Congress lowered the thresholds for triggering the penalties for transfer price misstatements. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13236 (amending I.R.C. § 6662). The IRS has steadily been increasing the resources that it devotes to international tax issues and to transfer pricing issues in particular, often by shifting resources out of domestic examinations. See Statement of Shirley D. Peterson, Commissioner of Internal Revenue, Before the Subcommittee on Oversight, House Ways and Means Committee, Hearings on Tax Underpayments by U.S. Subsidiaries of Foreign Corporations (Apr. 9, 1992), available in LEXIS, Fedtax Library, TNT File No. 92 TNT 77-67, at \*6 (Apr. 10, 1992); 1990 Hearings, *supra* note 5, at 79-80 (testimony of Fred T. Goldberg, Jr., then Commissioner of Internal Revenue).

<sup>9</sup> See H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 569-70 (1989) (arguing that the "earnings stripping" provision enacted as § 163(j) of the Code is consistent with the arm's length standard), reprinted in 1989 U.S.C.C.A.N. 3018, 3172-73.

ent instability of an international system of source-based corporate income taxation.<sup>10</sup>

The instability of the system is due largely to the incentives for governmental action created by the possibility of income shifting by multinationals. Notwithstanding the optimism expressed by Treasury and IRS officials,<sup>11</sup> it is unlikely that the recent U.S. initiatives will significantly reduce the ability of multinationals to shift income through transfer pricing,<sup>12</sup> much less reduce their ability to shift income through financial maneuvering. As long as multinationals have the ability to shift the reported source of their income, governments imposing source-based corporate income taxes will have an incentive to compete for this shiftable income. Governments can compete by aggressively enforcing their transfer price legislation, by penalizing behavior that might involve income shifting, or by enacting substantive tax rules that give multinationals an incentive to shift income to domestic affiliates—in particular, by lowering their corporate income tax rates. The effectiveness of these actions comes, however, at the expense of other countries. Moreover, a competition to lower corporate tax rates would threaten the long-term sustainability of income tax systems generally.<sup>13</sup>

Assuming, as this Article does, that governments have decided for domestic reasons to continue to rely on income taxation,<sup>14</sup> efforts should be directed toward the development of an international tax system that neutralizes the incentive for multinationals to shift income. One general approach would be to strengthen the current international system of source-based corporate income taxation. A more radical approach would be to recognize that the current difficulties of taxing multinationals do not call for improved implementation of source-based income taxation, but rather indicate that the basic ap-

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<sup>10</sup> The current international system of corporate income taxation is not a purely source-based system, but a hybrid of source-based and residence-based taxation. See *infra* text accompanying notes 15-38.

<sup>11</sup> See Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), Department of the Treasury, Before the Committee on Ways and Means, United States House of Representatives (Jul. 21, 1992) [hereinafter Statement of Fred T. Goldberg, Jr.], available in LEXIS, Fedtax Library, TNT File No. 92 TNT 149-164 (Jul. 22, 1992), at \*23; IRS REPORT, *supra* note 6, at \*6; John Turro, *IRS and Treasury Officials Urge Congress to Give Current Transfer-Pricing Enforcement Tools Time to Work*, 4 TAX NOTES INT'L 794 (1992).

<sup>12</sup> Commentators have long criticized the transfer pricing rules on the ground that they are indeterminate. See Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1219-23 (1976). As a general proposition, indeterminate tax rules are undesirable for a number of reasons: They make it impossible for taxpayers to plan their transactions with foreknowledge of the consequences; they inevitably lead to costly and time consuming disputes about the application of the standard to the facts of particular cases; and they erode confidence in the fairness of the tax system, thereby discouraging voluntary compliance.

<sup>13</sup> See *infra* Part IV.B.

<sup>14</sup> See *infra* note 171.

proach of source-based income taxation is flawed. As an alternative, nations might agree to forgo taxing the domestic source income of foreign persons and to move instead to an international system of purely residence-based income taxation. Under this approach, nations would use the comprehensive income tax as a means of allocating part of the cost of government among individual residents based on their ability to pay. Countries could continue to tax foreign persons, but they would not do so by imposing a source-based income tax dependent on transfer prices or on corporate financial decisions. Instead, they would impose taxes that more closely relate to the benefits that the foreign persons derive from the host country.

This Article analyzes the instability of the international system of source-based income taxation and develops the case for a residence-based system as a solution to this problem. Part I of this Article describes the basic structure of the current international system for taxing multinationals, and discusses the relationship between the arm's length standard and source-based income taxation. Part II examines how multinationals are able to minimize their global income tax liability by manipulating transfer prices and considers whether the arm's length standard is a satisfactory means for combatting this manipulation. Part III discusses financial maneuvering and the application of the arm's length standard to this tax minimization strategy. Part IV analyzes governmental responses to the arm's length standard and the long-term implications for the sustainability of an international system of source-based corporate income taxation.

In Part V, this Article considers possible approaches for enhancing the stability of international income taxation. Part V begins by briefly considering the possibility of strengthening the existing system of source-based corporate income taxation, either through concerted international tax harmonization or through international adoption of unitary taxation and formula apportionment. Next, this part analyzes the radically different approach of moving to an international system of corporate income taxation based exclusively on the residence of individual shareholders. This analysis includes a discussion of the practical difficulties that such an approach would involve, including the difficulty of reaching international agreement and problems of implementation and enforcement. Finally, Part V discusses more modest approaches that the United States could implement unilaterally or bilaterally in the short term. These approaches would alleviate current problems of taxing multinationals and move the U.S. tax system toward possible long-term solutions, including residence-based taxation of corporate income.

## I

THE RESIDENCE PRINCIPLE, THE SOURCE PRINCIPLE, AND THE  
INTERNATIONAL INCOME TAXATION OF  
MULTINATIONAL ENTERPRISES

Countries generally assert jurisdiction to tax income on the basis of the residence principle and the source principle.<sup>15</sup> Under the residence principle, a nation is entitled to tax its nationals and residents on their worldwide income.<sup>16</sup> The United States applies the residence principle to all "United States persons," a term that includes U.S. citizens and domestic corporations as well as U.S. resident individuals.<sup>17</sup> Under the source principle, a nation is entitled to tax nonresidents on the income they derive from sources within the country.<sup>18</sup>

To prevent double taxation of income from transnational activity, the residence country conventionally yields tax jurisdiction to the source country, either unilaterally through its domestic tax law or bilaterally through a tax treaty.<sup>19</sup> The residence country typically adopts one or a combination of two mechanisms for this purpose. The first mechanism exempts residents from taxation on their foreign source income, or at least on certain types of foreign source income. This is known as a "territorial" or "exemption" system.<sup>20</sup> The second mechanism grants residents a tax credit, applied against domestic taxes im-

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<sup>15</sup> See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES 258 (1986) (noting wide degree of international consensus on the law of jurisdiction to tax); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 5 (1992) [hereinafter ALI INCOME TAX TREATY PROJECT].

<sup>16</sup> See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 412(1)(a) (1986). In the case of the United States, see I.R.C. § 61(a) (West Supp. 1993) (defining gross income to mean all income "from whatever source derived"). This Article generally uses the term "resident" to refer to any person subject to tax under the residence principle.

<sup>17</sup> I.R.C. § 7701(a)(30) (West Supp. 1993) (defining "United States person" to mean a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or foreign trust).

<sup>18</sup> See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 412(1)(b), (c) (1986); ALI INCOME TAX TREATY PROJECT, *supra* note 15, at 5. In the case of the United States, see I.R.C. § 871 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13113, 13237 (tax on nonresident alien individuals); I.R.C. § 881 (West Supp. 1993) (tax on income of foreign corporations not connected with U.S. business); I.R.C. § 882 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13237 (tax on income of foreign corporations connected with U.S. business).

<sup>19</sup> See ALI INCOME TAX TREATY PROJECT, *supra* note 15, at 5-6.

<sup>20</sup> *E.g.*, I.R.C. § 911 (West 1988) (permitting qualified citizens or residents of the United States living abroad to exclude a portion of their foreign earned income from gross income subject to U.S. taxation). Countries using a territorial system will typically exempt foreign source active business income and intercorporate dividends from foreign subsidiaries, at least when received from specified countries.

posed on foreign source income,<sup>21</sup> for the amount of foreign income taxes paid.

The application of these principles to multinational enterprises involves a number of legal formalisms. Consider, for example, the case of a U.S.-based multinational consisting of a U.S. parent corporation, *P*, and a wholly-owned subsidiary, *S*, incorporated in a foreign country (the "host country"). Suppose for the sake of simplicity that *P* engages in business only in the United States, and that *S* engages in business only in the host country. In particular, *P* might be a U.S. manufacturer and *S* its distributor in the host country.

Because *P* is incorporated in the United States, the United States will classify *P* as a "United States person"<sup>22</sup> and will tax *P* on its worldwide income. The United States will treat *S* as a separate "person" for tax purposes. Thus, even though *P* owns *S* and economically accrues income when *S* accrues income, the United States generally will not tax *P* on *S*'s earnings until they are "repatriated" in the form of a dividend or other payment.<sup>23</sup> This treatment is termed "deferral."<sup>24</sup> Sim-

<sup>21</sup> *E.g.*, I.R.C. §§ 901-908 (West 1988 & Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13227, 13235 (U.S. foreign tax credit).

<sup>22</sup> I.R.C. § 7701(a)(4), (a)(30)(C) (West Supp. 1993).

<sup>23</sup> In contrast, if *P* conducted business in the host country through a branch in that country, the United States would tax *P* on the income of the branch on an accrual basis, with a credit for foreign tax paid on the branch's income.

The Code permits a U.S. parent corporation and its *domestic* affiliates to file a consolidated return and be taxed on their consolidated income, provided that the corporations are interconnected by at least 80 percent stock ownership. I.R.C. §§ 1501-1505 (West 1988 & Supp. 1993). Foreign corporations, however, generally are not eligible for inclusion in the affiliated group. *Id.* § 1503(b)(4). There are limited exceptions for certain foreign insurance companies and certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the law of those countries as to title and operation of property. *Id.* §§ 953(d), 1504(c)-(d).

<sup>24</sup> The Code contains several sets of provisions that limit the ability of U.S. shareholders of foreign corporations to defer U.S. tax on the foreign income of the foreign corporation. The primary anti-deferral regime is the set of controlled foreign corporation rules in subpart F of the Code. I.R.C. §§ 951-964 (West 1988 & Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13231-13233, 13235, 13239. For other anti-deferral regimes, see I.R.C. §§ 531-537 (West 1988 & Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201-13202 (accumulated earnings tax); I.R.C. §§ 541-547 (West 1988 & Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13201-13202 (personal holding company rules); I.R.C. §§ 551-558 (West 1988 & Supp. 1993) (foreign personal holding company rules); I.R.C. §§ 1246-1247 (West 1988 & Supp. 1993) (foreign investment company rules); I.R.C. §§ 1291-1297 (West 1988 & Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13231 (passive foreign investment company rules).

The Joint Committee on Taxation estimates that if corporate income tax liability were recomputed without the benefit of the deferral of taxation of the income of controlled foreign corporations, tax revenues would increase by \$1.0 billion in Fiscal Year 1993, rising to \$1.2 billion in Fiscal Year 1997. STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 2D SESS., ESTIMATES OF TAX EXPENDITURES FOR FISCAL YEARS 1993-1997, at 11 (Comm. Print 1992). The Treasury estimates that tax revenues would increase by \$200 million per year for Fiscal Years 1991, 1992, and 1993. U.S. OFFICE OF MANAGEMENT AND BUDGET, BUDGET



ilarly, although *S* is owned by *P*, a U.S. corporation that might in turn be owned by U.S. residents, the United States will treat *S* as a foreign person<sup>25</sup> earning foreign source income. Accordingly, the United States will not assert jurisdiction to tax *S*.

The host country, in turn, will likely classify *S* as a resident corporation and thus will impose its corporate income tax on the income of *S*. In addition, the host country will likely assert source jurisdiction to tax *P* on any dividends, interest, royalties, and similar payments that it receives from *S*. In lieu of imposing its regular corporate income tax on *P* with respect to this income—an approach that would be difficult to enforce—the host country will impose a flat-rate tax on the payments, with no allowance for deductions, and will enforce it by requiring *S* to withhold the sum from the underlying payments to *P*. This tax is referred to as a “withholding tax.”<sup>26</sup>

The system described above results in corporate-level taxation of the earnings of *S* by both sovereigns. The host country taxes the earnings by imposing its corporate income tax on *S*. When *S* eventually remits the remaining earnings to *P* by paying a dividend, the host country taxes the distributed earnings by imposing a withholding tax on the dividend. The United States taxes *P* on the distributed earnings by imposing its corporate income tax on the dividend that *P* receives.

The United States unilaterally provides relief from this compounding of U.S. and foreign taxation by allowing a “direct” and an “indirect” foreign tax credit.<sup>27</sup> Returning to the example above, the United States allows *P* to claim a direct foreign tax credit for the withholding tax that the host country imposed on the dividend. In addition, when the dividend is paid, *P* may claim an indirect foreign tax credit for the corporate income tax that the host country imposed on *S*.<sup>28</sup> The indirect foreign tax credit mechanism essentially disregards the separate legal existence of *S*. *P* is treated as if it had (1) earned the before-foreign-tax earnings out of which *S* paid the dividend, and

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OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1993, H.R. DOC. NO. 178 (Part Two), 102d Cong., 2d Sess. 25 (1992).

<sup>25</sup> I.R.C. § 7701(a)(1), (5) (West Supp. 1993).

<sup>26</sup> By imposing a withholding tax on intercorporate dividends, the host country subjects *S*'s earnings to taxation twice at the corporate level. It is difficult to justify this double taxation on policy grounds. See Peter R. Merrill et al., *Tax Treaties in a Global Economy: The Case for Zero Withholding on Direct Dividends*, 5 TAX NOTES INT'L 1387 (1992).

<sup>27</sup> I.R.C. § 901 (West Supp. 1993) (“direct” foreign tax credit); I.R.C. § 902 (West Supp. 1993) (“indirect” or “deemed paid” foreign tax credit).

<sup>28</sup> This treatment is an exception to the general view that a U.S. parent corporation and its foreign subsidiary are separate entities for tax purposes. A U.S. corporation may claim an indirect foreign tax credit for a portion of the foreign income taxes paid by a foreign corporation from which it receives a dividend, provided that the U.S. corporation owns at least 10 percent of the voting stock of the foreign corporation. I.R.C. § 902 (West Supp. 1993).

(2) paid the foreign income tax that *S* paid with respect to those earnings.<sup>29</sup> The United States will not, however, forgo its right to tax U.S. source income. Thus, the foreign tax credit is limited to the taxpayer's average before-credit U.S. tax rate times the amount of the taxpayer's foreign source income.<sup>30</sup>

A mirror-image analysis applies to the taxation of foreign-based multinationals with U.S. subsidiaries. The United States will treat the U.S. subsidiary as a "United States person"<sup>31</sup> and will impose the U.S. corporate income tax on the subsidiary's income. The United States also generally will impose source-based withholding taxes on the dividends, interest, royalties, and similar payments that the U.S. subsidiary makes to the foreign parent corporation.<sup>32</sup>

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<sup>29</sup> To illustrate these rules, suppose that the United States imposes a corporate income tax on *P* at a rate of 35 percent; that the host country imposes a corporate income tax on *S* at a rate of 20 percent; and that the host country imposes a withholding tax on dividends at a rate of 10 percent. Suppose further that *S* earns \$100 in the host country. (Assume for simplicity that the host country's definition of taxable income is the same as the U.S. definition of "earnings and profits.") *S* will owe \$20 under the host country's corporate income tax. If *S* distributes the remaining \$80 to *P* as a dividend, *P* will owe \$8 in withholding tax to the host country, which the host country will collect from *S*. In addition, the U.S. indirect foreign tax credit provision treats *P* as having earned \$100 of income (the \$80 dividend, "grossed up" by the \$20 of the host country corporate income tax paid by *S*, to equal the \$100 of before-foreign-tax earnings out of which the dividend was paid) and deems *P* to have paid the \$20 of the host country corporate income tax actually paid by *S*. At the assumed tax rate of 35 percent, *P* will owe \$35 in U.S. tax with respect to this income. However, *P* will be entitled to a direct foreign tax credit of \$8 and an indirect foreign tax credit of \$20, totalling \$28. After claiming this credit, *P* will owe \$7 in U.S. corporate income tax. The net result is that *S*'s \$100 of earnings will bear global corporate income taxes of \$35: \$28 paid to the host country and \$7 paid to the United States. This is identical to the global corporate income tax liability that would have resulted if *P* had simply earned \$100 of income in the United States. In effect, the United States has foregone its claim to tax the underlying foreign source income to the extent (\$28) that the host country has taxed that income.

<sup>30</sup> I.R.C. § 904(a) (West Supp. 1993). The limitation is expressed by the following formula:

$$\frac{\text{U.S. income tax liability on worldwide taxable income before foreign tax credit}}{\text{Worldwide taxable income}} \\ \times \text{Total foreign source taxable income from all foreign countries}$$

Foreign source taxable income consists of foreign source gross income less expenses allocated and apportioned to foreign source gross income. See I.R.C. §§ 861-865 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13234, 13239.

The foreign tax credit limitation is actually calculated and applied separately with respect to several categories or "baskets" of foreign source taxable income. I.R.C. § 904(d) (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13235. This system is designed to prevent foreign taxes paid on a category of highly taxed income (such as active business income) from being "cross-credited" against the residual U.S. tax otherwise due on a different category of lightly taxed income (such as passive investment income). See 1986 BLUE BOOK, *supra* note 3, at 861-62.

<sup>31</sup> I.R.C. § 7701(a)(30) (West Supp. 1993).

<sup>32</sup> I.R.C. § 881 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13237.

The multinational's home country could adopt any of a number of approaches to the taxation of the U.S. subsidiary's earnings. The home country could adopt a worldwide system of taxation, similar to the one employed by the United States, and tax the parent corporation on the subsidiary's earnings upon repatriation, with an allowance for a limited foreign tax credit. Alternatively, the home country could adopt a territorial system and exempt the subsidiary's earnings from corporate-level taxation when repatriated. The tax treatment of the ultimate individual shareholders will depend on whether the home country has integrated its corporate and individual income tax systems and, if so, on whether it treats foreign corporate income taxes like domestic corporate income taxes for integration purposes.<sup>33</sup>

The international corporate income tax system described above is based on "separate accounting," with each affiliate of a multinational treated as a separate taxpaying "person" and taxed on its income as determined from its separate accounts. Tax agencies will intervene to adjust these accounts, however, if they determine that the affiliate engaged in transactions with other affiliates that do not conform to the arm's length standard.<sup>34</sup>

The rule that corporations are separate taxpaying "persons" obscures the extent to which the current international tax system, and the arm's length standard in particular, implement the source principle rather than the residence principle. For example, when the United States imposes its corporate income tax on the U.S. subsidiary of a foreign-based multinational, it treats the subsidiary as a domestic resident (*i.e.*, a "United States person"). The United States then nominally uses the arm's length standard to allocate income between this resident taxpayer and nonresident taxpayers (the foreign affiliates of the multinational) in order to measure properly the resident taxpayer's income. Thus, the United States appears to use the arm's length standard to implement residence-based, rather than source-based, taxation.

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<sup>33</sup> Under a classical corporate income tax system, such as that in the United States, corporate earnings are taxed at the corporate level when earned and again at the individual shareholder level when the corporation distributes the after-tax earnings as dividends. The corporation is not allowed a deduction for the dividends paid, and the individual shareholders are not allowed a credit for the corporate taxes paid on the underlying earnings.

In an integrated income tax system, the corporate and individual income tax systems are coordinated so that corporate income is taxed only once. For a brief description of the integration systems in Australia, Canada, France, Germany, New Zealand, and the United Kingdom, see U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 159-84 (1992) [hereinafter TREASURY INTEGRATION REPORT].

<sup>34</sup> See *supra* note 7 (discussing status of arm's length standard as nominal international norm).

In this case, the United States could be viewed instead as exercising source-based jurisdiction over the multinational itself, because the affiliates of a multinational are under common ownership and control, and operate as an economic unit.<sup>35</sup> Even this analysis, however, treats the multinational as a taxpaying "person" that is a resident of the country in which the multinational is "based." This treatment is inconsistent with the view that corporations cannot bear the burden of taxes; the corporate tax, like all other taxes, is ultimately paid with a reduction in the real income of natural persons.<sup>36</sup> Under this view, the principal justification for the corporate income tax is that it serves as a withholding tax on individual shareholders, ensuring that those shareholders cannot indefinitely defer or evade paying personal income tax on the income they earn in corporate solution.<sup>37</sup>

If one takes this view of the corporate income tax, then the United States' tax on the U.S. subsidiary of a foreign-based multinational should be viewed as taxing, or at least as attempting to tax,<sup>38</sup> the ultimate individual shareholders of the multinational. Assuming that

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<sup>35</sup> Indeed, if the multinational operated through a U.S. branch rather than through a U.S. subsidiary, the U.S. tax system would formally treat the multinational as a single non-resident taxpayer earning U.S. source income, and the arm's length standard would be used explicitly to allocate a portion of the multinational's income to the United States as the source country. The fact that a U.S. corporate charter is interposed between the U.S. source income and the nonresident taxpayer should not be seen as altering the substance of the arrangement, unless one takes the implausible view that the corporate income tax is a tax on the privilege of being granted a corporate charter. See JOSEPH E. STIGLITZ, *ECONOMICS OF THE PUBLIC SECTOR* 586 (2d ed. 1988) (noting that most economists cannot see any strong argument for imposing a tax on the corporate form of organization, *i.e.*, on limited liability); DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* 103 (1986) (noting that "it is hard to construct a connection between the benefits of limited liability and anything like the system of corporate income taxation"); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 373-74 (5th ed. 1989) (noting that a tax on the privilege of limited liability cannot be justified on benefits grounds because the institution of limited liability is practically costless to society).

<sup>36</sup> See STIGLITZ, *supra* note 35, at 586. The opposing view is that the large, widely-held corporation is a separate legal entity that exercises great economic power in its own right, without significant shareholder control, and therefore appropriately should be the subject of separate taxation. See Alan Gunn, *The Case for an Income Tax*, 46 U. CHI. L. REV. 370, 394-96 (1979); MUSGRAVE & MUSGRAVE, *supra* note 35, at 372-73 (criticizing this view).

<sup>37</sup> See STIGLITZ, *supra* note 35, at 586-87; MUSGRAVE & MUSGRAVE, *supra* note 35, at 372. This rationale is most persuasive in systems where the corporate and individual tax systems are integrated. See *supra* note 33. The classical corporate income tax is difficult to rationalize if one takes the view that corporations cannot bear the burden of taxes. See STIGLITZ, *supra* note 35, at 586-88.

<sup>38</sup> Economists disagree about who bears the burden of the corporate income tax—its "incidence." See generally TREASURY INTEGRATION REPORT, *supra* note 33, at 146-47 (summarizing major views); STIGLITZ, *supra* note 35, at 564-571 (same). In imposing the corporate income tax, Congress presumably intends for it to be borne by shareholders; if it is shifted to consumers or workers, it is an irrational means of imposing a tax on sales or wages. See MUSGRAVE & MUSGRAVE, *supra* note 35, at 373 & n.3. An alternative explanation, however, is that Congress finds this tax attractive precisely because it is not clear who bears its burden. See *infra* note 220.

these individual shareholders are nonresidents of the United States, the tax is an exercise by the United States of source-based jurisdiction over nonresident individuals. Thus, the arm's length standard, as applied internationally, allocates the income that individuals earn from transnational business among the countries of source.

The view that a country is justified in imposing a source-based income tax on nonresidents is so universally accepted that it might seem self-evident. Yet this principle of source entitlement is at odds with the prevailing theory of the income tax. This theory justifies the income tax as a means of allocating the cost of government among taxpayers on the basis of their ability to pay.<sup>39</sup> The theory maintains that ability to pay is best measured by total income, comprehensively defined and determined without regard to source.<sup>40</sup> Because it is generally assumed that ability to pay rises more than proportionally with income, this leads to the conclusion that the income tax should be progressive.<sup>41</sup> Source-based income taxation is incompatible with this underlying theory.<sup>42</sup> The source country taxes only a fraction of a taxpayer's total worldwide income, thus violating the ability-to-pay principle. In addition, the source country does not base the rate of tax on the taxpayer's total income, thus violating the progressivity principle. Indeed, the source country generally does not even attempt to determine the taxpayer's total income.

One might attempt to justify the source principle by using a benefits theory of taxation.<sup>43</sup> Under this theory, the host country is entitled to impose a tax on nonresidents to cover the costs they impose on the public sector, including the cost of the public goods and services that they use, and the external costs, such as the costs of pollution, that their activities impose on residents. The problem with this rationale is that the income tax in general, and the corporate income tax in particular, cannot plausibly be viewed as a form of benefit fee or effluent charge.<sup>44</sup> There is no definite relationship between a corpora-

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<sup>39</sup> See Joseph A. Pechman, *The Future of the Income Tax*, 80 AM. ECON. REV. 1, 6 (1990).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* See generally WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953) (analyzing the arguments for and against progressivity).

<sup>42</sup> See U.S. DEP'T OF THE TREASURY, *BLUEPRINTS FOR BASIC TAX REFORM 99* (1977) [hereinafter *BLUEPRINTS FOR BASIC TAX REFORM*]. The definition of "income" most widely accepted by tax analysts—the Haig-Simons definition—is incompatible with the concept of source; under this definition, income is determined by consumption and wealth accumulation, which do not have any well-defined locational aspect. See Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 11, 30-31 (Assaf Razin & Joel Slemrod eds., 1990).

<sup>43</sup> See generally MUSGRAVE & MUSGRAVE, *supra* note 35, at 373-74 (discussing the argument that the corporate income tax can be justified as a benefits tax).

<sup>44</sup> See Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 149 (1992). Note that for purposes of the U.S. foreign tax credit, a foreign levy is not considered to be a tax at all if the levy is

tion's taxable income and the costs that the corporation imposes on the public sector.<sup>45</sup> In particular, a corporation's income depends significantly on the outcomes of the business risks that the corporation undertakes, whereas the costs the corporation imposes on the host country are generally independent of those outcomes. Moreover, foreign direct investment often provides substantial benefits to the host country, independently of any tax revenue.<sup>46</sup> It is likely that these benefits sometimes exceed the costs that the corporate taxpayer imposes on the host government. This is why developing countries are often willing to offer tax holidays to attract foreign direct investment. Under a benefits theory of taxation, the government should subsidize, rather than tax, this investment. Finally, if the income tax generally (and the corporate income tax in particular) were a form of benefit fee, it could not serve as a means of redistributing income. Yet the suitability of the income tax for this purpose is one of the principal justifications for adopting the income tax over other forms of taxation.

An alternative version of the benefits justification for source-based taxation might be that multinationals are sometimes able to earn pure economic profits ("rents") by taking advantage of some specific feature of a country.<sup>47</sup> A multinational might, for example, engage in business in a developing country to gain access to its natural resources, or it might engage in business in a developed country to gain access to its large market of affluent consumers. In either situation, the multinational earns a higher before-tax rate of return on its investment than it could have earned elsewhere. Arguably, the host country should be entitled to tax the multinational on these location-specific rents.<sup>48</sup> Moreover, raising revenue by taxing these rents is efficient, because the tax will not distort the taxpayer's economic decisions.

Although the argument outlined above might justify source-based taxation of location-specific rents, it does not justify a source-based corporate income tax. The corporate income tax does not distinguish between location-specific rents and the normal return on equity capital or rents that are specific to the multinational rather than to the

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exchanged for a specific economic benefit. Treas. Reg. § 1.901-2(a)(2)(i) (as amended in 1991) (definition of "tax").

<sup>45</sup> See MUSGRAVE & MUSGRAVE, *supra* note 35, at 373-74.

<sup>46</sup> See EDWARD M. GRAHAM & PAUL R. KRUGMAN, *FOREIGN DIRECT INVESTMENT IN THE UNITED STATES* 57-59 (2d ed. 1991). These benefits include the facilitation of trade in goods, services and knowledge, the introduction of new technology, and the training of workers. *Id.*

<sup>47</sup> See McLure, *supra* note 44, at 148 (arguing that the source principle is best justified as an entitlement to tax economic rents).

<sup>48</sup> See *id.* at 148-49.

country. For example, a multinational might be able to obtain rents because of its ownership of unique manufacturing knowledge, which it can exploit by building a factory anywhere in the world. It is not clear why the country that the multinational happens to choose as the location for the factory should have a special entitlement to tax the normal return on the investment in the factory<sup>49</sup> or even the firm-specific rents derived from the factory. Moreover, if the source country does tax such normal returns or firm-specific rents, the practical effect will be to discourage multinationals from investing in the country.

Another possible justification for source-based corporate income taxation is that it serves as a means for the source country to regulate the corporate activity that takes place within its borders.<sup>50</sup> For example, a country might wish to use taxation as an instrument to provide incentives or disincentives for corporate investment or saving, to restrict monopoly power or the absolute size of firms, or to constrain profits in connection with the imposition of direct controls over wages and prices.<sup>51</sup> Although taxation can be a useful device for accomplishing these purposes, the corporate income tax generally would not be the most suitable form of taxation to employ if these were truly the objectives of the tax.<sup>52</sup>

Although the best explanation for source-based taxation might simply be that governments have power to impose such taxes,<sup>53</sup> there is one pragmatic justification for the source principle that goes beyond *force majeure*. The country of source is generally in the best position to enforce a tax on transnational income. The source country can monitor this income by requiring local firms and financial intermediaries to report the income payments they make and to withhold taxes on such payments. The residence country, by contrast, has

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<sup>49</sup> See *id.* at 149 (arguing that the residence country rather than the source country should be entitled to tax the normal return to capital, because the residence country has generated the saving and investment on which that return is earned. Moreover, even apart from taxation, the host country benefits from the increased productivity for its own resources that the foreign-owned capital brings).

<sup>50</sup> See generally MUSGRAVE & MUSGRAVE, *supra* note 35, at 374-75 (discussing the argument that the corporate income tax can be justified as "an instrument of control over corporate behavior").

<sup>51</sup> See *id.*

<sup>52</sup> See *id.*

<sup>53</sup> See A.R. Albrecht, *The Taxation of Aliens Under International Law*, 29 BRIT. Y.B. OF INT'L L. 145, 148-49 (1952) (stating that the "right to tax aliens . . . is justified in international law essentially as an attribute of . . . sovereignty" rather than on the basis of contractual or ethical principles); Ault & Bradford, *supra* note 42, at 32 (speculating that acceptance of the primacy of source jurisdiction is based largely on *force majeure*); Richard M. Bird, *Shaping a New International Tax Order*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION 292, 294 (1988) (suggesting that the reason for the primacy of source jurisdiction is "the simple reality that the source country will in any case inevitably get first crack at any profits").

no jurisdiction over such foreign entities, and must rely on less effective means to ensure compliance. Residence countries will typically have to rely on their own investigations and on the cooperation of the host country's tax agency.

In conclusion, it is difficult to find a persuasive underlying justification for the host country's assertion of entitlement to tax the domestic source income earned by foreign persons.<sup>54</sup> Instead of imposing a limited income tax on foreigners, nations arguably should tax them on the basis of the costs that their activities impose on the public sector, or on the basis of the location-specific rents that they earn by engaging in activities within the country. The comprehensive income tax would then be used exclusively as a means of taxing residents. This approach, however, must overcome the enforcement problems that arise in taxing foreign source income.

## II

### TRANSFER PRICE MANIPULATION

A source-based system of corporate income taxation requires a method for allocating a multinational's income according to its source country. The current international tax system relies on the arm's length standard for this purpose.<sup>55</sup> This section takes a closer look at how multinationals can use transfer price manipulation to minimize their global income tax liability. Additionally, this section asks whether the arm's length principle provides a satisfactory means for tax agencies to combat this manipulation.

#### A. Global Tax Minimization Using Transfer Pricing

Because of the complexity of the international tax system, multinationals must consider a variety of factors if they wish to set transfer prices that will minimize their global tax burdens.

As an initial matter, changes in transfer prices will shift reported taxable income from one affiliate to another. Consider again the example of a U.S.-based multinational consisting of a U.S. corporation,

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<sup>54</sup> Apart from the question of entitlement, there is an argument for an international system of purely source-based corporate income taxation on the ground that it would promote global economic efficiency. In particular, such a system would be neutral with respect to the international allocation of world savings and ownership of capital. See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES* 39-42 (1991); Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793 (1980). Although the issue remains controversial, most analysts have concluded that greater benefits would be produced by a system, such as purely residence-based taxation, that was neutral with respect to the international allocation of world investment. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra*, at 42.

<sup>55</sup> For an explanation of the arm's length standard, see *supra* note 7.



*P*, with a foreign subsidiary, *S*, and no other foreign operations. Suppose *P* sells inventory to *S*, and *S* resells the inventory to customers in the host country. Suppose further that there is a "correct" transfer price, but that *P* can charge more (or less) without being challenged by the tax agency of either country. If *P* decreases the transfer price, the result will be to decrease *P*'s reported taxable income (by decreasing gross sales) and to increase *S*'s reported taxable income by an equal amount (by decreasing the cost of goods sold). If *P* and *S* are subject to different corporate income tax rates, the shift of income will alter the multinational's global tax burden.

Second, changes in transfer prices can affect a firm's foreign tax credit limitation.<sup>56</sup> If *P* decreases the transfer price, the result in many cases will be to decrease the amount of *P*'s foreign source taxable income.<sup>57</sup> This, in turn, will decrease *P*'s foreign tax credit limitation.

Third, changes in transfer prices shift the location of funds. If *P* decreases the transfer price, the result will be to shift funds from *P* to *S*. When *P* repatriates the shifted funds, both the United States and the host country generally will impose additional taxes on the income.

Finally, changes in transfer prices for payments such as interest, royalties, rents, and management fees can affect the multinational's liability for withholding taxes imposed on such payments.

It is useful to isolate the effects of deferral<sup>58</sup> and cross-crediting, two features of the current U.S. tax system, on a U.S.-based multinational's transfer pricing strategy. Cross-crediting occurs because the foreign tax credit limitation is calculated on an "overall" or worldwide

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<sup>56</sup> See *supra* note 30 and accompanying text.

<sup>57</sup> Under the Code's source-of-income rules, if *P* purchases the inventory in the United States and sells it with title passing to *S* outside of the United States, the gross income from the sale will be foreign source income. I.R.C. § 862(a)(6) (West Supp. 1993). If *P* manufactures the inventory in the United States and sells it with title passing to *S* outside of the United States, the gross income will be part U.S. source and part foreign source. *Id.* § 863(b)(2). In either case, a decrease in the transfer price will decrease *P*'s foreign source gross income.

The shift of income from *P* to *S* might further decrease the amount of *P*'s foreign source taxable income by increasing the extent to which *P*'s interest expense, if any, is allocated and apportioned to foreign source gross income. Interest expense is allocated and apportioned between U.S. source and foreign source gross income on the basis of assets. I.R.C. § 864(e)(2) (West Supp. 1993). For this purpose, assets may be valued either at fair market value or at tax book value. Treas. Reg. § 1.861-9T(g)(1)(ii) (as amended in 1989). In the latter case, the value of the stock of a foreign subsidiary must be increased by the amount of the subsidiary's undistributed earnings and profits. I.R.C. § 864(e)(4)(A) (West Supp. 1993). If income is shifted to a foreign subsidiary, it will increase its earnings and profits; if these earnings and profits are not repatriated currently as dividends, the undistributed earnings and profits will cause additional interest expense at the U.S.-parent level to be allocated and apportioned to foreign source gross income.

<sup>58</sup> See *supra* notes 23-24 and accompanying text.

basis, rather than on a per country basis.<sup>59</sup> Returning to the earlier example, suppose that the host country imposes a corporate income tax at a lower rate than the United States. If *P* decreases the transfer price for the inventory, the initial effect will be to reduce the multinational's global tax liability. The shifted income will be taxed at the low foreign rate rather than at the high U.S. rate. Suppose that *S* repatriates its earnings currently. When the shifted income (less the foreign corporate income tax) is repatriated as a dividend, the host country will impose a withholding tax on the dividend. Additionally, under the direct and indirect foreign tax credit mechanisms,<sup>60</sup> the United States will tax *P* on the shifted income, subject to a credit for the foreign taxes. This residual U.S. taxation will eliminate completely any initial tax benefit that the multinational obtained by shifting the income to *S*.<sup>61</sup>

Suppose, however, that *S* retains its earnings for some period of time. Although the United States will impose residual taxation when the shifted income is eventually repatriated,<sup>62</sup> the multinational will have the benefit of the initial tax savings in the interim. This benefit is equivalent to an interest-free loan from the U.S. Treasury in the amount of the residual U.S. tax liability.<sup>63</sup> Thus, the deferral principle of U.S. taxation creates an incentive for U.S.-based multinationals to shift income to subsidiaries in low-tax countries.<sup>64</sup>

Conversely, if the United States has a lower corporate income tax rate than the host country, the multinational will have an incentive to increase the transfer price, thus reducing *S*'s income and increasing *P*'s income. This increase in the transfer price will reduce the multinational's global corporate income tax liability. In addition, it will reduce the earnings that *S* has available to repatriate as dividends, and thus will reduce the multinational's liability for the host country's withholding taxes on dividends.

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<sup>59</sup> See *supra* note 30.

<sup>60</sup> See *supra* notes 27-29 and accompanying text.

<sup>61</sup> See *supra* note 29. Indeed, if the total amount of the host country tax (corporate income tax plus withholding tax) imposed on the shifted income exceeds the U.S. corporate income tax that would have been imposed on the income if it had not been shifted, there will be a tax detriment from shifting the income.

<sup>62</sup> In addition, the host country generally will impose a withholding tax on the dividend.

<sup>63</sup> In the case of a foreign corporation that qualifies as a "passive foreign investment company" (PFIC), the Code recognizes this equivalence and imposes an interest charge on the deferred U.S. taxes, unless the U.S. shareholder elects to be taxed currently on the PFIC's income. I.R.C. §§ 1291-1297 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13231.

<sup>64</sup> This assumes that there are attractive investment opportunities in the host country or that *S* can transfer its earnings to other affiliates of the multinational with better investment opportunities without triggering U.S. taxation or significant additional foreign taxation.

This analysis assumes that *P* has no foreign operations other than those it conducts through *S*. Suppose instead that *P* has a number of other foreign operations, all of which generate foreign source income that is subject to foreign taxation. If *P*'s foreign operations are concentrated in countries with higher effective corporate income tax rates than the United States, *P* is likely to be in a position where the amount of foreign taxes that it pays (or is deemed to pay) exceeds its foreign tax credit limitation.<sup>65</sup> If *P* is in such an "excess credit" position,<sup>66</sup> any additional foreign source income it earns will be subject only to foreign taxes.

Thus, if *P* is in an excess credit position, it will have a tax incentive to invest in low-tax foreign countries, even without regard to deferral. *P* will also have a tax incentive to use transfer pricing to shift income from its foreign subsidiaries, provided that the shifted income is characterized as foreign source income to *P* and that the foreign country does not impose high withholding taxes on the intercompany payments used to shift the income. In the earlier example, suppose *P* increases the transfer price for the sale of inventory to *S* by \$100. Assuming that the gross income from the sale is foreign source income to *P*<sup>67</sup> and that *P* is subject to U.S. corporate income tax at a 35-percent rate, this increase in the transfer price will increase *P*'s before-credit U.S. tax liability by \$35, but also will increase *P*'s foreign tax credit limitation by \$35. This increased limitation will enable *P* to use \$35 of its excess credits, completely offsetting the increase in *P*'s before-credit U.S. tax liability. This operation is termed "cross-crediting." *P* is crediting "excess" foreign taxes paid with respect to other foreign source income against U.S. tax liability attributable to income from the host country. As a result of this cross-crediting, the increase

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<sup>65</sup> See *supra* note 30 and accompanying text.

<sup>66</sup> After the Tax Reform Act of 1986, the effective U.S. corporate income tax rate is generally lower than foreign rates; thus, it is common for U.S. corporations to be in excess credit positions. See Ault & Bradford, *supra* note 42, at 16. The 1986 Act further increased the likelihood of U.S. corporations being in excess credit positions by reducing the extent to which gross income can be characterized as foreign source, increasing the extent to which expenses must be allocated and apportioned to foreign source gross income, and increasing the number of separate foreign tax credit limitation baskets. See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1201 (separate foreign tax credit limitation baskets), 1211 (source of gross income from sales of personal property), 1215 (allocation and apportionment of interest expense), 100 Stat. 2085, 2520-28, 2533-36, 2544-48 (1986).

A taxpayer may carry excess foreign tax credits back two years and forward five years to offset U.S. tax liability for those years, but only to the extent that there is "excess limitation" available; that is, to the extent that foreign taxes on foreign income in those years are less than the U.S. tax. I.R.C. § 904(c) (West Supp. 1993). However, if a taxpayer is chronically in an excess credit position, it will not be able to use its excess credits. Moreover, credits carried forward lose their value, since there is no interest adjustment.

<sup>67</sup> See *supra* note 57.

in the transfer price will reduce global taxes by  $\$100t_f$ , where  $t_f$  is the host country's corporate income tax rate.

Similarly, if  $P$  is in an excess credit position, it will have an incentive to maximize the transfer prices for deductible intercompany payments (such as interest, royalties, rents, or management fees) from its foreign subsidiaries, provided that the payments are foreign source income to  $P$  and the foreign country's withholding tax rate applicable to the payment is less than its corporate income tax rate.<sup>68</sup>

A mirror-image analysis applies to foreign-based multinationals with U.S. subsidiaries, assuming that the home country, like the United States, taxes its residents on their worldwide income and allows a foreign tax credit with a worldwide limitation. If the home country uses a territorial system, in which foreign source active business income and dividends paid by foreign subsidiaries are exempt from taxation, then the foreign-based multinational will generally have an incentive to shift income to the country with the lower statutory corporate income tax rate. A foreign country might also give its multinationals an incentive to shift income to the parent corporation by integrating its corporate and individual income tax systems using an imputation system that grants imputation credits for domestic tax payments but not for foreign tax payments.<sup>69</sup>

In summary, multinationals often have an incentive to shift income from affiliates in countries with high corporate income tax rates to affiliates in countries with low corporate income tax rates. Even in cases where a multinational has an incentive to shift income from a low-tax country to a high-tax country (perhaps because the parent corporation is in an excess credit position, or because of the home country's system of integration), the incentive to shift will decrease as the low-tax country's corporate income tax rate falls.

## B. Rationales for the Arm's Length Standard

To control the possibilities for manipulation described above, tax agencies are generally authorized to reallocate income by adjusting transfer prices that are deemed to be artificial. It is highly desirable that tax agencies employ for this purpose a method that is internationally accepted. If different countries use different allocation methods, international under-taxation or over-taxation of income is inevitable.

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<sup>68</sup> See *infra* note 116 and accompanying text (discussing tax minimization strategies using interest payments on intercompany loans).

<sup>69</sup> See Hugh J. Ault, *Corporate Integration and Tax Treaties: Where Do We Go from Here?*, 4 TAX NOTES INT'L 545, 546 (1992). In an imputation system, an individual shareholder who receives a dividend from a corporation must "gross up" the dividend by the amount of corporate income tax attributable to the earnings out of which the dividend is paid, include the grossed-up dividend in income, and claim an "imputation credit" for the attributed corporate income tax.

That is, portions of a multinational's income will either remain untaxed or be subjected, without relief, to the taxes of more than one country. The same result will likely occur if countries agree in principle on a method that is indeterminate in practice.

Proponents of the arm's length standard, including the U.S. Treasury, defend it on the ground that it has achieved international acceptance and is, or can be made to be, a reasonably objective, determinate standard. In addition, they argue that the arm's length standard is desirable because it does not distort a firm's decisions about whether to affiliate with other firms and because it accurately allocates income to firms or locations based on where economic activity occurs.

### 1. *International Acceptance and Determinacy of the Arm's Length Standard*

As the German government noted in expressing reservations to a recent report by the Organisation for Economic Co-operation and Development (OECD), "the consensus regarding the actual application of the 'arm's length principle' is extremely vague and precarious."<sup>70</sup> Under the arm's length standard, a tax agency may adjust the price charged in a transaction between commonly controlled firms to conform to the price that would have been charged had the same transaction occurred between unrelated parties.<sup>71</sup> The only objective way to determine such a price is to find unrelated firms that in fact engage in the same transaction under the same circumstances as the commonly controlled firms. This is seldom possible. A more generally applicable but less objective approach is to find unrelated firms that engage in similar, though not identical, transactions under similar circumstances, and to adjust the uncontrolled price to compensate for any differences. These approaches are collectively known as the "comparable uncontrolled price" method.<sup>72</sup>

It has long been recognized, however, that suitable comparable uncontrolled transactions are often impossible to find.<sup>73</sup> Integrated

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<sup>70</sup> ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, ISSUES IN INTERNATIONAL TAXATION NO. 2, THIN CAPITALISATION AND TAXATION OF ENTERTAINERS, ARTISTES AND SPORTSMEN 36 (1987) [hereinafter OECD THIN CAPITALISATION REPORT].

<sup>71</sup> See *supra* note 7.

<sup>72</sup> See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES ¶ 11, at 13 (1979) [hereinafter OECD TRANSFER PRICING REPORT]; see, e.g., Treas. Reg. § 1.482-2A(d)(2)(ii) (as amended in 1993) (transfers of intangible property); Temp. Treas. Reg. § 1.482-4T(c) (1993) (same); Treas. Reg. § 1.482-2A(e)(2) (as amended in 1993) (transfers of tangible property); Temp. Treas. Reg. § 1.482-3T(b) (1993) (same).

<sup>73</sup> See WHITE PAPER, *supra* note 1, at 19 (noting that comparable uncontrolled transfers of intangible property are often unavailable); *id.* at 21-22 (referring to studies showing that the IRS usually resorts to methods other than the comparable uncontrolled price method to adjust transfer prices for tangible property); OECD TRANSFER PRICING REPORT,

multinationals often come into existence in situations where market transactions between unrelated parties would be so inefficient that they do not occur. In particular, transfers of intangible property, such as patents, trademarks, and know-how, among the affiliates of a multinational often have no market counterparts.

When comparable uncontrolled transactions do not exist, the alternative is to use a theoretical model to determine what unrelated firms would have charged had they engaged in the same transaction as the related firms. The pre-1993 Treasury regulations under Section 482 did not provide any generally applicable approach to answering this hypothetical question.<sup>74</sup> In particular, with respect to transfers of intangible property, the regulations merely provided a list of general factors to be considered, with no suggestion of how the factors should be weighted.<sup>75</sup>

One difficulty in developing a theoretical approach is that a highly simplified—indeed, oversimplified—underlying theory must be used to arrive at an administrable methodology.<sup>76</sup> A second difficulty emerges because unrelated firms dealing at arm's length often determine prices on the basis of expectations.<sup>77</sup> In the case of transfers of intangible property, the transferee generally will use the property over a period of time as part of a productive process, and therefore will value the property based on projections of how much it will contribute to future earnings. Any approach to determining arm's length prices that is *not* based on expectations at the time of the transfer will

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*supra* note 72, ¶ 11, at 13. In a report issued in 1981, the U.S. General Accounting Office found that the IRS used the comparable uncontrolled price method in only 15 percent of its total recommended § 482 adjustments relating to transfers of tangible property (representing 2 percent of total dollar value), while it used ad hoc methods in 47 percent of all adjustments (representing 86 percent of total dollar value). U.S. GENERAL ACCOUNTING OFFICE, IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS 31 (1981).

<sup>74</sup> See WHITE PAPER, *supra* note 1, at 35 (concluding that the pre-1993 regulations failed "to provide guidance in the absence of comparable . . . transactions").

<sup>75</sup> Treas. Reg. § 1.482-2A(d)(2)(iii) (as amended in 1993).

<sup>76</sup> For example, one might redefine the notion of an arm's length price as the price that would provide the managers of decentralized units of a multinational enterprise with the correct incentives to maximize the before-tax profits of the enterprise as a whole. Given certain simplifying conditions, the transfer price for tangible property should then be set equal to marginal cost. See Jack Hirshleifer, *On the Economics of Transfer Pricing*, 29 J. Bus. 172 (1956); Ann D. Witte & Tasneem Chipty, *Some Thoughts on Transfer Pricing*, 49 TAX NOTES 1009, 1014 (1990). In practice, however, marginal cost information is rarely known within a firm because it depends on opportunity costs; even if it were known, the IRS could not be assured that the firm would truthfully reveal it. See Bengt Holmstrom & Jean Tirole, *Transfer Pricing and Organizational Form*, 7 J. L. ECON. & ORG. 201 (1991). Although regulatory economists have developed methods for estimating marginal costs, see Witte & Chipty, *supra*, at 1018, firms and the IRS would likely find it extremely costly to apply these methods on a routine basis for determining transfer prices for tax purposes.

<sup>77</sup> See Laurie J. Dicker & George N. Carlson, *The Proposed Transfer Pricing Regulations: Comments and Concerns*, 45 NAT'L TAX J. 235-36 (1992).

be difficult to defend as being consistent with the arm's length principle. This will be particularly true if the approach is based on an oversimplified theory. As a result, the approach is unlikely to achieve international acceptance unless all countries agree to reinterpret the arm's length principle. The alternative, an approach to determining arm's length prices that is based on such expectations, will inevitably be indeterminate and difficult to administer. Recent Treasury proposals<sup>78</sup> for implementing the arm's length principle have failed to resolve this dilemma.

Before turning to the Treasury proposals, it is instructive to consider a formal approach to determining the arm's length price for a transfer of intangible property on the basis of expectations.<sup>79</sup> This approach would analyze the transfer pricing problem from the perspective of an independent investor contemplating a purchase of the line of business in which the transferred intangible property is to be used. Under a standard financial investment analysis, the investor would determine whether to purchase the business by calculating its net present value.<sup>80</sup> To make this calculation, the investor would first forecast the cash flows to be generated by the business over its economic life, including negative amounts representing the projected royalty payments for the transferred intangible property (assuming, for the moment, that the royalty rate is known). The investor would then determine the appropriate opportunity cost of capital for the business, which would reflect both the time value of money and the nondiversifiable risk involved in the business. The investor would then use the opportunity cost of capital to discount the projected cash flows of the business to present value. Finally, the investor would calculate net present value by subtracting the required initial investment

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<sup>78</sup> WHITE PAPER, *supra* note 1; Prop. Treas. Reg. §§ 1.482-1 to -2, 57 Fed. Reg. 3571 (1992), *withdrawn by* INTL-401-88, 1993-10 I.R.B. 60; Temp. Treas. Reg. §§ 1.482-0T to -5T (1993).

<sup>79</sup> For a more detailed discussion of this approach, see Daniel J. Frisch, *The BALRM Approach to Transfer Pricing*, 42 NAT'L TAX J. 261 (1989); see also A.R. Durando, *Prices on Transfer of Intangible Property Between Related Taxpayers: Can the Section 482 White Paper's Arm's Length Return Method Work?*, 41 FLA. L. REV. 813 (1989); Edward A. Purnell, *The Net Present Value Approach to Intangible Transfer Pricing Under Section 482: An Economic Model Takes the BALRM Floor*, 45 TAX LAW. 647 (1992); Witte & Chipty, *supra* note 76, at 1021-23. The term "BALRM" refers to the "Basic Arm's Length Return Method" proposed by the Treasury Department in 1988. See WHITE PAPER, *supra* note 1, at 94-99.

<sup>80</sup> For a standard textbook discussion of this approach to investment decisionmaking, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* pts. 1-3 (4th ed. 1991).

from the present value of the business.<sup>81</sup> The investor should invest in the business if its net present value is positive.<sup>82</sup>

To use this approach in determining the arm's length royalty rate for the transferred intangible property, one would treat the royalty rate as a variable and determine the value for the royalty rate that would equate net present value to zero. This solution would be the highest royalty rate that an independent investor would be willing to accept. Assuming perfect competition among potential investors, this solution would yield the arm's length royalty rate.<sup>83</sup>

Despite its theoretical merits,<sup>84</sup> this expectations-based approach would be unsatisfactory in practice.<sup>85</sup> It would require the taxpayer and IRS to determine the fair market value of the business's existing tangible and intangible assets as well as the opportunity cost of capital for the business. In general, neither of these determinations is objective or determinate.<sup>86</sup> More importantly, this approach would require the taxpayer to make cash flow projections, and the IRS to audit those projections. A taxpayer could manipulate the projections to justify any desired transfer price, and it would be difficult for the IRS to establish that the projections were not bona fide.

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<sup>81</sup> The amount of the required initial investment would be equal to the fair market value of the existing tangible and intangible property used in the business. In practice, it might be extremely difficult to estimate this value unless the business (or a similar business) had recently been purchased or unless all of the property used in the business were readily marketable.

<sup>82</sup> BREALEY & MYERS, *supra* note 80, at 23-24.

<sup>83</sup> An approach along these lines was used by the Tax Court in *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991). In *Bausch & Lomb*, the U.S. parent corporation established a subsidiary in Ireland to manufacture soft contact lenses. The parent corporation transferred a unique manufacturing process to the subsidiary in exchange for royalty payments, which the IRS contended did not represent an arm's length price for the technology. The court in *Bausch & Lomb* determined an arm's length royalty rate on the basis of cash flow projections that the parent corporation had prepared for the purpose of determining the feasibility of the Irish manufacturing facility, and on the basis of the court's estimate of the appropriate internal rate of return for the facility given the riskiness of the venture. The court stated that it found little relevance in *Bausch & Lomb Ireland's* actual results of operations, since those results would not have been available to a potential licensee negotiating a license agreement.

<sup>84</sup> Actually, the theoretical merits of the approach outlined above are debatable. The standard method for determining the appropriate opportunity cost of capital is based on the capital asset pricing model (CAPM). See Frisch, *supra* note 79, at 265-66. This model is not perfectly validated by empirical tests. See THOMAS E. COPELAND & J. FRED WESTON, *FINANCIAL THEORY AND CORPORATE POLICY* 212-17, 216 (3d ed. 1988) (concluding that "the pure theoretical form of the CAPM does not agree well with reality.").

<sup>85</sup> See Michael E. Granfield & Frances M. Horner, *Putting Economic Models in Their Section 482 Place: A Safe Harbor Approach*, 49 TAX NOTES 561 (1990).

<sup>86</sup> See BREALEY & MYERS, *supra* note 80, at 196-200 (explaining that determination of the appropriate discount rate is generally a matter of judgment); Frisch, *supra* note 79, at 267 (noting that a discounted cash flow analysis "will always involve judgement [sic] and uncertainty in its application").



Congress and the Treasury have chosen not to rely on expectations-based approaches for determining arm's length prices. Congress amended Section 482 in 1986 to make it clear that the IRS is not bound to accept transfer prices based on profit expectations for intangible property.<sup>87</sup> This amendment requires the IRS to adjust transfer prices if the actual income attributable to the intangible property turns out to be greater than the projected income.<sup>88</sup> Similarly, the recent Treasury proposals for implementation of the arm's length principle attempt to generate arm's length prices from actual profits rather than from expected profits.<sup>89</sup> In general terms, the Treasury's approach involves comparing the reported profitability of one of the parties to the controlled transaction (the "tested party")<sup>90</sup> to the profitability of operationally similar uncontrolled companies.<sup>91</sup> The com-

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<sup>87</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (amending I.R.C. § 482) (1986). This amendment added a new sentence at the end of § 482, which provides that "in the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." *Id.* The Joint Committee on Taxation's official explanation of the Act states that Congress intended that the IRS should not limit itself to considering whether the compensation for a transfer of intangible property was appropriate in light of "the facts in existence at the time of the transfer." 1986 BLUE BOOK, *supra* note 3, at 1016. Instead, the IRS also should consider the actual profit experience realized as a consequence of the transfer. *Id.* The legislative history indicates that Congress was concerned that taxpayers could easily conceal from the IRS their true expectations of the profit potential of the transferred intangible property. H.R. REP. NO. 426, 99th Cong., 1st Sess. at 424 (1985).

<sup>88</sup> See 1986 BLUE BOOK, *supra* note 3, at 1016.

<sup>89</sup> These proposed methods are the "arm's length return method" of the *White Paper*, the "comparable profit method" of the regulations proposed in 1992, and the "comparable profits method" of the temporary regulations issued in 1993. WHITE PAPER, *supra* note 1, at 94-102; Prop. Treas. Reg. § 1.482-2(d)(5), (e), (f), 57 Fed. Reg. 3571 (1992), *withdrawn by* INTL-401-88, 1993-10 I.R.B. 60; Temp. Treas. Reg. § 1.482-5T (1993). The proposed regulations would have required the IRS to employ the comparable profit method in determining arm's length profits for all transfers of tangible or intangible property whenever the comparable uncontrolled price method, narrowly interpreted, was inapplicable.

These methods are of use primarily to the IRS in auditing taxpayers. They are of little use to taxpayers in setting transfer prices, because taxpayers must establish their transfer prices before they have information about actual profits.

<sup>90</sup> Temp. Treas. Reg. § 1.482-5T(b) (1993).

<sup>91</sup> More precisely, the *White Paper*, the proposed regulations, and the temporary regulations contemplate that the IRS will apply this methodology to component functions or operations of the tested party. WHITE PAPER, *supra* note 1, at 107; Prop. Treas. Reg. § 1.482-2(f)(5), 57 Fed. Reg. 3571 (1992), *withdrawn by* INTL-401-88, 1993-10 I.R.B. 60; Temp. Treas. Reg. § 1.482-5T(b)(2) (1993). This means that the IRS must allocate joint costs and assets among the various functions or operations of the tested party in order to determine the profitability of the functions or operations in question. It is a well-established principle of public utility regulation, however, that any such allocation is arbitrary, and that it is meaningless to talk about the profitability of a portion of an integrated firm's activities. See Witte & Chipty, *supra* note 76, at 1017; William J. Baumol et al., *How Arbitrary Is "Arbitrary"?*—or, *Toward the Deserved Demise of Full Cost Allocation*, PUB. UTIL. FORT., Sept. 3, 1987, at 16.

parison entails calculating financial ratios<sup>92</sup> for the uncontrolled companies and applying them to the financial data of the tested party to reconstruct its income.<sup>93</sup> For example, the IRS might reconstruct the income of a controlled company by finding an uncontrolled company with similar operations, calculating the uncontrolled company's ratio of operating profit to operating assets, and multiplying this ratio by the value of the controlled company's operating assets.<sup>94</sup> Once the IRS reconstructs the income of the controlled company in this manner, it can work backwards mathematically to determine the proper transfer price adjustment.<sup>95</sup>

The Treasury's approach to determining arm's length prices is based on an oversimplified economic theory and ignores the distinction between expected profits and actual profits. The approach assumes that factors of production are homogeneous and mobile, and that the market is competitive and in long-run equilibrium.<sup>96</sup> These assumptions are particularly unlikely to be satisfied in the often oligopolistic markets in which multinationals operate, which are generally characterized by new innovation and occasional entry and exit of firms rather than by long-run equilibrium.<sup>97</sup>

Even if one takes these assumptions as true, the conclusion that follows is merely that two firms that assume equal risk will expect to earn the same economic return on assets. The Treasury's approach contemplates comparing a controlled firm's actual (or reported) ac-

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<sup>92</sup> Potentially applicable financial ratios, also referred to as "profit level indicators," include the rate of return on capital employed (i.e., the ratio of operating profit to operating assets), the ratio of operating profit to sales, and the ratio of gross profit to operating expenses. See WHITE PAPER, *supra* note 1, at 97-98; Prop. Treas. Reg. § 1.482-2(f)(6)(iii)(C), 57 Fed. Reg. 3571 (1992), *withdrawn by* INTL-401-88, 1993-10 I.R.B. 60; Temp. Treas. Reg. § 1.482-5T(e) (1993).

<sup>93</sup> The *White Paper* contemplates that this "basic arm's length return method" will be applied only when the tested party performs simple, low-risk economic functions using measurable assets or other factors, but not using significant self-developed intangibles. WHITE PAPER, *supra* note 1, at 107. In more complex cases where both of the related parties perform complex economic functions, bear significant economic risks, and use significant self-developed intangibles, the White Paper approach is to apply the "basic arm's length return method," described above, to the measurable assets or other factors of each of the parties, and then to split the residual consolidated income of the parties between them based on the relative values of their unique intangibles. *Id.*

<sup>94</sup> The temporary regulations contemplate that the IRS might repeat this process using a number of uncontrolled companies, producing a range of reconstructed incomes for the tested party. Temp. Treas. Reg. § 1.482-5T(d) (1993). If the reported income of the tested party falls within this "arm's length range," the IRS will not adjust the prices used and the income reported by the related parties. Temp. Treas. Reg. § 1.482-1T(d)(2)(i) (1993).

<sup>95</sup> Temp. Treas. Reg. § 1.482-1T(d)(2)(i)(C) (1993).

<sup>96</sup> WHITE PAPER, *supra* note 1, at 83.

<sup>97</sup> See ELHANAN HELPMAN & PAUL R. KRUGMAN, TRADE POLICY AND MARKET STRUCTURE 1 (1989); Michael E. Granfield, *An Economist in the BALRM*, 44 TAX NOTES 217, 220-22 (1989).

counting returns with the actual accounting returns of comparable uncontrolled firms. Accounting returns, however, are not the same as economic returns; even when calculated over long periods of time, they generally diverge from economic returns in arbitrary and sometimes substantial ways.<sup>98</sup>

Moreover, when risk is present, actual returns are not the same as expected returns. Expected returns reflect the probabilities that various possible outcomes will occur in the future; actual returns reflect outcomes that in fact occurred in the past. A multinational might set transfer prices for transactions between two affiliates based on the reasonable expectation that those prices will permit each affiliate to earn normal profits. Yet, either or both affiliates might well end up reporting losses. Thus, the fact that a controlled firm earns a lower return than a comparable uncontrolled firm does not necessarily mean that it has manipulated transfer prices. It might only mean that the controlled firm was adversely affected by the unique risks that it faced. As a result, a low profitability index can be used, at most, as an indicator that a firm might be manipulating transfer prices.

Given the possible disparity between actual and expected returns, a firm should be entitled to show that its transfer prices were set on the basis of reasonable expectations, and that its low profitability was the result of adverse outcomes. Any such approach, however, would dissolve into a subjective facts-and-circumstances analysis.

Because the Treasury's approach would often reject transfer prices based on the reasonable expectations of the parties at the time of the transfer, it will probably not gain international acceptance. The OECD has recommended that the comparable profit method be used primarily to complement or cross-check other methods of determining transfer prices and as a tool for selecting cases for audit. The OECD has also recommended that the comparable profit method be used only as a method of last resort for determining specific adjustment amounts.<sup>99</sup> The German Parliament has passed a resolution expressing its view that the comparable profit method is inconsistent with the arm's length principle.<sup>100</sup> Leading members of the Parlia-

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<sup>98</sup> For a discussion of the difference between economic and accounting rates of return, see BREALEY & MYERS, *supra* note 80, at 270-71; Franklin M. Fisher & John J. McGowan, *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits*, 73 AM. ECON. REV. 82 (1983).

<sup>99</sup> Committee on Fiscal Affairs, Organisation for Economic Co-operation and Development, *The United States Proposed Regulations Dealing with Tax Aspects of Transfer Pricing Within Multinational Enterprises* (1993), reprinted in 6 TAX NOTES INT'L 93, 97 (1993).

<sup>100</sup> RESOLUTION OF THE FINANCE COMMITTEE OF THE DEUTSCHER BUNDESTAG (GERMAN FEDERAL PARLIAMENT), ON THE DRAFT GUIDELINES OF THE U.S. REVENUE ADMINISTRATION FOR THE DETERMINATION AND REVIEW OF INTERNAL TRANSFER PRICES FOR GROUPS OF COMPANIES, available in LEXIS, Fedtax Library, TNT File No. 92 TNT 150-108 (July 23, 1992) (Adnex).

ment visited the United States to convey this view to the Treasury and to Congress.<sup>101</sup> Indeed, apart from the principle that comparable uncontrolled prices should be used if available, there appears to be little international agreement on the content of the arm's length standard.

The Treasury's approach also fails to resolve the uncertainty inherent in finding arm's length prices for transfers that occur only between controlled parties.<sup>102</sup> The indeterminacy involved in reconstructing arm's length prices under Section 482 will almost certainly increase over time. This is because in the past, the IRS has focused on transactions between U.S. parent companies and their wholly-owned subsidiaries in tax haven countries.<sup>103</sup> More recently, the emphasis has shifted to transactions between foreign parent companies and their U.S. affiliates, a trend which will probably continue.<sup>104</sup> Because the interrelated operations are likely to be far more complex, the difficulty in applying Section 482 is likely to be much greater when the related companies are both located in developed countries.

More generally, it is likely that transactions between related corporations will become increasingly prevalent and more complex with the growth of worldwide economic integration and intercompany trade. As a result, there will be fewer uncontrolled transactions available to use as standards for comparison. Moreover, world trade increasingly involves intermediate goods and high-technology products whose manufacture and distribution involve intangible property. Comparable uncontrolled transactions are particularly unlikely to be available for these types of transfers.<sup>105</sup> Finally, as the number of intercompany transactions grows, it will become increasingly difficult for the IRS to examine more than a small proportion of such transactions.<sup>106</sup>

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<sup>101</sup> This visit reportedly "represents the first time a German delegation has visited a foreign country to discuss that country's domestic legislation." John Turro, *German Officials Fault U.S. Foreign Tax Bill and Proposed Transfer-Pricing Regs.*, 5 TAX NOTES INT'L 175 (1992).

<sup>102</sup> See, e.g., Alan W. Granwell & Kenneth Klein, "Objective" Tests of Transfer Pricing Prop. Regs. Require Subjective Determinations, 76 J. TAX'N 308 (1992) (discussing the indeterminacy of the methodology of the proposed regulations); Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299, 318-21 (1990) (discussing the indeterminacy of the methodology of the *White Paper*).

<sup>103</sup> See WHITE PAPER, *supra* note 1, at 14; GAO, INTERNATIONAL TAXATION, *supra* note 6, at 26-29.

<sup>104</sup> See Barbara L. Rollinson & Rom P. Watson, *The New Intercompany Pricing Regulations*, 45 NAT'L TAX J. 225, 226 (1992); WHITE PAPER, *supra* note 1, at 15.

<sup>105</sup> See GAO, INTERNATIONAL TAXATION, *supra* note 6, at 63.

<sup>106</sup> For example, it has been reported that 3M Corp. must compute transfer prices for 120,000 products. Lee Sheppard, *Tax Foundation Hosts Conference on Transfer Pricing*, 4 TAX NOTES INT'L 1193, 1194 (1992). This problem can only be avoided by using methodologies based on aggregate results rather than specific transactions.

## 2. *Neutrality Between Affiliated and Unaffiliated Firms*

An independent rationale for using the arm's length standard to allocate income among commonly controlled corporations is that it neutralizes the tax incentive that a corporation otherwise might have to affiliate with other corporations.<sup>107</sup> Consider a domestic firm that is contemplating engaging in business abroad. The firm could do so either by creating or acquiring foreign affiliates, or by engaging in market-based transactions with unrelated foreign firms. The two approaches involve different costs. For example, with the first approach there are costs of exercising internal control over a multinational operation and start-up costs associated with learning how to conduct business in a foreign country.<sup>108</sup> Under the second approach there are transaction costs, which can include the costs of negotiating, monitoring, and enforcing long term contracts needed to protect the domestic firm's intangible property rights and prevent the unrelated trading partners from engaging in opportunistic behavior.<sup>109</sup> Ideally, the form of organization should be chosen on the basis of economic costs, and should not be distorted by tax considerations.<sup>110</sup>

Suppose, for example, that a manufacturing corporation, *P*, can market its product overseas equally efficiently either by selling to an unrelated foreign distributor, *T*, or by forming its own foreign distribution subsidiary, *S*. If the tax rates in the home and host countries are different, the tax liabilities incurred under each option will depend on the transfer price. If *P* sells the product to *T*, the fact that *P* and *T* have adverse interests in setting the price will generally ensure that the price will not be tax motivated, at least as long as *P* and *T* cannot make side payments that they can conceal from the tax authorities. If, however, *P* sells the product to *S*, central management could direct the two commonly controlled firms to set the transfer price in order to minimize their combined taxes. Thus tax considerations could induce *P* to create or acquire a foreign distribution subsidiary rather than to sell to unrelated foreign distributors. Indeed, even if selling to unrelated foreign distributors were more efficient, the tax savings might induce *P* to affiliate with its distributor. If it were possible to enforce a rule requiring *P* and *S* to use the same transfer price

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<sup>107</sup> See Charles H. Berry et al., *Arm's-Length Pricing: Some Economic Perspectives*, 54 TAX NOTES 731, 732 (1992); WHITE PAPER, *supra* note 1, at 82. This rationale appears to be of recent vintage.

<sup>108</sup> See RICHARD E. CAVES, *MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS* 12-13 (1982).

<sup>109</sup> See *id.* at 16-18.

<sup>110</sup> This statement does not take into account second-best considerations (the presence of some inefficiency elsewhere). The removal of one tax distortion will not necessarily increase efficiency if there are other distortions in the system. See Berry et al., *supra* note 107, at 732 n.4.

as  $P$  and  $T$  (the arm's length price), the tax incentive to affiliate would be eliminated.

This neutrality rationale provides a cogent reason for applying the arm's length standard to those multinationals whose intercompany transactions could be carried out with approximately equal (or greater) efficiency by unrelated firms. As noted above, many multinationals do not fall into this class, but instead come into being because market transactions are not feasible. Nonetheless, it is possible that, if the arm's length standard were replaced by a different methodology for allocating income, inefficient multinationals would come into existence for tax-driven reasons.

### 3. *Allocation of Income Based on Economic Activity*

A final proffered rationale for using the arm's length standard is that it accurately allocates income among affiliates of a multinational in proportion to each affiliate's economic activity.<sup>111</sup> A frequent objection to this rationale is that it ignores the industrial organization theory of the multinational enterprise. According to this theory, the profitability of a multinational enterprise is largely attributable to the organizational form itself, which enables the multinational to reduce transaction costs, achieve integration economies, and exploit intangible assets, which often cannot be localized. Consequently, all of the income of a multinational cannot be allocated among its affiliates in any principled manner.<sup>112</sup>

A more basic difficulty with the argument that the arm's length standard is desirable because it accurately allocates income to source is that this argument rests on the underlying premise that a source-based tax on income is justified. As discussed in Part I, this premise is open to question.

## III

### FINANCIAL MANEUVERING

Congress and the Treasury have focused their attention predominantly on the use of artificial transfer pricing as a strategy for global tax minimization. However, a multinational can achieve essentially the same shifting of income through intercompany lending or the al-

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<sup>111</sup> See WHITE PAPER, *supra* note 1, at 79-80 (stating that the goal of the arm's length standard is to ensure that an economic activity's return is allocated to the party that performs it); H.R. CONF. REP. NO. 281, 99th Cong., 2d Sess. II-637 (1986) (stating that the 1986 amendment to § 482 was intended to ensure that the division of income between related parties reasonably reflects the economic activities of each).

<sup>112</sup> See Stanley I. Langbein, *Transaction Cost, Production Cost, and Tax Transfer Pricing*, 44 TAX NOTES 1391, 1407-8 (1989); Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 654-69 (1986); see also WHITE PAPER, *supra* note 1, at 89-82 (discussing this criticism of the arm's length standard).

location of third-party debt among affiliates. Even if the Treasury were to succeed in implementing the arm's length principle in a way that would prevent transfer pricing, the victory would be hollow if multinationals could continue to minimize taxes through financial maneuvering.

## A. Global Tax Minimization Using Financial Maneuvering

### 1. *Intercompany Lending*

Consider again the case of a U.S. corporation, *P*, with a foreign subsidiary, *S*. If *P* lends funds to *S* rather than contributing the funds to the capital of *S*, the return to *P* will take the form of interest payments. *S* will be entitled to a deduction for the interest payments and therefore will avoid the host country's tax on the earnings out of which the interest is paid. Moreover, the host country's withholding tax on the interest payments will often be imposed at a lower rate than its withholding tax on dividends.<sup>113</sup> Treaties often reduce the withholding tax rate on interest to zero, in which case no host country tax will be imposed on the earnings out of which the interest is paid. The United States will tax *P* on the interest payments received, subject to a foreign tax credit for any withholding tax paid to the host country. The interest generally will be foreign source income,<sup>114</sup> and therefore will increase *P*'s foreign tax credit limit.

If *P* is in an excess limitation position, and the foreign corporate income tax rate is greater than the U.S. corporate income tax rate, the multinational will reduce its global tax burden by increasing the interest paid by *S* to *P*.<sup>115</sup> Conversely, when the U.S. corporate income tax rate is greater than the foreign corporate income tax rate, the multinational will reduce its global tax burden by decreasing the interest

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<sup>113</sup> See U.S. MODEL TREATY, *supra* note 7, art. 10(2)(a) (limiting the rate of withholding tax on dividends to five percent where the recipient is a corporation owning at least 10% of the voting stock of the company paying the dividends); *id.* art. 11(1) (reducing the rate of withholding tax on interest to zero). Consistent with these provisions of the U.S. Model Treaty, many European countries do not impose any withholding tax on interest paid to a U.S. parent corporation, but do impose a withholding tax on dividends, generally at five percent. Japan imposes withholding taxes on dividends and interest at the same rate of 10%. On the other hand, Belgium and Canada impose a higher withholding tax rate on interest (15%) than on dividends (5% and 10%, respectively).

<sup>114</sup> I.R.C. §§ 861(a)(1), 862(a)(1) (West Supp. 1993). However, if the intercompany loan is foreign-currency denominated, the foreign currency "interest" received will be treated in part as interest (based on the average exchange rate for each accrual period) and in part as foreign currency gain or loss (based on the spot exchange rate on the date payments are received). Treas. Reg. § 1.988-2(b)(2)(ii)(C) and (b)(3) (1992). Any foreign currency exchange gain will be U.S. source income, and any foreign exchange loss will be allocated to U.S. source income. Treas. Reg. § 1.988-4(a) (1992).

<sup>115</sup> If *P* is in an excess limitation position, the payment of \$1 of interest by *S* to *P* will result in a net change in global tax liability of  $t_f - t_u$ , where  $t_u$  is the U.S. corporate income tax rate and  $t_f$  is the host country's corporate income tax rate.

paid by *S* to *P*. In the latter case, the multinational will be better off replacing the intercompany debt with equity, which would enable the multinational to defer U.S. corporate income taxation by accumulating earnings abroad. On the other hand, if *P* is in an excess credit position, the multinational will reduce its global tax burden by increasing the interest paid by *S* to *P*, regardless of which country has the higher corporate income tax rate, provided that the foreign corporate income tax rate is greater than the foreign withholding tax rate on interest payments.<sup>116</sup>

In theory, the multinational could change the amount of interest paid by *S* to *P* by adjusting the interest rate on intercompany loans, but this strategy would leave the multinational vulnerable to attack under transfer pricing rules. In practice, therefore, the multinational is likely to change the amount of interest paid by *S* to *P* by adjusting the amounts of equity and intercompany debt used to finance *S*.

## 2. *Third-party Lending*

Even without directly making intercompany loans, a multinational can arrange its financial structure to achieve global tax minimization. Consider again the case of a U.S. corporation, *P*, with a foreign subsidiary, *S*. Suppose for simplicity that both *P* and *S* have borrowed funds from third parties at the same interest rate, *r*, and that the applicable currency exchange rate is constant. If *P* repays \$1 of its debt and *S* simultaneously borrows an additional \$1, the result will be to shift  $r \times \$1$  of annual income from *S* to *P*. The multinational will reduce its global tax liability by shifting income from affiliates that are subject to high corporate income tax rates to affiliates that are subject to low corporate income tax rates.

Once again, it is necessary to refine this analysis to take into account the effect of the borrowing on *P*'s foreign tax credit limitation. Under U.S. tax law, a portion of the interest expense of a U.S. corporation must be allocated to foreign source gross income if the corporation has assets producing foreign source gross income.<sup>117</sup> A portion of *P*'s interest expense will therefore be allocated to foreign source gross income because *P* owns the stock of *S*, an asset producing foreign source gross income (dividends). If *P* is in an excess credit position, the allocation of a portion of *P*'s interest expense to foreign source gross income reduces *P*'s binding foreign tax credit limitation and therefore is equivalent to the denial of a deduction for this portion of the interest expense. This can give a U.S.-based multinational

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<sup>116</sup> If *P* is in an excess credit position, the payment of \$1 of interest by *S* to *P* will result in a net change in global tax liability of  $w_f - t_f$ , where  $w_f$  is the rate of the host country's withholding tax on interest payments and  $t_f$  is the host country's corporate income tax rate.

<sup>117</sup> I.R.C. § 864(e)(2) (West Supp. 1993).



in an excess credit position an incentive to shift third-party debt from the U.S. parent corporation to foreign subsidiaries, even if the foreign subsidiaries are subject to lower corporate income tax rates than the parent corporation. The lower the foreign corporate income tax rate, however, the less the incentive to shift the debt.

There are likely to be few non-governmental constraints on the multinational's ability to arrange its financial structure in order to minimize its global tax liability. Even assuming that there is an optimal debt-to-equity ratio for the multinational as a whole,<sup>118</sup> it is likely to be irrelevant, apart from the tax consequences, how the debt is allocated among the affiliates. This is because, as a practical matter, the parent corporation will almost certainly keep lenders whole if an affiliate defaults, even if it has no legal obligation to do so.<sup>119</sup> Therefore, in determining what interest rate to demand, lenders to an affiliate of a multinational are likely to take into account the multinational's consolidated debt-to-equity ratio, rather than the separate debt-to-equity ratio of the affiliate.

Nevertheless, there are several possible constraints on the extent to which a multinational will use financial maneuvering to minimize global taxes. All else being equal, if one affiliate has unique access to low-cost loans, such as government-subsidized loans or loans from international agencies, the multinational might want to have that affiliate incur the maximum amount of debt possible. In addition, the multinational might wish to adopt a strategy of requiring each affiliate to meet most of its own financing needs with local borrowing. This strategy can reduce political risks, such as governmental expropriation or imposition of exchange controls,<sup>120</sup> and reduce the risks associated with exchange rate fluctuations.<sup>121</sup> The multinational also might pursue this strategy in order to diversify its sources of funds, thus lessening its dependence on any one financial market and broadening its sources of economic and financial information.<sup>122</sup> Finally, by relying on local financial institutions to monitor the activities of its foreign affiliates, this strategy could reduce the multinational's agency costs.<sup>123</sup> Nevertheless, despite these possible constraints, multination-

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118 See BREALEY & MYERS, *supra* note 80, at 922 (concluding that there is no accepted, coherent theory about capital structure); COPELAND & WESTON, *supra* note 84, at 536 (same; noting that "casual empiricism" suggests that firms behave as though an optimal capital structure does exist).

119 ALAN C. SHAPIRO, *MULTINATIONAL FINANCIAL MANAGEMENT* 747 (3d ed. 1989).

120 See *id.* at 734-35; BREALEY & MYERS, *supra* note 80, at 879-80.

121 See SHAPIRO, *supra* note 119, at 734.

122 See *id.* at 737-38.

123 See *id.* at 746. However, if the local financial institutions believe that the multinational will keep them whole if the affiliate defaults, as suggested above, they will not have a strong incentive to monitor the activities of the foreign affiliate.

als are likely to have considerable flexibility to adjust their global financial structure to minimize taxes.

## B. Application of the Arm's Length Standard to Financial Maneuvering

Arm's length pricing rules are of limited value in preventing multinationals from using financial maneuvering to reduce taxes. Although these rules can be used to adjust non-arm's length interest rates on intercompany loans, financial maneuvering does not depend on non-arm's length charges. In order to use the arm's length standard to counter financial maneuvering, the tax agency must recharacterize intercompany debt as equity (or deny deductions for interest expense on such debt) on the ground that unrelated firms would not have lent to one another under similar conditions. More difficult still, the tax agency must recharacterize third-party lending on the ground that the lenders would not have lent to independent firms on the same basis that they lent to affiliates of the multinational.

This type of recharacterization has proven to be difficult in the analogous context of loans by shareholders to closely held corporations. The judicial approaches to the problem of distinguishing between debt and equity in this context have been largely ad hoc,<sup>124</sup> and regulatory attempts to systematize the analysis have failed.<sup>125</sup> If the government could determine the optimal debt-to-equity ratio for a given firm, it could insist that each affiliate of a multinational conform to this ratio. As indicated above, however, financial theory has not conclusively established that such an optimal ratio exists. Even if such a ratio does exist, it is likely that the value of a firm is relatively con-

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<sup>124</sup> See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696-97 (3d Cir. 1968) (listing 16 criteria for determining whether an investment in the form of debt should be recharacterized as equity, but noting that no series of criteria can provide a conclusive answer). See generally William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

<sup>125</sup> In 1969, Congress enacted § 385, which authorizes the Treasury to prescribe regulations to determine whether an interest in a corporation is to be treated as stock or debt for Federal income tax purposes. Eleven years later, on March 24, 1980, the Treasury issued proposed regulations under § 385. 45 Fed. Reg. 18,957 (1980). These regulations became final on December 31, 1980, with an effective date of May 1, 1981. T.D. 7747, 45 Fed. Reg. 86,438 (1980). This effective date was later postponed to January 1, 1982, and then to July 1, 1982. E.g., T.D. 7774, 46 Fed. Reg. 24,945 (1981). The Treasury issued new proposed regulations on December 30, 1981, anticipating that these would go into effect on July 1, 1982. T.D. 7801, 47 Fed. Reg. 164 (1982). However, these regulations never became effective. The Treasury withdrew all of the § 385 regulations on July 6, 1983. T.D. 7920, 48 Fed. Reg. 31,054 (1983). To date, no additional regulations have been issued. As the Joint Committee on Taxation has noted, "[t]he section 385 regulations did not succeed in the attempt to develop objective standards for distinguishing debt from equity." STAFF OF THE JOINT COMM. ON TAXATION, 101ST CONG., 1ST SESS., FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 37 (Comm. Print 1989).

stant over a wide range of debt-to-equity ratios.<sup>126</sup> In any case, an extremely wide range of debt-to-equity ratios is observed in practice. As a result, the search for an arm's length debt-to-equity ratio is destined to be futile.<sup>127</sup>

Nevertheless, countries are increasingly enacting measures to recharacterize "excessive" debt as equity or to deny deductions for interest paid on such debt, particularly when the debt is advanced by non-resident related parties.<sup>128</sup> Congress first enacted such a "thin capitalization" or "earnings stripping" provision, Section 163(j) of the Code, in 1989.<sup>129</sup> This provision prohibits a corporation from deducting interest paid to a related foreign party under certain circumstances—generally, if the corporation's debt-to-equity ratio exceeds 1.5-to-1<sup>130</sup> and the interest payment is not subject to U.S. tax.<sup>131</sup> Even then, the prohibition applies only to the extent that the corporation's net interest expense exceeds 50 percent of its adjusted taxable income.<sup>132</sup> This provision involves arbitrary line drawing. The triggering debt-to-equity ratio of 1.5-to-1 is highly arbitrary, particularly since assets are generally valued at their adjusted basis.<sup>133</sup> Moreover, as explained above, even when triggered, the provision only partially prevents the stripping of earnings.

The Conference Committee Report on Section 163(j) argued that this provision is consistent with the arm's length standard.<sup>134</sup> Under the traditional interpretation of the arm's length standard, however, one would determine whether a subsidiary was thinly capitalized by examining the debt-to-equity ratios of comparable uncon-

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<sup>126</sup> See SHAPIRO, *supra* note 119, at 739.

<sup>127</sup> See Berry et al., *supra* note 107, at 739 n.19.

<sup>128</sup> See Thomas R. Bretz & E. Steven White, *Cross-Border Placement/Movement of Indebtedness and Tax-Effective Use of Cash Accumulated Offshore*, 68 TAXES 1103, 1119-21 (1990) (summarizing "thin capitalization" measures in Canada, France, Germany, Japan, the Netherlands, and the United Kingdom).

<sup>129</sup> Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(a), 103 Stat. 2106, 2339-42 (enacting I.R.C. § 163(j)).

<sup>130</sup> I.R.C. § 163(j) (2) (A) (ii) (West Supp. 1993).

<sup>131</sup> I.R.C. § 163(j) (3) (A) (West Supp. 1993), *as amended by* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13228. To the extent that the U.S. withholding tax on an interest payment is reduced by treaty to a rate below the statutory 30-percent rate, the interest payment is treated as not subject to U.S. tax. *Id.* § 163(j) (5) (B) (West Supp. 1993), *as amended by* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13228.

<sup>132</sup> I.R.C. § 163(j) (2) (B) (West Supp. 1993).

<sup>133</sup> I.R.C. § 163(j) (2) (C) (i) (West Supp. 1993).

<sup>134</sup> H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 569-70 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3172-73. Unless the provision merely adjusts the income of the U.S. subsidiary of a foreign parent corporation to reflect the income the subsidiary would have earned had its dealings with the parent been conducted on an arm's length basis, it is likely that the provision violates the nondiscrimination provisions of the United States's income tax treaties. As the House report conceded, the impact of the provision will likely fall predominately on foreign-based multinational corporations. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1249 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2719.

trolled corporations. As the conferees recognized, uncontrolled corporations exhibit an extremely wide range of debt-to-equity ratios, sometimes far exceeding 1.5-to-1.<sup>135</sup> The conferees dealt with this awkward fact by simply rejecting the view that the arm's length standard is satisfied if unrelated parties would have entered into a transaction involving the same thinness of capitalization, conceding that "[t]his may be different from the ordinary use of the term 'arm's length' under Code section 482."<sup>136</sup> Instead, the conferees asserted that thin capitalization rules based on averages among firms and typical patterns are consistent with the arm's length standard.<sup>137</sup>

The OECD took a contrary approach in its report on thin capitalization.<sup>138</sup> The OECD report concludes that thin capitalization rules are consistent with the arm's length principle only if they are based on a facts-and-circumstances approach using evidence of transactions between independent parties.<sup>139</sup> The report notes that the majority of the OECD countries believe that use of a fixed debt-to-equity ratio, such as one fixed by reference to the kind of ratio commonly found in the open market, "would undoubtedly be inconsistent with the arm's length principle" unless used merely as a rebuttable presumption.<sup>140</sup> While the OECD approach is consistent with the traditional interpretation of the arm's length principle, it fails to produce workable standards. The OECD report concedes that an arm's length approach is difficult to apply to thin capitalization problems because of "the absence of any clear guidelines as to what are the practices adopted by independent parties, and thus the difficulty of devising any consistent practice."<sup>141</sup>

In any event, Section 163(j) imposes only limited constraints on a multinational's intercompany financing decisions. Moreover, multinationals might be able to avoid even this limited constraint by using the services of a multinational bank. Rather than have the foreign parent corporation lend funds directly to its U.S. subsidiary, the parent can lend to a branch of a multinational bank and have the subsidiary borrow from another branch of the same bank. In theory, the IRS can recharacterize such a back-to-back loan as a direct intercompany loan.<sup>142</sup> In many cases, however, the parent can accomplish the same

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<sup>135</sup> See H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 569-70 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3172.

<sup>136</sup> *Id.* at 569.

<sup>137</sup> *Id.* at 570.

<sup>138</sup> OECD THIN CAPITALISATION REPORT, *supra* note 70, at 29-32.

<sup>139</sup> *Id.* ¶ 75, at 30.

<sup>140</sup> *Id.* ¶ 79, at 31.

<sup>141</sup> *Id.* ¶ 25, at 15.

<sup>142</sup> See Rev. Rul. 87-89, 1987-2 C.B. 195; Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383. The House Ways and Means Committee report on the Omnibus Budget Reconciliation Act of 1989 states that the committee intended that the Treasury

result by simply reducing its borrowing from its branch, in which case the back-to-back loan analysis does not readily apply. Alternatively, the foreign parent corporation can guarantee a bank loan to its U.S. subsidiary in lieu of making a direct intercompany loan. Prior to enactment of the Revenue Reconciliation Act of 1993, the IRS could have attacked such a transaction only by arguing that in substance the bank made the loan to the parent, which either re-lent the funds to the subsidiary or contributed the funds to the capital of the subsidiary.<sup>143</sup> In the former case, Section 163(j) would be applicable to the deemed intercompany loan. In the latter case, the subsidiary's interest payments would be characterized as nondeductible dividends. In 1993, Congress amended Section 163(j) to apply directly to such guaranteed loans.<sup>144</sup> Even so, this new provision does not appear to be applicable where the bank lends to the subsidiary with only a tacit understanding that the parent corporation will repay the loan if the subsidiary defaults.<sup>145</sup> In conclusion, the large scope of permissible creative financial maneuvering will seemingly allow multinationals to stay one step ahead of the tax authorities.

#### IV

#### GOVERNMENTAL RESPONSES TO AN INDETERMINATE STANDARD

##### A. Enforcement

As long as the rules for combatting transfer pricing and financial maneuvering rely on an indeterminate standard, enforcement of

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would use its regulatory authority under § 163(j) to issue regulations treating back-to-back loans through third parties like direct loans to related parties. H.R. REP. NO. 247, 101st Cong., 1st Sess. 1246-47 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2716-17. The proposed regulations under § 163(j) have reserved comment on how § 163(j) will apply if such techniques are used, however, reflecting the difficulty of the problem. Prop. Treas. Reg. § 1.163(j)-9, 56 Fed. Reg. 27907 (1991) (reserved for regulation dealing with guarantees and back-to-back loans). In addition, Congress in 1993 specifically authorized the Treasury to issue regulations establishing rules for recharacterizing multiple-party financing transactions as transactions directly among any two or more parties, where recharacterization is appropriate to prevent tax avoidance. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13238 (enacting new Code § 7701(l)).

<sup>143</sup> See *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972). See also H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 567 (1989), *reprinted in* 1989 U.S.C.C.A.N. 3018, 3170; H.R. REP. NO. 247, 101st Cong., 1st Sess. 1246-47 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2716-17.

<sup>144</sup> Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13228 (amending I.R.C. § 163(j)).

<sup>145</sup> Section 163(j), as amended, defines "guarantee" to include "any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness," except as provided in regulations. I.R.C. § 163(j)(6)(D)(iii) (West Supp. 1993), *as amended by* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13228. Although this definition is broad, it is presumably not infinitely elastic.

those rules will in many cases have primarily an *in terrorem* effect. Consider the case of a multinational with operations in two countries, and suppose that the multinational sets transfer prices and establishes its financial structure to achieve goals other than global tax minimization.<sup>146</sup> If one of the countries subsequently enacts aggressive transfer pricing and thin capitalization rules and, in enforcing these rules, resolves all indeterminacies in its own favor,<sup>147</sup> the multinational will likely seek to avoid costly disputes and possible penalties by changing its transfer prices and financial structure to increase the proportion of consolidated income reported in that country.<sup>148</sup> This increase in the enforcing country's tax base will come at the expense of the other country's tax base. The other country might respond to the erosion of its tax base by tightening its own rules and taking extreme positions in its enforcement actions.<sup>149</sup> In the end, the multinational might well revert to its initial transfer pricing and financial policies, particularly if these served significant internal purposes. As a result, the governments and the multinational will incur substantial additional costs

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<sup>146</sup> The multinational might be in a situation where transfer pricing and financial maneuvering would have little effect on its global tax liability. This would likely be the case if, for example, the corporate income tax rates in the two countries were similar, the parent corporation were not in an excess credit position, and the home country did not have an integrated tax system that provided integration benefits to shareholders only with respect to domestic corporate income tax payments.

<sup>147</sup> A country that took such actions would risk deterring transnational investment, possibly to that country's long-term detriment. Nevertheless, the country might find this strategy attractive if its political leaders had a short-term perspective, because the strategy might maximize tax revenues in the short term, or if its political leaders wanted to use the income tax system to protect or otherwise benefit particular domestic industries or other interest groups. Cf. Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 930-32 (1992) (discussing the political basis for tax discrimination against out-of-state producers or consumers).

<sup>148</sup> In the case of the United States, some foreign observers viewed the enactment of the commensurate-with-income provision of § 482, see *supra* note 87, as an attempt to encourage taxpayers to overstate their U.S. income tax at the expense of foreign governments. See, e.g., John A. Calderwood, *Pricing for Intangibles, Goods and Services Under Super-Royalty: A Canadian View*, in TRANSFER PRICING FOR INTANGIBLES: A COMMENTARY ON THE WHITE PAPER 51, 56 (Fred C. de Hosson ed., 1989); Go Kawada, *Comments on Section 482 White Paper*, in TRANSFER PRICING FOR INTANGIBLES, *supra*, at 62, 63. Mr. Calderwood was the Director of the International Audits Division, Revenue Canada, Taxation, and Mr. Kawada was the Director, Office of International Operations, Ministry of Finance, Tokyo. The recent U.S. enactment of penalties for transfer price misstatements, see *supra* note 8, also might be viewed as an attempt to induce multinationals to shift income to the United States, particularly given the acknowledged lack of clear guidance on how to determine arm's length prices.

<sup>149</sup> For example, Japanese tax auditors reportedly have begun aggressively to enforce Japan's transfer pricing rules, which took effect in 1987. See Gary M. Thomas, *Japan*, 3 TAX NOTES INT'L 859, 860 (1991); see also Akira Akamatsu & Gary M. Thomas, *Update of Recent Japanese Developments in Transfer-Pricing Enforcement*, 5 TAX NOTES INT'L 227 (1992).

of enforcement, compliance, and dispute resolution,<sup>150</sup> yet neither government will increase its tax revenue.<sup>151</sup>

Thus, international enforcement of the arm's length standard might assume characteristics of the prisoner's dilemma.<sup>152</sup> Each country acting separately has an incentive to maximize enforcement, regardless of what other countries do, though all countries might be better off if they could agree to enforce the arm's length standard only in clearly abusive cases.

## B. Corporate Income Tax Rates

An international system of source-based corporate income taxation is vulnerable to tax competition because multinationals will respond to tax rate differentials in determining where to locate their investments. This section discusses the dynamics of this process and suggests that there are several limits on the extent to which the mobility of physical investment threatens the stability of the present system. A much greater potential threat comes from the ability of multinationals to shift the reported location of their profits through transfer pricing and financial maneuvering.

Consider an idealized world in which all countries impose a purely source-based<sup>153</sup> corporate income tax at the same rate and us-

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<sup>150</sup> Litigation involving proposed § 482 adjustments for Sundstrand Corporation's taxable years 1977 and 1978 provides an indication of the magnitude of these costs. Sundstrand reportedly spent millions of dollars and thousands of work hours on its defense, which resulted in more than 2,000 pages of testimony, hundreds of stipulations, 2,000 proposed findings of fact, and 1,800 pages of briefs. See Deborah Siebrandt, *Practitioners Discuss Accounting, Transfer Pricing Issues at Silicon Valley Conference*, 53 TAX NOTES 1110 (1991). The Tax Court issued a final decision in February 1991, more than 11 years after the IRS audit began. *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991).

<sup>151</sup> If the two governments impose conflicting requirements on the multinational and do not resolve the conflict through mutual agreement, their tax revenues might increase in the short run, but will likely decrease in the long run as international business activity diminishes.

<sup>152</sup> The "prisoner's dilemma," a situation studied in game theory, involves the following scenario: Two suspects are arrested for a crime and separated. The district attorney is certain they are guilty of a specific crime but does not have enough evidence to convict them without a confession. She tells each suspect that if he confesses and his companion does not, she will recommend that he receive a sentence of three months, whereas his companion will receive the maximum sentence of 10 years. If both confess, she will recommend that each receive a sentence of eight years. Each suspect knows that if neither confesses, the lack of evidence will cause them to be tried for a lesser crime for which each will receive a sentence of one year. Each suspect will minimize his sentence by confessing, regardless of what the other suspect does. But if each suspect adopts this strategy, the result will be suboptimal: Each will receive an eight-year sentence rather than the one-year sentence that would result if neither confessed. See R. DUNCAN LUCE & HOWARD RAIFFA, *GAMES AND DECISIONS* 94-97 (1957). International enforcement of the arm's length standard differs from the classic prisoner's dilemma situation because countries, unlike prisoners, can coordinate their strategies and because they repeat the "game" indefinitely.

<sup>153</sup> That is, all countries tax corporations on income earned from sources within the country and exempt foreign source income from taxation.

ing the same tax base. This system of taxation will not distort the international allocation of capital. Suppose, however, that one country were to lower its tax rate. This would induce multinationals, at the margin, to locate new investment in the low-tax country rather than in the remaining high-tax countries.<sup>154</sup> The tax cut would decrease the country's tax revenue from the investment existing in the country at the time of the change and from new investment that would have been made in the country even without the rate reduction. On the other hand, the tax cut would attract additional corporate investment and consequently augment the country's tax base. Furthermore, the growth in investment would increase the income earned by the owners of immobile factors of production (such as land and labor) located within the country. Depending on the magnitude of these responses, the tax cut might appear attractive from a purely national perspective.

From an international perspective, however, the unilateral tax cut is a beggar-thy-neighbor strategy. Much of the additional investment that is channeled to the low-tax country because of the tax cut will come at the expense of the remaining high-tax countries, and will earn a lower than optimal before-tax rate of return.<sup>155</sup> If the low-tax country sets its tax rate from a purely national perspective and on the assumption that the tax policies of other countries are fixed, it will fail to consider these negative external effects.<sup>156</sup> The remaining high-tax countries, however, might respond to the outflow of investment by lowering their own corporate income tax rates. This process will result in a global reduction of corporate income tax rates, culminating in rates below the level that countries would have set had they adopted a cooperative approach.<sup>157</sup>

The basic analysis of international tax competition presented above must be refined to take into account several factors that contrib-

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<sup>154</sup> This statement assumes that the low-tax country does not match its tax cut with a reduction in the public goods and services that benefit corporations. This assumption will generally be satisfied. As discussed above, there is little relationship between the corporate income tax that a corporation pays and the benefits that it receives from the government. *See supra* notes 44-45 and accompanying text.

<sup>155</sup> To some extent, however, the additional investment might come from additional saving induced by the tax cut.

<sup>156</sup> *See* Joel Slemrod, *Tax Principles in an International Economy*, in *WORLD TAX REFORM: CASE STUDIES IN DEVELOPED AND DEVELOPING COUNTRIES* 11, 20 (Michael J. Boskin & Charles E. McLure, Jr. eds., 1990).

<sup>157</sup> There is, however, no assurance that this cooperative solution would have been optimal. If distortions in the political process cause governments to maintain corporate income taxes at higher than optimal levels, the pressure created by international tax competition to reduce corporate income tax rates could be beneficial. *See id.* at 20. The problem is that international tax competition does not contain any built-in mechanism to ensure that when corporate income taxes fall to an optimal level, equilibrium will be reached.



ute to the sustainability of corporate income taxation. First, physical investment, while mobile in the long run, is fixed in the short run. A factory cannot be picked up and moved to another country. Rather, physical capital moves from one country to another gradually. Existing investment in one location depreciates and is not replaced; new investment is begun in a different location. As a result, governments can efficiently tax income from existing investment, which is immobile. It is only new investment that might be driven abroad by high tax rates.<sup>158</sup> Therefore, if a government taxes corporations at rates higher than those imposed in other countries, it will maximize revenue in the short run, but will deter new investment. As a result, the long-run burden of the incremental tax will probably be borne by immobile domestic groups, such as labor. If politicians have a sufficiently short-term perspective, this trade-off will likely appear attractive.

Second, if a country raises its corporate income tax rate, the inducement for corporations to locate new investment elsewhere will occur only at the margin. To the extent that new corporate investment can earn a higher before-tax rate of return in the country than it could elsewhere, it will not be driven away by higher tax rates.<sup>159</sup> A country might have a number of features, such as natural resources, relatively inexpensive labor, or a large market of affluent consumers, that enable corporations to earn higher than marginal before-tax rates of return.<sup>160</sup> It is generally believed that these features are more important than tax rates in determining the location of new direct investment.<sup>161</sup>

Finally, a group of similar countries might succeed in maintaining corporate income tax rates at a common equilibrium level through a process of mutual forbearance. Each country might refrain from attempts to attract corporate investment by lowering its tax rate,

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<sup>158</sup> The ideal strategy from a government's point of view would be to tax income from existing investment and, at the same time, to promise not to tax income from new investment. One difficulty with this strategy is that governments generally cannot bind themselves to future actions, and therefore cannot make convincing promises about their future tax policies. If a government taxes income from existing investment, investors will likely assume that it will also tax income from new investment, at least once the investment is firmly in place.

<sup>159</sup> See Charles E. McLure, Jr., *Lessons for LDCs of U.S. Income Tax Reform*, in *TAX REFORM IN DEVELOPING COUNTRIES* 347, 357 (Malcolm Gillis ed., 1989).

<sup>160</sup> To some extent, these features are created by governmental programs, which are financed by taxes. This might suggest that the government could raise corporate income taxes, use the revenue to increase the attractiveness of the country to business, and not lose any investment. Once again, the problem with this analysis is that the corporate income tax burden faced by each business bears little relationship to the value of government programs to that particular business. See *supra* note 154.

<sup>161</sup> See DONALD J.S. BREAN, *INTERNATIONAL ISSUES IN TAXATION: THE CANADIAN PERSPECTIVE* 103 (1984).

if it is aware that such attempts will harm other countries and might cause them to reciprocate, thus nullifying the expected benefits.

One additional refinement must be made to the analysis presented above: it is necessary to consider the possible impact of transfer price manipulation and financial maneuvering. If the international tax system provides opportunities for such behavior, the incentives for countries to lower their corporate tax rates would increase significantly because by doing so they could expect to induce multinationals to shift reported income into the country.<sup>162</sup>

The possibility of shifting reported income reduces the incentives that multinationals might otherwise have to change the location of physical investment in response to tax differentials. By shifting income, multinationals can keep physical investment in high-tax countries without subjecting the income to the higher taxes. At least initially, therefore, transfer pricing and financial maneuvering improve the international allocation of capital. In the long run, however, this might not be the case, because the international tax system is not a simple, purely source-based system. Global tax minimization strategies often require multinationals to invest the shifted funds locally rather than repatriate the funds to the home country, even if the local investment opportunities are sub-optimal.<sup>163</sup>

The potential for income shifting has a much more destabilizing effect on the international tax system than does the mobility of physical investment. Unlike the movement of physical investment, the movement of reported income (which requires merely a change in interual prices or in internal financing) can occur virtually instantaneously.<sup>164</sup> Moreover, the magnitude of the response is likely to be very high. If there were no internal or governmental constraints on transfer pricing and financial maneuvering, multinationals might have an incentive to shift all of their reported profits from a country with high tax rates to one with even slightly lower tax rates. Unless the multinational's tax minimization strategy depends on investing the shifted funds locally rather than repatriating them, the existence of location-specific advantages will not deter this shifting of profits. If, on the other hand, the multinational's strategy does depend on investing

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<sup>162</sup> As discussed above, multinationals do not invariably have an incentive to shift income from high-tax to low-tax countries. See *supra* notes 159-61 and accompanying text. For example, a U.S.-based multinational in an excess credit position with fixed physical investments often has an incentive to use transfer pricing and financial maneuvering to shift income to the U.S. parent corporation, even if foreign tax rates are relatively low. Even so, a foreign country that lowers its corporate income tax rate will reduce the magnitude of this incentive.

<sup>163</sup> See *supra* text accompanying notes 62-64.

<sup>164</sup> Note, however, that too rapid a change would likely catch the attention of tax authorities.

shifted funds locally, governments will have an increased incentive to attract shiftable income and funds for new investment by reducing corporate income tax rates.

The process of international tax competition described above directly affects corporate income tax rates. Any reduction in corporate income tax rates, however, will place downward pressure on individual income tax rates as well. If a country tries to maintain a system of low corporate income tax rates and high individual income tax rates, individuals can indefinitely defer the burden of the high individual income tax with respect to their income from capital by investing their capital through corporate intermediaries and retaining the earnings in corporate solution.

Governments could respond to the loss of tax revenue resulting from such tax competition in several ways. They could reduce governmental services and transfer payments, impose increased taxes directly on the owners of immobile factors of production such as labor, or, to the extent feasible, impose user fees and taxes that closely reflect benefits received by taxpayers. In any case, governments would find it difficult to use tax and expenditure policy to redistribute income from owners of mobile capital to immobile, and often low-income, individuals.

This negative assessment of international tax competition contrasts with the widely-held view that interjurisdictional tax competition at the local level, and to a lesser extent at the state level, is generally beneficial.<sup>165</sup> This latter view assumes that, in the absence of tax competition, the political process will keep taxes and governmental expenditures above the levels preferred by citizens.<sup>166</sup> If, however, individuals are mobile and communities must compete with one another for residents, the competition will force communities to offer packages of taxes and services that are attractive to potential residents.<sup>167</sup> This analysis assumes that communities do not attempt to impose source-based taxes on mobile capital, but instead raise revenue through user fees and taxes on residents that reflect the benefits that those residents receive from governmental goods and services.<sup>168</sup>

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<sup>165</sup> See generally ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, INTERJURISDICTIONAL TAX AND POLICY COMPETITION: GOOD OR BAD FOR THE FEDERAL SYSTEM? (1991); Daphne A. Kenyon & John Kincaid, *Introduction*, in COMPETITION AMONG STATES AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM I (Daphne A. Kenyon & John Kincaid eds., 1991).

<sup>166</sup> See THOMAS R. DYE, AMERICAN FEDERALISM: COMPETITION AMONG GOVERNMENTS 21-23, 68-69 (1990) (citing additional references).

<sup>167</sup> The seminal article describing this theory is Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

<sup>168</sup> See Charles E. McLure, Jr., *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?*, 39 NAT'L TAX J. 341, 341-43 (1986).

Similarly, if national governments were to forgo attempts to impose source-based corporate income taxes and instead taxed corporate income exclusively on the basis of residence,<sup>169</sup> national corporate income taxes would be largely insulated from the pressures of tax competition. This is because in all but exceptional cases, individuals are unlikely to change their national residence in response to tax differentials.<sup>170</sup> Thus, moving to an international system of residence-based corporate income taxation would not ensure governmental efficiency or responsiveness to citizens' preferences any more than a system of source-based corporate income taxation. Residence-based taxation would, however, enable governments to continue to rely on income taxation as a cornerstone of a redistributive fiscal policy.

Moving to an international system of residence-based corporate income taxation may not be feasible, however, because of implementation and enforcement problems and the difficulty of obtaining international agreement. Assuming for the moment that this approach is not feasible, and assuming further that governments desire to maintain a comprehensive income tax as a matter of domestic policy,<sup>171</sup> governments must take other steps to preserve the current system of

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<sup>169</sup> See *infra* part V.B.

<sup>170</sup> If residents were internationally mobile in response to tax differentials, international tax competition would tend to drive national tax systems toward a benefit tax structure, as does tax competition at the state and local levels. As noted above, this precludes the use of tax policy to redistribute income. This consequence is generally not considered to be a fatal flaw in the case of tax competition at the state and local levels, even by those who favor redistributive taxation, but only because it is assumed that redistributive policies can be carried out effectively by the national government. See, e.g., McLure, *supra* note 168, at 346; MUSGRAVE & MUSGRAVE, *supra* note 35, at 454-55; Wallace E. Oates & Robert M. Schwab, *The Allocative and Distributive Implications of Local Fiscal Competition*, in COMPETITION AMONG STATES AND LOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM, *supra* note 165, at 127, 128.

<sup>171</sup> Some analysts argue that there would be significant advantages to a worldwide shift from comprehensive income taxation to direct consumption taxation as the international norm. See, e.g., McLure, *supra* note 44, at 145 (citing additional references in note 1); George R. Zodrow & Charles E. McLure, Jr., *Implementing Direct Consumption Taxes in Developing Countries*, 46 TAX L. REV. 405 (1991). This Article does not address this proposal, because it assumes that governments will maintain comprehensive income taxes as a matter of domestic policy. See TREASURY INTEGRATION REPORT, *supra* note 33, at 13-14 (noting the U.S. government's commitment to comprehensive income taxation); Michael J. Graetz, *Revisiting the Income Tax vs. Consumption Tax Debate*, 57 TAX NOTES 1437, 1438 (1992) (noting that the Tax Reform Act of 1986 reflects "the recent political decision by both Republicans and Democrats to retain and strengthen the income tax, rather than heed the calls of economists and some politicians to replace it with a consumption tax"); see, e.g., Gunn, *supra* note 36 (arguing in favor of comprehensive income taxation); Pechman, *supra* note 39 (same). On the other hand, most developed countries rely more heavily than the United States on consumption taxation and many tax analysts continue to advocate that the United States supplement or replace the income tax with a consumption tax. See Graetz, *supra*, at 1438; see also CENTER FOR STRATEGIC AND INT'L STUDIES, THE STRENGTHENING OF AMERICA COMMISSION, FIRST REPORT 96-102 (1992) (recommending replacement of the current U.S. income tax with a direct consumption tax). Indeed, the reader might conclude that the difficulties with maintaining comprehensive income taxation described

corporate income taxation against pressures from international tax competition.

The analysis of international tax competition presented above generally assumes that countries employ purely source-based corporate income tax systems. The adoption by some countries of tax systems based on worldwide taxation of residents, with relief from international double taxation provided by foreign tax credits, potentially contributes to the sustainability of a common equilibrium level of corporate income taxation.<sup>172</sup> Consider the United States as an example of a gross capital-exporting nation that uses a worldwide system of taxation. Leaving deferral and cross-crediting aside for the moment, a country that is host to a large amount of direct investment from the United States has an incentive to adopt the same corporate income tax rate and base as the United States.<sup>173</sup> If the host country does so, the corporate income tax that it imposes on U.S.-based multinationals will be borne fully by the U.S. Treasury as a consequence of the U.S. foreign tax credit mechanism, and therefore will not deter such multinationals from investing in the country. The system of worldwide taxation and foreign tax credits can therefore contribute to the international convergence of national tax systems. Note, however, that the existence of deferral and cross-crediting, which give host

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in this Article ultimately constitute an argument for abandoning or reducing reliance upon this form of taxation rather than for strengthening the system.

<sup>172</sup> See Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47 J. FIN. 1159 (1992) (arguing that the United States' dominance as a capital exporting country during much of the postwar period and its maintenance of a worldwide system of income taxation might have contributed to the survival of a non-zero equilibrium level of capital income taxes during this period, in spite of the openness of national economies).

<sup>173</sup> See, e.g., RICHARD M. BIRD, *TAXING CORPORATIONS* 15 (1980) (noting that "so long as the United States has a corporate income tax, so should Canada, and at about the same rates"); Robin Boadway, *Corporate Tax Harmonisation: Lessons from Canada*, in *BEYOND 1992: A EUROPEAN TAX SYSTEM* 52, 54 (Malcolm Gammie & Bill Robinson eds., 1989) (noting that as long as the United States allows a foreign tax credit on corporate taxes paid by subsidiaries abroad, "Canada would be foolish not to tax these firms on an origin basis and up to the limit of the allowable credit").

More precisely, the optimal strategy for the host country (ignoring deferral and cross-crediting) would be first to adopt the broadest possible tax base and then to choose a statutory tax rate that would result in an effective corporate income tax rate equal to the effective U.S. corporate income tax rate. In that way, the country's corporate income tax imposed on a U.S.-based multinational would be fully creditable against the multinational's U.S. tax liability, and the low statutory rate would attract shiftable income. See Slemrod, *supra* note 156, at 15-16. Note, however, that in the case of direct investment made through subsidiaries rather than branches in the host country, the relevant U.S. tax base consists of earnings and profits, a broader base than taxable income.

The host country also might find it desirable to integrate its corporate and individual income tax systems, but not to extend integration benefits to foreign shareholders. The host country's corporate income would then serve domestically as a form of withholding tax, and internationally as a means of obtaining revenue at the expense of foreign treasuries. See Arnold C. Harberger, *Principles of Taxation Applied to Developing Countries: What Have We Learned?*, in *WORLD TAX REFORM*, *supra* note 156, at 25, 36-38.

countries an incentive to employ lower corporate income tax rates than the United States, undermines this stabilizing and harmonizing effect.<sup>174</sup>

The dynamics of the international tax system discussed above can be seen in the worldwide tax reform movement that followed the United Kingdom's tax reform of 1984 and the U.S. tax reform of 1986.<sup>175</sup> Both countries lowered their corporate income tax rates and broadened their corporate income tax bases by reducing investment incentives. The Canadian response to these reforms is illustrative. In 1987, Canada announced a tax reform package similarly aimed at lowering corporate income tax rates and broadening the tax base.<sup>176</sup> This reform was motivated in part by the same efficiency concerns that motivated the reforms in the United Kingdom and the United States.<sup>177</sup> It is clear, however, that concerns about international tax competition also motivated the Canadian tax reforms.<sup>178</sup> Canadian tax analysts believed that if Canada did not reduce its corporate tax rates toward the U.S. level, the reduced U.S. rates would lead U.S.-based multinationals to use transfer pricing and increased debt financing of Canadian subsidiaries to shift reported taxable income out

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<sup>174</sup> Cross-crediting might also insulate host countries with high corporate income tax rates from pressures to lower their rates. This would occur to the extent that U.S.-based multinationals could credit high taxes against residual U.S. tax liability attributable to foreign source income derived in countries with low tax rates.

A country might also want to lower its corporate income tax rates in order to make foreign control of domestic firms less attractive. Domestically-owned firms would receive a tax reduction by the full amount of the tax cut. In contrast, multinationals based in foreign countries with worldwide tax systems would find their reduced host-country tax liability offset by an increased liability to the home-country government because of the foreign tax credit mechanism. Again, this analysis does not take into account the effects of deferral and cross-crediting. See GRAHAM & KRUGMAN, *supra* note 46, at 49-50.

<sup>175</sup> See generally John Bossons, *International Tax Competition: The Foreign Government Response in Canada and Other Countries*, 41 NAT'L TAX J. 347 (1988) (concluding that the U.S., as market leader, sets the corporate income tax rate to which other countries must conform); John Whalley, *Foreign Responses to U.S. Tax Reform, in DO TAXES MATTER?: THE IMPACT OF THE TAX REFORM ACT OF 1986*, at 286 (Joel Slemrod ed., 1990) (arguing that the worldwide tax reform movement of the 1980's was partly a direct response to U.S. tax reform and partly the result of common intellectual influences).

<sup>176</sup> CANADA, DEPARTMENT OF FINANCE, *THE WHITE PAPER: TAX REFORM 1987* (1987).

<sup>177</sup> See *id.* at 55, 72; see also Jack Mintz & John Whalley, *Introduction, in THE ECONOMIC IMPACTS OF TAX REFORM 1, 3* (Jack Mintz & John Whalley eds., 1989) (arguing that a broadening of the tax base will reduce the aggregate amount of tax losses, deductions and credits).

<sup>178</sup> See John Whalley, *Recent Tax Reform in Canada: Policy Responses to Global and Domestic Pressures, in WORLD TAX REFORM*, *supra* note 156, at 73, 81 (stating that the Canadian tax reforms in 1987 were less the outcome of a conscious strategy for improving the Canadian tax system than a response to pressures generated by falling corporate and personal tax rates around the world and the perception that the Canadian tax system undermined the country's international competitiveness).

of Canada.<sup>179</sup> Analysts also expressed concern that with reduced tax rates in the United States, Canadian taxes imposed on U.S.-based multinationals might not be fully creditable against U.S. taxes, and would thus discourage direct U.S. investment in Canada.<sup>180</sup>

## V

### ALTERNATIVE APPROACHES

As discussed above, countries that attempt to maintain high corporate income tax rates will likely find their tax and investment bases eroded as multinationals move physical capital or shift income to countries that impose lower taxes. The two principal methods for shifting income, transfer pricing and financial maneuvering, are not adequately addressed by the arm's length standard. The difficulties of applying this standard will only increase as economic activity becomes increasingly integrated across national boundaries. This in turn will intensify the problems of tax base erosion and international tax competition. At some point a fundamentally different approach, one that neutralizes the effects of internal transactions on the multinational's global income tax liability, will become necessary.<sup>181</sup>

Without moving away from the current system of source-based corporate income taxation, the most direct and effective long-term solution to the problems of tax base erosion and international tax competition would be concerted international tax harmonization. Alternatively, these problems could be alleviated within the context of a source-based system through international acceptance of a standardized method for allocating a multinational's worldwide consolidated income among the source countries. Finally, and most radically, these problems could be addressed through international adoption of a system that granted jurisdiction to tax corporate income solely on the basis of the residence of the corporation's ultimate individual shareholders.

It is unlikely that any of these approaches will achieve international acceptance in the short or even intermediate term.<sup>182</sup> In the meantime, the United States will have to consider interim approaches

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<sup>179</sup> *Id.* at 81; *see, e.g.*, John Bossons, *The Impact of the 1986 Tax Reform Act on Tax Reform in Canada*, 40 NAT'L TAX J. 331, 332-34 (1987); D.A. Dodge, *Economic Objectives of Tax Reform*, in *THE ECONOMIC IMPACTS OF TAX REFORM*, *supra* note 177, at 36, 37; Vijay M. Jog & Jack Mintz, *Corporate Tax Reform and Its Economic Impact: An Evolution of the Phase 1 Proposals*, in *THE ECONOMIC IMPACTS OF TAX REFORM*, *supra* note 177, at 83, 84-85; Mintz & Whalley, *supra* note 177, at 3.

<sup>180</sup> *See* sources cited *supra* note 179.

<sup>181</sup> As noted above, this Article assumes that national governments have decided to maintain systems of income taxation as a matter of domestic policy, and therefore does not analyze the alternative of moving to consumption taxation as the international norm. *See supra* note 171.

<sup>182</sup> *See infra* Part V.A-B.

that it can implement unilaterally or bilaterally within the framework of the existing international tax system. A key question in evaluating these interim approaches should be whether they move the system in the direction of a desired long-term solution. If successful, an interim approach might well be adopted by other nations, and might gradually evolve into an international norm; such norms are extremely difficult to change, particularly if they become codified in the language of bilateral tax treaties.<sup>183</sup>

## A. Long-term Approaches to Preserving an International System of Source-Based Corporate Income Taxation

### 1. *Harmonization of National Tax Systems*

The most direct way for governments to eliminate international competition for a share of a mobile and shiftable tax base would be to agree on a common corporate income tax system. Harmonization would also reduce the tax incentives for multinationals to manipulate intercompany transactions and would reduce the tax-induced distortions to the international allocation of capital. Moreover, harmonization would reduce the costs to multinationals of complying with a multiplicity of different national tax systems.<sup>184</sup>

Harmonization of effective tax rates would be extremely difficult to attain, however. It would require countries to surrender a great deal of sovereignty and would preclude their use of corporate income taxation as a means for implementing national economic policies.

Harmonization of effective tax rates would require agreement not only on uniform statutory tax rates, but also on a uniform corporate tax system (classical or integrated) and a uniform definition of the tax base.<sup>185</sup> In the United States, the combined federal and state tax systems would have to be brought into conformity with the international norm. This would require the elimination, or the complete harmonization, of all state corporate income tax systems. But even if statutory tax rates and the definition of the tax base were made uniform, effective tax rates would still differ from country to country unless tax enforcement, both administrative and judicial, were also

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<sup>183</sup> See Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region? (Part I)*, 45 BULL. FOR INT'L FISCAL DOCUMENTATION 99, 103 (1991) (discussing the inflexibility of bilateral tax treaties).

<sup>184</sup> The cost savings from harmonization would be partially offset by transition costs that would arise as governments changed their existing tax systems to conform to the agreed-upon standard.

<sup>185</sup> This would include agreement on such features as depreciation rules, investment incentives, the treatment of capital gains and losses, the survival of net operating losses, rules governing the realization and recognition of income, and the treatment of inflation.



standardized.<sup>186</sup> Finally, even if effective tax rates were successfully harmonized, the goal of investment neutrality would be undermined by competition on the expenditure side of the budget or in the regulatory sphere.<sup>187</sup>

The benefits of harmonization might also be weakened if tax haven countries refused to join the system.<sup>188</sup> Multinationals could then evade the harmonized tax systems of the world by channeling their international transactions through the remaining tax haven countries. Even if a worldwide harmonized tax system were achieved, it might lack stability. Governments would be tempted to break the bargain whenever they perceived a national advantage from doing so, and they would not necessarily be deterred by tax treaty commitments.<sup>189</sup> Thus, to be effective, harmonization might require delegation of national sovereignty to an international tax authority that would define the tax system, collect the taxes, and distribute the revenue among the individual nations.

Harmonization would entail drawbacks as well as benefits, and on balance it is not clear that complete harmonization would be a desirable objective. The differences in national tax systems are not merely irrational impediments to international allocative efficiency. Rather, they often reflect substantial economic, political, and social differences among countries.<sup>190</sup> Even if these national differences were not

<sup>186</sup> See Sijbren Cnossen, *On the Direction of Tax Harmonization in the European Community*, in REFORMING CAPITAL INCOME TAXATION 209, 217 (Horst Siebert ed., 1990).

<sup>187</sup> See *id.*

<sup>188</sup> For a description of tax haven countries, see WALTER H. DIAMOND & DOROTHY DIAMOND, *TAX HAVENS OF THE WORLD* (1993).

<sup>189</sup> See generally COMMITTEE ON FISCAL AFFAIRS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *TAX TREATY OVERRIDES* (1989), reprinted in 2 *TAX NOTES INT'L* 2525 (1990) (expressing opposition to domestic legislation intended to have effects in "clear contradiction to international treaty obligations."). Under U.S. law, for example, international treaties and statutes are of equal force. U.S. CONST. art. VI, § 2; I.R.C. § 7852(d)(1) (West 1993); see RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(a), § 115 cmt. a and reporter's note 1 (1986). Thus, under domestic law, Congress can override a treaty provision by subsequently enacting inconsistent legislation. See *id.*; *The Cherokee Tobacco*, 78 U.S. 616, 621 (1871). By doing so, Congress breaches an obligation of the United States under international law. See RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(b), § 115 cmt. b and reporter's note 2 (1986). However, the aggrieved treaty partner has few remedies. See ALI INCOME TAX TREATY PROJECT, *supra* note 15, at 73-76. In recent years, Congress has shown considerable willingness to override treaties through legislative enactments. See *id.* at 4, 69-72; Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 *TAX LAW* 173 (1989).

<sup>190</sup> These include differences in areas such as preferences for public sector size, per capita costs of providing government services, levels of public debt, rates of inflation, feasibility of implementing various alternative taxes, and views of the desirability of using tax policy to provide various economic incentives and disincentives. See Cnossen, *supra* note 186, at 218.

present, it might be desirable to have experimentation on the national level with different tax policies.<sup>191</sup>

An additional drawback to harmonization, at least in the absence of an international tax authority, is that the need for international agreement would make the task of changing the tax system difficult and time-consuming. This would impede countries from adjusting their tax systems rapidly in response to changes in economic circumstances and, in particular, from using tax policy as an instrument for macroeconomic stabilization.<sup>192</sup>

More modest harmonization goals would be easier to achieve. Harmonization of statutory rates, for example, would reduce the tax incentive for multinationals to shift income by engaging in transfer pricing or financial maneuvering, because the tax benefits from these practices depend on differences in statutory rates rather than on differences in effective rates.<sup>193</sup> An even more modest goal would be agreement on a minimum statutory corporate tax rate, which would place a floor on the extent to which tax competition could result in reduced rates.<sup>194</sup>

Harmonization would not necessarily eliminate the problem of transfer pricing and financial manipulation; it would merely reduce the tax-minimizing incentive to engage in these actions.<sup>195</sup> A multinational still might, for example, shift reported income to the country where its shareholders and managers reside in order to increase the amount (or decrease the personal tax cost) of public goods and services enjoyed by those individuals. Thus, even with complete harmonization, governments might find it necessary to enforce the arm's length standard to protect their tax bases.<sup>196</sup>

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<sup>191</sup> *But see* Shaviro, *supra* note 147, at 973-74 (questioning the benefits of governmental experimentation in the tax area).

<sup>192</sup> *See generally* JOSEPH A. PECHMAN, *FEDERAL TAX POLICY* 8-37 (5th ed. 1987) (discussing the use of taxation as an instrument for stabilizing the economy at high employment, maintaining price stability, and promoting economic growth and efficiency).

<sup>193</sup> *See* Slemrod, *supra* note 156, at 21.

<sup>194</sup> A Committee established by the Commission of the European Communities recently recommended that the Commission prepare, by the end of 1994, a draft directive requiring all Member States to adopt a minimum statutory corporate income tax rate of 30%, and that, at a later stage, it direct all Member States to adopt a maximum statutory corporate income tax rate of 40%. COMMISSION OF THE EUROPEAN COMMUNITIES, *REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION* 209-10 (1992).

<sup>195</sup> Even if corporate taxes were harmonized, multinationals might engage in transfer pricing or financial maneuvering in order to reduce their liability for withholding taxes.

<sup>196</sup> In the *White Paper*, the Treasury rejected a proposed "safe harbor" under which the IRS would not make transfer price adjustments if the tax rate in the foreign jurisdiction was at least 90 percent of the U.S. rate. The Treasury anticipated that taxpayers would sometimes engage in transfer price manipulation even if it did not result in global tax savings. *See* WHITE PAPER, *supra* note 1, at 76-77.

## 2. Unitary Taxation with Formula Apportionment

If countries agreed to tax multinationals on the basis of their worldwide consolidated incomes ("worldwide unitary taxation"), there would be no need for tax authorities to examine and recharacterize internal transactions. Consolidated income could be allocated among countries in accordance with an agreed-upon formula based on factors such as the proportion of the multinational's total property, payroll, and sales in each country ("formula apportionment").<sup>197</sup> Formula apportionment and, to a lesser extent, unitary taxation are currently used by state governments to allocate jurisdiction to tax the income of corporations that engage in multistate businesses.<sup>198</sup>

This approach has a number of advantages over the arm's length method. It is more consistent with the economic reality that highly integrated multinationals operate as a unit, with each affiliate contributing to the overall profit of the enterprise, rather than as a group of separate entities acting at arm's length.<sup>199</sup> It provides greater certainty for taxpayers by requiring a division of profits rather than a search for arm's length prices and arm's length financial arrangements. It does not interfere with the multinational's transfer pricing or financial decisions, which have important implications for the efficient operation of the enterprise.<sup>200</sup> It also focuses directly on the ultimate question of how to achieve an equitable division of the international corporate income tax base.<sup>201</sup> Ironically, this very feature guarantees that it would be difficult to attain international agreement.

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<sup>197</sup> Although widely used by the states in the United States, a formula based on property, payroll, and sales is difficult to justify and undoubtedly could be improved upon. See William Vickrey, *An Updated Agenda for Progressive Taxation*, 82 AM. ECON. REV. 257, 260-61 (1992) (referring to the three-factor formula as a "simple but arbitrary and capricious formula [that] has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics.").

<sup>198</sup> See Uniform Division of Income for Tax Purposes Act, 7A U.L.A. § 1 (1978). Many states apply formula apportionment only to individual corporations. Some states combine formula apportionment with "unitary" taxation; that is, the state requires a group of corporations under common control and engaging in interdependent operations to file a combined report, and the state then uses formula apportionment to allocate a fraction of the group's consolidated income to the state. A few states apply unitary taxation on a worldwide basis; that is, they require foreign as well as domestic affiliates to be included in the combined report. See generally Charles E. McLure, Jr., *Economic Integration and European Taxation of Corporate Income at Source: Some Lessons from the U.S. Experience*, 29 EUR. TAX'N 243, 245-47 (1989) (describing the use of formula apportionment and unitary taxation in the United States and its relevance for international taxation).

<sup>199</sup> See U.S. GENERAL ACCOUNTING OFFICE, *supra* note 73, at 50-52; Johnny C. Finch, *The Apportionment of Multistate and Multinational Corporate Income for Tax Purposes*, 38 BULL. FOR INT'L FISCAL DOCUMENTATION 51, 56-57 (1984); Note, *supra* note 12, at 1202, 1228.

<sup>200</sup> See Note, *supra* note 12, at 1216-19, 1228.

<sup>201</sup> See Stanley S. Surrey, *Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions*, 10 LAW & POL'Y INT'L BUS. 409, 415 (1978).

The arm's length method is probably superior to the unitary method, however, in the case of multinationals whose affiliates are not highly integrated. The intercompany transactions of such multinationals are likely to have market counterparts. Thus, by comparing the intercompany transactions with similar transactions in the market, the arm's length standard is likely to be relatively easy to administer and would prevent tax-induced affiliations. The states that use the unitary method treat commonly controlled corporations as a "unitary" business only if their activities are sufficiently interdependent.<sup>202</sup> The definition of a unitary business is a continuing source of controversy where unitary taxation is used<sup>203</sup> and would likely be a source of controversy in the international arena as well.<sup>204</sup> International agreement on the definition of a unitary business would be necessary; if one jurisdiction taxes a multinational under the unitary method and another jurisdiction taxes the multinational under the separate-accounting method, the result will likely be under-taxation or over-taxation.<sup>205</sup>

In order to eliminate under-taxation and over-taxation, it would also be necessary to obtain international agreement on the apportionment formula, the methods for valuing the factors in the formula,<sup>206</sup> and the definition of taxable income (the total amount to be apportioned among the jurisdictions).<sup>207</sup> This in turn would require agreement on approaches to currency translation.<sup>208</sup> Since each country would have an incentive to use a formula and valuation methods that emphasize the factors most in abundance in that country, these agreements would be difficult to achieve.<sup>209</sup>

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<sup>202</sup> See Charles E. McLure, Jr., *Defining a Unitary Business: An Economist's View*, in *THE STATE CORPORATION INCOME TAX: ISSUES IN WORLDWIDE UNITARY COMBINATION* 89 (Charles E. McLure, Jr. ed., 1984).

<sup>203</sup> See Finch, *supra* note 199, at 57-58.

<sup>204</sup> See Note, *supra* note 12, at 1229-30.

<sup>205</sup> See McLure, *supra* note 198, at 248.

<sup>206</sup> The valuation problem would be particularly difficult if the apportionment formula were to include intangible assets.

<sup>207</sup> See McLure, *supra* note 198, at 248; Surrey, *supra* note 201, at 416.

<sup>208</sup> Suppose, for example, the U.S. dollar had depreciated relative to foreign currencies during the year. Under U.S. principles, a foreign-based multinational might be considered profitable on a consolidated basis, merely because of the appreciation in value (measured in U.S. dollars) of its overseas assets. The United States would then tax the U.S. affiliate on a portion of this consolidated income. From the home country's perspective, however, the multinational as a whole, and the U.S. affiliate in particular, might appear to have operated at a loss.

<sup>209</sup> See Note, *supra* note 12, at 1230-31. This phenomenon can be observed at the state level in the United States. Although the states generally use a three-factor formula based on property, payroll, and sales, they do not use exactly the same formula or definitions of the factors. States that are predominantly market states rather than producing states tend to give extra weight to the sales factor. See Shaviro, *supra* note 147, at 918; McLure, *supra* note 198, at 247 (noting substantial nonuniformity in state corporate income tax systems, including methods of apportionment); Finch, *supra* note 199, at 58 (same).

Under formula apportionment, multinationals would have an incentive to shift formula factors, such as property or employees, to low-tax countries.<sup>210</sup> This would cause economic distortions and give rise to tax competition by countries seeking to attract those factors. The tax competition would likely be more limited than under the arm's length approach, however, because multinationals would have to alter their real business operations in order to minimize taxes.

The unitary method would also present significant compliance and enforcement problems.<sup>211</sup> Multinationals would have to provide information about their worldwide operations to every country to which they potentially owed taxes. Unless there were international agreement on the definition of net income, multinationals would have to translate the books and accounts of every affiliate to conform with the tax accounting standards of every country to which they reported.<sup>212</sup> Each country would have to audit the multinational's worldwide operations, including transactions that had no connection to the country. One ameliorating factor, however, is that the information required to implement unitary taxation might be more objectively verifiable than the often hypothetical arm's length prices required to implement the arm's length method.

The success of unitary taxation and formula apportionment at the state level in the United States (and in other countries with federal systems) does not demonstrate that it would be successful at the international level. State corporate income tax rates are generally much lower than national corporate income tax rates, particularly when the federal income tax deductibility of state corporate income taxes is taken into account.<sup>213</sup> Because of the lower rates, formula apportionment is less distortionary in the federal system than it would be in the international system. Furthermore, formula apportionment in the United States is facilitated by the existence of a single currency and by the convergence of state corporate income tax bases, which are often based on the federal income tax model. Finally, the compliance and enforcement problems are much easier to solve at the interstate level than at the international level.

The case for the unitary method and formula apportionment will become stronger as international business operations become increasingly integrated across national boundaries. Given the drawbacks of the unitary method, however, it is not clear that international business

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<sup>210</sup> See Roger Gordon & John D. Wilson, *An Examination of Multijurisdictional Corporate Income Taxation Under Formula Apportionment*, 54 *ECONOMETRICA* 1357 (1986).

<sup>211</sup> See Finch, *supra* note 199, at 58; Note, *supra* note 12, at 1230.

<sup>212</sup> See Finch, *supra* note 199, at 58.

<sup>213</sup> I.R.C. § 164(a)(3) (West 1993); see McLure, *supra* note 198, at 247-48.

integration has reached the point where this method would be clearly superior to the arm's length method.<sup>214</sup>

## B. Residence-Based Taxation of Corporate Income

Source-based income taxation is difficult to justify on theoretical grounds.<sup>215</sup> In particular, source-based taxation is difficult to reconcile with the prevailing theory of the income tax as a means of allocating the cost of government among individuals on the basis of ability to pay.<sup>216</sup> Moreover, it is the attempt by governments to tax income on the basis of source that gives rise to income shifting and to tax competition among governments. The ultimate solution to these problems would be to move to an international tax system that uses the residence of individuals as the exclusive basis for income tax jurisdiction.

A pure residence-based system of income taxation would require that corporate income be allocated to individual shareholders on a passthrough basis.<sup>217</sup> The shareholders would include their allocable share of corporate income on their personal income tax returns and pay tax on their total income to their country of residence.<sup>218</sup> To avoid double taxation by the residence country, the shareholders would increase their stock basis by the amount of corporate income allocated to them. Shareholders would then treat actual corporate distributions as a return of capital to the extent of their stock basis, and would treat any excess as capital gain. Withholding taxes on dividends, interest, royalties, and other transnational financial flows would be eliminated.

The approach described above would replace the classical corporate income tax system with a pure passthrough integration system, similar to the current U.S. system for taxing shareholders of sub-

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<sup>214</sup> Certain businesses, such as global securities trading, might be exceptions. See Charles T. Plambeck, *The Taxation Implications of Global Trading*, 48 TAX NOTES 1143 (1990).

<sup>215</sup> See *supra* text accompanying notes 39-54.

<sup>216</sup> See *supra* text accompanying notes 39-42.

<sup>217</sup> It would be possible to devise a residence-based system at the corporate level by obtaining international agreement on the definition of corporate "residence" and giving the residence country exclusive jurisdiction to impose the corporate income tax. It would be difficult to justify such an allocation of jurisdiction on theoretical grounds, however, except insofar as the residence of a corporation was a good proxy for the residence of its individual shareholders. Moreover, if corporations had flexibility to choose their country of residence, as would likely be the case, the result would be tax competition among countries to induce corporations to become residents. The end result might be the effective elimination of corporate income taxation, at least for multinational enterprises.

<sup>218</sup> To prevent double taxation, it would be necessary to reach international agreement on the definition of "residence." The United States might have to yield the right to tax its nonresident citizens to the countries in which they reside. See I.R.C. § 7701(a)(30)(A) (West 1993) (defining a U.S. citizen as a "United States person," subject to U.S. taxation under the residence principle).

chapter S corporations.<sup>219</sup> However, any country that wished to retain a system under which corporate income was taxed twice could do so by imposing a separate "corporate income" tax on its resident individual shareholders with respect to the corporate income allocated to them.<sup>220</sup> Individual countries would be free to set individual income tax rates (and, if applicable, residence-based corporate income tax rates) at any level they desired.

This system could be implemented by having each corporation calculate its taxable income based on its separate accounts, as is done under current law.<sup>221</sup> The corporation would then allocate this income among its shareholders, both individual and corporate. This process would continue through any chains of corporate ownership until all corporate income was allocated to individual shareholders.

Under this approach, the taxable income of each separate corporate affiliate of a multinational enterprise would still depend on transfer prices and on the multinational's global financial structure. However, as long as all of the corporate affiliates of the multinational were under the same ultimate individual ownership, the total amount of corporate taxable income passed through to each individual shareholder would not be affected by income shifting within the multinational. Because all taxes would be paid by individuals exclusively to their country of residence, income shifting under these circumstances would have no effect on the tax liability of any taxpayer or on the tax revenues of any country. If the corporate affiliates of the multinational were not under identical ownership, however, transfer pricing and financial manipulation could affect tax liabilities and revenues. In that case, the existence of adverse interests among the individual shareholders would likely be sufficient to deter income shifting.

Under a residence-based system of corporate income taxation, corporate income would be taxed identically by the individual shareholders' countries of residence, regardless of where the corporation invested its capital and earned its taxable income. International tax

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<sup>219</sup> 1.R.C. §§ 1361-1379 (West 1993) (subchapter S); see *supra* note 33 (discussing integration). The Treasury proposed such a system of integration in 1977, see BLUEPRINTS FOR BASIC TAX REFORM, *supra* note 42, at 68-75, but rejected this approach to integration in 1992 for policy reasons and because of the administrative complexity it would entail. See TREASURY INTEGRATION REPORT, *supra* note 33, ch. 3. Canada and the Federal Republic of Germany also considered, but did not adopt, a passthrough approach to integration. See *id.* at 27 n.4.

<sup>220</sup> Relative to current law, this approach would increase the degree of double taxation of corporate income, since shareholder-level taxation of undistributed corporate income would no longer be deferred. In addition, this approach to implementing a separate tax on corporate income might be unattractive from a political perspective. The political popularity of the classical corporate income tax is arguably the result of a fiscal illusion, in particular "to the tendency of all of the parties concerned to believe strongly that it is paid by someone other than themselves." Vickrey, *supra* note 197, at 259.

<sup>221</sup> See *supra* text accompanying note 34.

competition would be eliminated, except in the form of competition among countries to be the place of residence of individual shareholders. Because individuals do not readily move between countries in response to tax differentials, it is not likely that this form of tax competition would be very significant.<sup>222</sup>

Residence-based taxation does present several potential problems. First, if each country continued to maintain its own definition of the corporate income tax base, corporations would have to calculate their taxable income under the rules of each country in which any of their ultimate individual shareholders resided. Second, enforcement would be difficult, because each country would have to monitor the worldwide operations of every multinational enterprise in which any of its residents were shareholders. Third, shareholders might have cash-flow problems, because they would have to pay tax on the corporate income allocated to them regardless of whether the corporations actually distributed the income.

Thus, as a practical matter, the approach outlined above would probably be feasible only if governments were to agree on a uniform definition of the corporate income tax base. Corporations would then be required to make only a single calculation of their taxable income. Governments, however, would have to give up sovereignty to define their own corporate income tax bases. As a consequence, they would have to forgo using national tax policy as a means of controlling corporate behavior.

The shareholder cash-flow problem and the enforcement problem could be alleviated by imposing a corporate-level income tax purely as a withholding mechanism. Because this corporate-level tax would not affect ultimate tax liabilities, it might be relatively easy to obtain international agreement on the assignment of jurisdiction to impose the tax. It would be logical to assign corporate-level tax jurisdiction on the basis of ability to enforce the tax. This would likely mean assigning such jurisdiction exclusively on the basis of the source of income.

Under this system, each corporation would allocate to shareholders not only its corporate income, but also tax credits for the amounts of corporate-level tax that it paid to each country in which it earned income.<sup>223</sup> The tax credits would be refundable by the countries whose tax gave rise to the credits.<sup>224</sup> This use of a corporate-level tax

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<sup>222</sup> See *supra* note 170 and accompanying text.

<sup>223</sup> The shareholders would then increase their stock basis by the difference between their share of before-tax corporate income and their share of corporate-level tax credits.

<sup>224</sup> In practice, a clearing-house system could be devised. Under such a system, the residence country might permit an individual resident shareholder to use the allocated tax credits against the shareholder's residence-based corporate income tax liability (if the country imposed such a tax) or against the shareholder's residence-based personal income



as a withholding mechanism would directly ameliorate the shareholder cash-flow problem. It would also alleviate the enforcement problem, at least insofar as the source countries conscientiously enforced the corporate-level tax.<sup>225</sup>

Such a system would entail, however, all of the administrative difficulties inherent in a system of passthrough integration. To be successful, the system would have to address the problems of how to allocate corporate income among shareholders,<sup>226</sup> how to treat corporate losses,<sup>227</sup> how to deal with changes in stock ownership during the reporting period,<sup>228</sup> and how to solve various reporting and auditing issues.<sup>229</sup>

This type of residence-based system would require a high degree of international agreement and coordination. The system would provide some benefit, however, even if it were not universally adopted. Multinationals based in non-participating countries would continue to be taxed under the current international tax system. With respect to multinationals based in participating countries, intercompany transactions and financial flows involving subsidiaries located in non-participating countries would also continue to be taxed under the current international tax system.

A substantial obstacle to moving to a residence-based system would be that it would alter the international division of the tax base in favor of countries that are net exporters of capital ("residence" countries) and to the detriment of countries that are net importers of capital ("source" countries). However, many countries that are net

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tax liability. If the amount of the shareholder's tax credits exceeded those liabilities, the residence country would refund the excess amount to the shareholder. The residence country would then obtain reimbursement from the source countries that collected the taxes that the residence country credited or reimbursed. For a description of such a system, see Alberto Giovannini & James R. Hines, Jr., *Capital Flight and Tax Competition: Are There Viable Solutions to Both Problems?*, in *EUROPEAN FINANCIAL INTEGRATION* 172 (Alberto Giovannini & Colin Mayer eds., 1991). See also Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 *LAW & POL'Y INT'L BUS.* 461, 484-85, 493 (1978) (discussing proposed EEC clearing-house system for imputation credits).

A clearing-house system of this type is currently specified for imputation credits in the income tax treaty between France and Germany. Germany has an imputation credit system that grants German shareholders in French corporations imputation credits for French corporate income taxes. Under the treaty, the French government reimburses the German government for the cost of the credits (reduced by a withholding tax). See Ault, *supra* note 69, at 548.

<sup>225</sup> Conscientious enforcement would not be assured. A source country would have no incentive (short of reciprocity) to expend resources enforcing the corporate-level tax against a multinational whose shareholders all resided in other countries. On the contrary, a source country might have an incentive to facilitate tax evasion in an attempt to attract investment.

<sup>226</sup> See *TREASURY INTEGRATION REPORT*, *supra* note 33, at 32-33.

<sup>227</sup> See *TREASURY INTEGRATION REPORT*, *supra* note 33, at 30.

<sup>228</sup> See *TREASURY INTEGRATION REPORT*, *supra* note 33, at 33-35.

<sup>229</sup> See *TREASURY INTEGRATION REPORT*, *supra* note 33, at 35.

importers nevertheless export large amounts of capital—they merely import even more than they export. Such countries would have sufficiently strong residence-country interests that they might support an effective and efficient residence-based tax system. By contrast, countries that are not significant exporters of capital, particularly developing countries, would likely lose tax revenue under an international system of residence-based corporate income taxation. Note, however, that participation in the system of residence-based corporate income taxation would not preclude source countries, including developing countries, from imposing benefits taxes or taxes on location-specific rents, such as those based on the extraction of natural resources. These source-based taxes would not, however, be creditable in the residence country.

### C. Interim Approaches

The long-term approaches discussed above would require international agreement on a new approach in principle as well as on the details of its implementation. These approaches also would require countries to make significant changes in their domestic corporate income tax systems, including, at least as a practical matter, a move to an internationally accepted definition of the corporate income tax base. There is little likelihood that one of the approaches described above will achieve widespread acceptance in the near term. Realistically, therefore, the United States must continue to search for solutions that it can implement either unilaterally or bilaterally on a reciprocal basis.

#### 1. *Taxation of U.S.-based Multinationals on a Consolidated Basis*

When the United States taxes a U.S.-based multinational, it is in principle asserting residence-based jurisdiction, at least to the extent that the ultimate individual shareholders of the multinational are U.S. residents. Under the current international tax norms, however, the United States must yield primary tax jurisdiction to source countries. The United States accomplishes this through the foreign tax credit mechanism. Through this mechanism, the United States actually yields more jurisdiction than is necessary to prevent international double taxation. Because of deferral, the residual U.S. tax on the income of a U.S. parent corporation's foreign subsidiary is generally postponed until the income is repatriated.<sup>230</sup> If the parent corporation postpones repatriation indefinitely, the deferral becomes the equivalent of an exemption. Moreover, because of cross-crediting, a parent corporation that is in an excess credit position will see its for-

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<sup>230</sup> See *supra* notes 23-24 and accompanying text.

foreign income effectively exempt from residual U.S. taxation even if repatriated currently, at least at the margin.<sup>231</sup> Thus, because of deferral and cross-crediting, the taxation of U.S.-based multinationals can be equivalent to pure source-based taxation. By eliminating deferral and cross-crediting, the United States could shift the taxation of U.S.-based multinationals towards a residence-based system.

The elimination of deferral has been a recurring proposal of international tax reform in the United States.<sup>232</sup> The debate over deferral generally has focused on the consequences of deferral for foreign investment, domestic investment, domestic employment, the U.S. trade balance, economic growth, the distribution of income, the competitiveness of U.S. corporations overseas, and the welfare of developing countries.<sup>233</sup> This Article does not revisit these issues, but rather focuses on the possibility that the elimination of deferral could move the tax system in the direction of all three of the long-term approaches discussed earlier.<sup>234</sup>

The United States could take either of two approaches to the elimination of deferral. The first would be to extend the existing regime of subpart F of the Code.<sup>235</sup> Under this regime, a "United States shareholder" of a "controlled foreign corporation" ("CFC") is taxed as if the corporation had distributed a pro rata portion of its "subpart F

<sup>231</sup> See *supra* text accompanying note 67.

<sup>232</sup> In 1961 the Kennedy Administration proposed eliminating deferral for all foreign corporations controlled by U.S. persons, with an exception for certain corporations organized in developing countries. See MESSAGE FROM THE PRESIDENT OF THE UNITED STATES RELATIVE TO OUR FEDERAL TAX SYSTEM, H.R. DOC. NO. 140, 87th Cong., 1st Sess. 6-7, 51-56 (1961). Congress scaled down the proposal in enacting the subpart F provisions of the Code in 1962. Revenue Act of 1962, Pub. L. No. 87-834, §§ 951-964, 76 Stat. 960, 1006-27 (1962). Subsequent amendments to subpart F, particularly those in 1986, have substantially broadened the scope of the subpart F rules.

The Foreign Trade and Investment Act of 1973, H.R. 62, 93d Cong., 1st Sess. (1973) (the "Burke-Hartke Bill"), would have eliminated deferral completely. Although this bill received strong support in Congress, ultimately it was not enacted as law.

In 1978 the Carter Administration proposed the complete elimination of deferral. See U.S. DEP'T OF THE TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM: DETAILED DESCRIPTIONS AND SUPPORTING ANALYSES OF THE PROPOSALS 282-97 (1978) [hereinafter THE PRESIDENT'S 1978 TAX PROGRAM].

In 1992 Representatives Rostenkowski and Gradison introduced a bill that included a proposal to eliminate deferral. Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess. §§ 201-202 (1992).

<sup>233</sup> See, e.g., William W. Park, *Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits*, 78 COLUM. L. REV. 1609 (1978); THE PRESIDENT'S 1978 TAX PROGRAM, *supra* note 232, at 282-97; Thomas E. Jenks, *Taxation of Foreign Income*, 42 GEO. WASH. L. REV. 537 (1974); Lawrence M. Stone, *United States Tax Policy Toward Foreign Earnings of Multinational Corporations*, 42 GEO. WASH. L. REV. 557 (1974).

<sup>234</sup> See *supra* Part V.A-B.

<sup>235</sup> I.R.C. §§ 951-964 (West Supp. 1993), as amended by Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13231-13233, 13235, 13239; see Kaplan, *supra* note 102, at 326 (suggesting expansion of the scope of the subpart F regime as a means of combatting transfer price manipulation).

income" to the U.S. shareholder as a dividend each year.<sup>236</sup> For this purpose, a "United States shareholder" is any U.S. person who owns, directly or indirectly, at least 10 percent of the voting rights of a foreign corporation's stock.<sup>237</sup> A foreign corporation is a "CFC" if "United States shareholders" as a group own, directly or indirectly, more than 50 percent, in terms of either voting rights or value, of the corporation's stock.<sup>238</sup>

As originally proposed in 1961,<sup>239</sup> the subpart F rules would have taxed U.S. shareholders as if the CFC had distributed a pro rata portion of *all* of its earnings each year.<sup>240</sup> When Congress enacted the subpart F rules in 1962, however, it narrowed their scope to eliminate deferral only with respect to certain types of mobile income that is shifted to tax haven countries.<sup>241</sup> For example, a multinational can shift sales income to a tax haven by establishing a subsidiary in the tax haven to serve as a conduit for the sales. The multinational can maximize the extent of this shifting by charging the subsidiary artificially low transfer prices. Thus, "subpart F income" includes sales income, as well as services income, earned by such conduit subsidiaries.<sup>242</sup>

Expansion of the subpart F regime to cover all CFC income would reduce, but not eliminate, the incentive for transfer pricing and financial maneuvering. A multinational would still be able to minimize U.S. and global taxes by shifting income from U.S. or foreign

<sup>236</sup> More precisely, each U.S. shareholder of a CFC must include in income its pro rata share of the sum of the CFC's subpart F income for the year, plus amounts relating to the CFC's investment of earnings in U.S. property or in excess passive assets, plus amounts relating to previously excluded subpart F income. I.R.C. § 951(a)(1) (West Supp. 1993), *as amended by* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13231(a), 13232(c)(1), (2). The subpart F income of a CFC for any taxable year is limited to the CFC's earnings and profits for the taxable year. § 952(c)(1) (West Supp. 1993).

<sup>237</sup> I.R.C. § 951(b) (West Supp. 1993).

<sup>238</sup> I.R.C. § 957(a) (West 1988). Various constructive ownership and stock attribution rules apply to prevent avoidance. *See* I.R.C. § 958(a), (b) (West 1988). These ownership thresholds provide some assurance that the affected U.S. shareholders will be able to control the CFC. Without such control, shareholders might not be able to obtain the information needed to comply with subpart F or to obtain actual dividend payments, which might be needed to pay the tax liability.

<sup>239</sup> *See* MESSAGE FROM THE PRESIDENT OF THE UNITED STATES RELATIVE TO OUR FEDERAL TAX SYSTEM, *supra* note 232, at 6-7, 51-56.

<sup>240</sup> MESSAGE FROM THE PRESIDENT OF THE UNITED STATES RELATIVE TO OUR FEDERAL TAX SYSTEM, *supra* note 232, at 7, 51-54.

<sup>241</sup> This legislation represented a compromise between the Administration and certain business interests. These interests argued that complete elimination of deferral would place U.S. corporations operating in low-tax countries at a tax disadvantage relative to local corporations and corporations from countries that permitted exemption or deferral of income earned by foreign subsidiaries. *See* HOUSE COMM. ON WAYS & MEANS, 90TH CONG., 1ST SESS., LEGISLATIVE HISTORY OF H.R. 10650, 87TH CONGRESS, THE REVENUE ACT OF 1962, PUBLIC LAW 87-834, at 464 (1967) (testimony of business representatives).

<sup>242</sup> I.R.C. § 952(a)(2),(d) (West Supp. 1993). *See generally id.* § 952 (definition of "subpart F income").

affiliates reporting a profit to foreign affiliates reporting a loss, since losses do not flow through to U.S. shareholders under subpart F.

An alternative approach to eliminating deferral would be to require U.S. shareholders of a CFC to include currently in income their pro rata share of the CFC's gross income and deductions, as if they had earned such gross income and incurred such deductions directly.<sup>243</sup> Thus, losses as well as profits of a CFC would flow through to the U.S. shareholders. Similarly, the foreign taxes imposed on the CFC would be treated as if they had been imposed on the U.S. shareholder directly. The resulting U.S. tax liability of the U.S. shareholder would closely approximate the amount that it would have incurred if it had established the CFC as a foreign branch rather than as a foreign corporation.<sup>244</sup>

From the standpoint of neutralizing transfer pricing and financial maneuvering, this approach would be preferable to the subpart F approach. Transfer pricing would no longer have any effect on the calculation of a U.S.-based multinational's worldwide taxable income.<sup>245</sup> If such a multinational were in an excess credit position, however, it might still have an incentive to use transfer pricing to shift income to foreign affiliates in low-tax countries, if by doing so it could increase the amount of its reported foreign source income and thus increase the amount of its foreign tax credit limitation.<sup>246</sup> This residual incen-

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<sup>243</sup> This is the approach that the Carter Administration proposed in 1978. See THE PRESIDENT'S 1978 TAX PROGRAM, *supra* note 232, at 292-97.

<sup>244</sup> To prevent double U.S. taxation of the income earned by a CFC, a U.S. shareholder's basis in the stock of a CFC would be increased or decreased as the shareholder recognized gross income and deductions of the CFC. Actual distributions from the CFC would reduce the shareholder's stock basis and, if in excess of basis, would be treated as capital gain.

<sup>245</sup> Transfer pricing would, however, have an effect on the calculation of the multinational's foreign tax liability. A U.S.-based multinational in an excess credit position might have an incentive to use transfer pricing to shift income to the U.S. parent corporation in order to reduce foreign corporate income taxes. The multinational might also have an incentive to use transfer pricing to reduce foreign withholding taxes. Thus, continued enforcement of foreign transfer pricing rules against U.S.-based multinationals would be required.

<sup>246</sup> For example, suppose that *P* manufactures property in the United States and sells it to its foreign subsidiary *S* (which might be incorporated in a tax haven) for distribution in foreign countries. Under the current source-of-income rules, *P*'s gross income from the sales to *S* will be part U.S. source income and part foreign source income. I.R.C. § 863(b)(2) (West Supp. 1993). If *P* is in an excess credit position and the United States has a sufficiently higher corporate income tax rate than the country in which *S* is incorporated, the multinational will reduce its global tax liability by decreasing the transfer price and thus shifting income to *S*. This will be the case even without deferral, because the shifted income will be characterized entirely as foreign source gross income rather than partly as U.S. source gross income.

This analysis assumes that the source-of-income rules would continue to be applied on a corporation-by-corporation basis, using separate accounting and the arm's length standard. Alternatively, the source-of-income rules could be applied by ignoring intercompany transactions and characterizing only transactions with third parties. Transfer pricing

tive to shift income would be substantially reduced if the United States were to change from a worldwide foreign tax credit limitation to a per-country foreign tax credit limitation.<sup>247</sup> This change would eliminate the ability of a U.S.-based multinational to cross-credit foreign taxes paid to a high-tax country against the residual U.S. tax otherwise due on income earned in a low-tax country.

Similarly, the placement of debt would no longer have any effect on the calculation of a U.S.-based multinational's worldwide taxable income. Interest expense would be currently deductible whether incurred by a domestic or foreign affiliate. Moreover, if the multinational's worldwide interest expense were allocated and apportioned between U.S. source and foreign source gross income on the basis of the multinational's worldwide assets,<sup>248</sup> the placement of debt would no longer have any effect on the calculation of the multinational's foreign tax credit limitation. A U.S.-based multinational would then have no tax incentive to engage in financial maneuvering except, if it were in an excess credit position, to move debt to foreign affiliates in order to reduce foreign taxes.<sup>249</sup>

As a mechanical matter, this latter approach to eliminating deferral could be implemented by mandating the extension of existing consolidated return rules to foreign subsidiaries of U.S. corporations.<sup>250</sup>

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would then cease to have any effect on the foreign tax credit limitation. However, this latter approach would likely result in international under-taxation or over-taxation because the calculation of foreign source income for U.S. foreign tax credit purposes would be based on a completely different method from the calculation of foreign taxable income for foreign tax purposes, which presumably would continue to be based on separate accounting and the arm's length standard.

<sup>247</sup> The Treasury recommended such a change in 1984. See U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 360-63 (1984). Under the Treasury's proposal, losses in one foreign country would be allocated to the profits in other foreign countries when computing the applicable foreign tax credit limitations.

<sup>248</sup> The Foreign Income Tax Rationalization and Simplification Act of 1992 included a proposal to revise the interest expense allocation rules along these lines. H.R. 5270, 102d Cong., 2d Sess., § 101 (1992). This proposal would be a logical concomitant to the elimination of deferral, particularly if accomplished by treating U.S.-based multinationals as consolidated entities. As an administrative matter, however, it might be difficult for the IRS to audit the allocation of interest expense on the basis of worldwide assets.

<sup>249</sup> Thus, foreign countries would continue to be concerned about the thin capitalization of local subsidiaries of U.S.-based multinationals.

<sup>250</sup> See *supra* note 23 (briefly discussing consolidated return rules); see also William C. Gifford, Jr., *United States Tax Effects of Foreign Losses: A Symmetry Analysis*, 83 YALE L.J. 312, 354-56 (1973). Cf. Foreign Income Tax Rationalization and Simplification Bill of 1992, H.R. 5270, 102d Cong., 2d Sess. § 202 (1992) (permitting a U.S. shareholder to make an irrevocable election to treat all of its CFCs as domestic corporations; if this election were made, 80 percent-owned CFCs would be eligible for tax consolidation); STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 1ST SESS., PROPOSAL RELATING TO CURRENT U.S. TAXATION OF CERTAIN OPERATIONS OF CONTROLLED FOREIGN CORPORATIONS (H.R. 2998—AMERICAN JOBS AND MANUFACTURING PRESERVATION ACT OF 1991) AND RELATED ISSUES 52-56 (Comm. Print 1991) (discussing proposal to permit elective treatment of U.S.-controlled foreign corporations as domestic).

This would eliminate deferral for foreign subsidiaries that are at least eighty percent owned by a U.S.-based multinational. It would not eliminate deferral for less-than-eighty-percent owned subsidiaries or for foreign corporations owned by individuals. From the standpoint of neutralizing transfer pricing and financial maneuvering, however, this coverage would likely be sufficient. The existence of substantial minority ownership alone would deter manipulative income shifting. Furthermore, significant international transfer pricing issues seldom arise with respect to transactions between individual shareholders and their corporations.

There is no reason, however, why international consolidation rules could not be more inclusive than either domestic consolidated return rules or subpart F rules. For example, it might be appropriate to use the same cutoff in requiring consolidation that is currently used for allowing an indirect foreign tax credit.<sup>251</sup> Under this approach, a U.S. corporation owning ten percent or more of the stock of a foreign corporation would currently take into account its pro rata share of the foreign corporation's income and deductions, and could claim a foreign tax credit for foreign taxes paid on those earnings.

The elimination of deferral by the United States would be a direct, if unilateral, step in the direction of an international tax system based on the unitary principle. In addition, the elimination of deferral would move the U.S. tax system toward residence-based taxation.<sup>252</sup> Finally, to the extent that other countries attempt to design their tax systems to take maximum advantage of features of the U.S. tax system, elimination of deferral and cross-crediting would be likely to enhance the international convergence of corporate income tax rates and bases.<sup>253</sup> The convergence would further harmonize the international tax system,<sup>254</sup> with countries acting unilaterally in their national self-interest rather than from concerted action. One significant drawback to such a mechanism for achieving harmonization is that the tax rate and base would effectively be determined by the dominant capital-exporting country or countries that use worldwide systems of taxation. Even assuming that those countries were to choose a

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<sup>251</sup> See Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227, 293 (1984).

<sup>252</sup> See *supra* Part V.B.

<sup>253</sup> See *supra* text accompanying notes 173-74. Deferral and cross-crediting give host countries an incentive to lower their corporate income tax rate below the U.S. rate. In addition, cross-crediting tends to insulate host countries with relatively high corporate income tax rates from pressure to lower their rates. This insulation can occur because U.S.-based multinationals might be able to cross-credit taxes paid to such countries against their residual U.S. tax liability otherwise due on income earned in low-tax countries. In this case, the high taxes are ultimately borne by the U.S. Treasury rather than by the multinationals.

<sup>254</sup> See *supra* Part V.A.1.

rate and base that was optimal from their national perspective, there is no assurance that it would be optimal from a global perspective.

## 2. *Taxation of Foreign-based Multinationals Using an Imputed Income Approach*

When the United States taxes the U.S. subsidiary of a foreign-based multinational, it nominally asserts residence-based jurisdiction under the rule that a U.S. corporation is a "United States person."<sup>255</sup> In principle, however, assuming that the ultimate individual shareholders of the foreign-based multinational are foreign residents, the United States is asserting source-based jurisdiction.

Notwithstanding the arguments favoring international agreement on a residence-based system of corporate income taxation, the United States should not unilaterally forgo source-based taxation. If there were international agreement on a residence-based system, the United States would increase the tax revenue it collects from residents, because it would no longer yield to other countries the primary right to tax such persons on their foreign source income. If, by contrast, the United States were unilaterally to relinquish source-based taxation, it would lose the revenue it now collects from foreign persons without increasing the revenue it collects from residents. In many cases, the revenue the United States now collects from foreign persons ultimately comes from foreign governments, insofar as those governments grant their residents foreign tax credits for their payments of U.S. tax. Under these circumstances, source-based taxation is an efficient source of revenue for the United States. In addition, if the United States unilaterally relinquished source-based taxation, it might become a tax haven for direct foreign investment. This would occur if foreign countries continued to employ territorial or worldwide systems that allow either deferral or cross-crediting. The result would be to distort the international allocation of capital.

The conclusion that the United States should not unilaterally forgo source-based taxation does not necessarily mean that the United States should continue to tax U.S. subsidiaries of foreign-based multinationals by allocating income to them in accordance with the arm's length standard. The justifications for an arm's length standard are particularly weak if the multinational's home country has a corporate income tax rate that is approximately equal to the U.S. rate, and the multinational does not channel its intercompany transactions through tax haven countries. The arm's length standard is neither internationally accepted nor satisfactorily precise except in very limited circumstances. Therefore, the goal of eliminating under-taxation or over-

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<sup>255</sup> I.R.C. § 7701(a)(4), (30)(C) (West Supp. 1993).



taxation could be more surely accomplished if the home country and the United States were to agree on a more precisely defined and determinate method for allocating income to the U.S. subsidiary. Although the arm's length standard serves to neutralize the tax incentive for firms to affiliate, this incentive is not significant if the home country and the United States have similar corporate income tax rates.

A different neutrality argument sometimes advanced is that a foreign-controlled U.S. subsidiary should be required to pay the same amount of U.S. corporate income tax as a comparable domestically-controlled U.S. corporation in order to prevent the former from enjoying a competitive advantage.<sup>256</sup> This argument ignores the taxes imposed on the foreign parent corporation. As long as the tax rates in the home country and the United States are comparable, a foreign-based multinational will not obtain any global tax advantage by shifting income from a U.S. subsidiary to the parent corporation in the home country.

Conversely, even if a foreign-controlled U.S. subsidiary and a comparable domestically-controlled U.S. corporation pay the same amount of U.S. corporate income tax, there is no assurance that the global corporate-level tax burdens on the income attributable to the two U.S. operations will be equal. First, if the home country does not agree with the United States' allocation of income to the U.S. subsidiary, some of the consolidated income that the United States taxes as income of the subsidiary might be taxed again by the home country as income of the parent corporation. Second, in addition to the corporate income tax that the United States imposes on the foreign-controlled U.S. subsidiary, the United States also imposes withholding taxes on the dividends, interest, royalties, and similar payments that the subsidiary makes to the parent corporation. The United States does not impose such taxes on intercompany payments that a domestically-controlled U.S. corporation makes to its parent corporation. Finally, unless the home country employs a territorial system of international taxation, it will impose its own corporate income tax

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<sup>256</sup> See, e.g., 1990 Hearings, *supra* note 5, at 30 (statement of Rep. Schultz). This principle is also sometimes advocated on grounds of fairness. *Id.* It makes no sense, however, to talk of fairness to corporations. Looking through to the individual shareholders, it is not clear why fairness requires that nonresidents and residents earning the same amount of U.S. source income should bear the same U.S. tax burden: As discussed above, the justifications for source-based income taxation and residence-based income taxation are not the same. See *supra* text accompanying notes 39-42. Moreover, even with respect to residents, an international view of horizontal equity would require only that taxpayers with equal incomes pay equal amounts of global taxes, not necessarily that they pay equal amounts of taxes to the United States. Such an international view of horizontal equity underlies the U.S. foreign tax credit mechanism, which attempts to equalize the global (not U.S.) income taxes paid by U.S. persons who earn equal amounts of worldwide income.

(usually subject to a foreign tax credit) on the earnings of the U.S. subsidiary when they are repatriated to the foreign parent corporation as a dividend, as well as on other payments that the U.S. subsidiary makes to the parent corporation. Ultimately, therefore, the global tax burden imposed on the earnings of the U.S. subsidiary of a foreign-based multinational is determined not by the United States, but by the home country.

This analysis indicates that the United States should focus primarily on two goals in devising a system for taxing U.S. subsidiaries of foreign-based multinationals: bilateral agreement on the method of allocating income and determinacy of the results. These goals place no constraint on the substance of the allocation rule. As a practical matter, however, the choice will be constrained by revenue neutrality, in that it is unlikely that either country will accept a rule that it expects to result in a loss of revenue. The requirement of revenue neutrality will generally mean that the United States must continue to impose its corporate income tax on a measure of the U.S. subsidiary's taxable income that closely approximates the *expected* arm's length amount of taxable income for that subsidiary.<sup>257</sup>

Nevertheless, it is possible that methods based on formula imputation of income to the U.S. subsidiary could be devised that would satisfy this requirement. For example, income could be imputed to the U.S. subsidiary based on an annually published rate of return on assets or gross sales. This rate could be chosen to reflect the profitability of domestically-controlled U.S. firms in the relevant industry.<sup>258</sup> Any residual consolidated income would then be attributed to the par-

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<sup>257</sup> In the special case of the United States and a foreign country where the earnings from cross-border direct investment in both directions are equal, revenue neutrality would be satisfied by any allocation rule that is applied on a reciprocal basis. This special case will rarely, if ever, occur. Generally, one of the countries will be a net capital exporter relative to the other.

<sup>258</sup> For a proposed new minimum corporate income tax based on such an approach, see James E. Wheeler & Richard P. Weber, *A New Minimum Tax as a Solution to Inbound and Outbound Section 482 Problems, the Complexity of the Current, and the Need for More Tax Revenues*, 49 TAX NOTES 793 (1990). The Wheeler-Weber proposal would not eliminate § 482 problems: The minimum tax would be a backstop for the regular corporate income tax, not a replacement, and liability under the regular corporate income tax would continue to depend on transfer prices.

For a legislative proposal to tax certain foreign corporations and foreign-controlled U.S. corporations using such an approach, see Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess. § 304 (1992). Because this legislation would impose the approach unilaterally, it would likely violate the provisions of the United States' bilateral income tax treaties requiring the use of the arm's length standard and prohibiting discrimination against foreign-controlled taxpayers. See Statement of Fred T. Goldberg, Jr., *supra* note 11, at \*22-\*23.

ent corporation (or, more generally, to the other affiliates of the multinational).<sup>259</sup>

This methodology would likely result in the imputation of a relatively constant amount of income to the U.S. subsidiary of a foreign-based multinational. This would be true even in years in which the subsidiary operated at a loss on a separate-accounting basis, and even in years in which the multinational as a whole operated at a loss.<sup>260</sup> Most of the fluctuations in consolidated income would be attributed to the parent corporation. The home country nevertheless might agree in advance to such a system of taxation, as long as it concluded that its expected tax revenue under the imputed income approach would approximately equal its expected tax revenue under an approach based on separate accounting and the arm's length standard. It might be appropriate for the United States to use a relatively low rate of return for the purpose of imputing income to the U.S. subsidiary, however, since the home country would bear most of the risk of fluctuations in tax revenues.<sup>261</sup>

An imputed income approach would represent a move in the direction of unitary taxation and formula apportionment, in the sense that a portion of the multinational's consolidated income would be

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<sup>259</sup> If the two countries agreed on a method of taxation based on imputing income to the U.S. subsidiary, it would be necessary to determine the amount of income properly reportable by the foreign parent corporation to the home country. In practice, this could be accomplished, as under the proposed regulations, by working backward from imputed income to a set of transfer prices. The home country would then use these transfer prices to determine the parent corporation's taxable income. Note, however, that in working backward it is possible to determine only an aggregate transfer price, not individual transfer prices. This limitation would be a problem if, for example, the parent corporation transferred both tangible and intangible property to the U.S. subsidiary. Since the United States imposes a withholding tax on royalties but not on payments for tangible property, it would make a difference how the aggregate transfer price was allocated between royalties for the intangible property and the transfer price for the tangible property.

<sup>260</sup> This system might be unduly harsh to the multinational if it operated at a consolidated loss for a year, obtained no home country tax refund based on the loss, and yet had taxable income imputed to the U.S. subsidiary and taxed by the United States. Start-up ventures would be particularly likely to face this situation. It might be desirable to have an exception under which the U.S. subsidiary would be relieved of U.S. taxes under these circumstances.

<sup>261</sup> The countries could devise an imputation method under which the subsidiary's income would reflect industry-wide or economy-wide fluctuations in earnings, although there would be a timing problem: If the applicable rate of return were published in advance of the taxable year, information about industry-wide or economy-wide earnings for the period would not yet be available. In any case, the home country would still bear the risk of fluctuations in tax revenues due to firm-specific factors. The aggregate risk from these factors would be minimal, however, if the imputation methodology were applied to a large number of firms, because by definition the firm-specific risks faced by different firms are uncorrelated. In addition, however, the home country would bear the risk of potentially substantial fluctuations in tax revenues due to factors common to U.S. subsidiaries of multinationals based in the home country, such as the risk of unanticipated exchange rate fluctuations.

allocated to the U.S. subsidiary using the imputation formula, with the remaining portion allocated to the parent corporation. This approach would, however, differ significantly from the conventional system of unitary taxation and formula apportionment.<sup>262</sup> Under that system, a positive fraction of the multinational's consolidated income or loss would be allocated to each affiliate. By contrast, the imputed income approach might allocate more than 100 percent of the multinational's consolidated income to the U.S. subsidiary, leaving a loss to be allocated to the parent corporation. Similarly, this approach might allocate income to the U.S. subsidiary even if the multinational experienced a consolidated loss. In that case, more than 100 percent of the consolidated loss would be allocated to the parent corporation.

The imputed income approach would also represent a move towards source-based benefits taxation. A benefits tax would be based on the costs that the taxpaying corporation imposes on the public sector, including the cost of the public goods and services that the corporation uses. In general, these costs are not closely related to the corporation's income.<sup>263</sup> This is in part because the costs imposed on the public sector by the corporation need not depend on the outcomes of the business risks the corporation undertakes, while the income earned by the corporation depends critically on those outcomes. A tax based on imputed income, as described above, would resemble a tax on the corporation's assets or sales, with the rate of tax dependent upon the industry-wide level of profitability but not upon the outcomes of the unique risks faced by the corporation. This tax would be likely to reflect benefits more accurately than a true income tax. The imposition of benefits taxation by the host country is consistent with the proposal to move to an international system of residence-based corporate income taxation.<sup>264</sup>

It is unlikely that the United States and a foreign country would be able to agree on a single, universally applicable method of imputing income to U.S. subsidiaries. Variations in circumstances from industry to industry and multinational to multinational might make it difficult to find a satisfactory universal approach. Moreover, a significant amount of tax revenue would hinge on the actual operation of any universal method. Neither government might be willing to undertake such a risk. It might be more feasible for the two governments to

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<sup>262</sup> See *supra* Part V.A.2.

<sup>263</sup> See *supra* note 45 and accompanying text.

<sup>264</sup> Under a system of residence-based corporate income taxation, the host country would retain the right to impose benefits taxes, but these taxes would not be creditable in the home country. Indeed, the foreign tax credit would be eliminated. Instead, benefits taxes would be treated as a deductible cost of doing business. In contrast, the imputed income approach described above contemplates that the home country will treat the tax as a creditable income tax if the home country employs a worldwide system of taxation.

proceed cautiously, experimenting with approaches tailored to a single multinational, a limited number of multinationals, or a single industry. The mechanism for implementing this type of limited approach already exists in the United States in the form of the advance pricing agreement procedure.<sup>265</sup> This procedure specifies that any proposed transfer pricing methodology must be consistent with the arm's length standard.<sup>266</sup> The procedure also states, however, that taxpayers may propose methodologies other than those specifically described in the Section 482 regulations.<sup>267</sup> Thus, in practice, methodologies other than traditional arm's length approaches are permissible even under the current advance pricing agreement procedure.<sup>268</sup>

A modest proposal would have the IRS actively encourage U.S. subsidiaries of foreign-based multinationals to propose advance pricing agreements based on imputed income methodologies rather than on traditional arm's length pricing methods supported by detailed economic analysis. If the IRS approved such a method, it would enter into an advance pricing agreement that would be contingent upon acceptance of the methodology by all affected foreign tax agencies.<sup>269</sup>

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<sup>265</sup> Rev. Proc. 91-22, 1991-1 C.B. 526. Under the advance pricing agreement procedure, a taxpayer proposes a methodology to be used in determining transfer prices for specified intercompany transactions. *Id.* § 2. The taxpayer must provide data showing that the proposed methodology produces arm's length results. *Id.* §§ 2, 3.01-3.02, 5. If the IRS accepts the proposal, the taxpayer and the IRS will execute an advance pricing agreement. *Id.* §§ 2, 6.06, 9. In appropriate cases, the IRS also will enter into agreements with foreign competent authorities regarding the use of the proposed methodology. *Id.* §§ 2, 7. (The "competent authority" is the individual representative designated in a tax treaty to carry out the administrative provisions of the treaty.) Any IRS audit of the taxpayer's transfer prices while the agreement is in effect will focus on whether the taxpayer set prices in accordance with the agreement. *Id.* §§ 9.02, 10.03.

<sup>266</sup> *Id.* § 3.01.

<sup>267</sup> *Id.*

<sup>268</sup> For example, two multinational banks have reportedly entered into advance pricing agreements with the IRS under which the income and expenses of their global businesses are allocated among countries using formula apportionment. See John Turro, *IRS Grants Two APAs in Derivative Products Area*, 4 TAX NOTES INT'L 959 (1992).

<sup>269</sup> If adopted unilaterally, a nontraditional transfer pricing methodology might violate tax treaty provisions requiring allocation of income based on the arm's length standard and nondiscrimination against U.S. branches and subsidiaries of foreign corporations. See U.S. MODEL TREATY, *supra* note 7, arts. 7(2) (allocation of income based on arm's length standard), 9 (same), 24(3), (5) (nondiscrimination). The proposal discussed above does not involve unilateral action, however. Instead, the competent authorities of all affected countries and the taxpayer itself would agree on the applicable methodology. U.S. tax treaties generally authorize the competent authorities to resolve any difficulties or doubts arising as to the interpretation or application of the treaty by mutual agreement, and in particular to agree to the same allocation of income from multinational business. See *id.* art. 25(3) (a), (b). This mutual agreement provision would appear to authorize competent authorities to implement the proposal discussed above. If necessary, however, tax treaties could be amended explicitly to authorize the competent authorities to agree on transfer pricing methodologies that do not strictly conform to the arm's length principle or the nondiscrimination rule.

This approach would give the IRS and foreign tax agencies experience with how such methods work, which methods work best, what problems occur, and how those problems can be solved. It would also enable firms to prepare advance pricing agreement requests at a relatively low cost and would enable the IRS to process a large number of requests.<sup>270</sup> In addition, since firms would not need to disclose much, if any, sensitive information about their operations in support of their requests, this approach would alleviate taxpayer concerns that sensitive data might be disclosed to foreign governments and ultimately to foreign competitors.<sup>271</sup> Finally, it would enable the IRS to make the advance pricing agreement process much more open, since both the requests and the methodologies generally could be made public without disclosing sensitive information.

### CONCLUSION

The consequences of transfer pricing and financial maneuvering can appear very different depending on whether one views them from a short-term, national perspective or from a long-term, international perspective. From a short-term, national perspective, the key consequence is the potential erosion of the national corporate income tax base; from a long-term, international perspective, the key concern is the potential instability of the international system of income taxation. While the United States must respond to the threat of the erosion of its tax base, it should evaluate any contemplated responses in light of their long-term consequences for maintaining the ability of nations to preserve their systems of comprehensive income taxation. The ultimate solution to these problems would be to move to an international system of residence-based income taxation. Although this is a long-run solution, there are several approaches that the United States could take in the short run that would alleviate the current problems of policing against transfer price manipulation and financial maneuvering. These include taxation of U.S.-based multinationals on a consolidated basis, and taxation of U.S. subsidiaries of foreign-based multinationals, pursuant to bilateral agreements with the tax agencies of the home countries, using formula imputation of income. In addition to alleviating current problems, these approaches would move the current U.S. system in the direction of residence-based taxation as well as in the direction of other possible long-term solutions to the problem of preserving comprehensive income taxation.

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<sup>270</sup> See 1990 Hearings, *supra* note 5, at 349-40 (statement of Roscoe L. Egger, Jr., former Commissioner of Internal Revenue) (predicting that many taxpayers will not seek advance pricing agreements because of the high cost, enormous data requirements, and concerns about confidentiality).

<sup>271</sup> *Id.*