

**IS THE UNITED STATES OBLIGATED TO  
DRIVE ON THE RIGHT?**

**A MULTIDISCIPLINARY INQUIRY INTO THE  
NORMATIVE AUTHORITY OF  
CONTEMPORARY INTERNATIONAL LAW  
USING THE ARM'S LENGTH STANDARD AS A  
CASE STUDY**

BRIAN D. LEPARD\*

CONTENTS

I. THE DEBATE ON THE AUTHORITY OF THE ARM'S LENGTH STANDARD AS A CASE STUDY OF THE PROBLEM OF THE NORMATIVE AUTHORITY OF CONTEMPORARY INTERNATIONAL LAW.....	46
A. Introduction.....	46
B. The Problem of Allocating Income Among Related U.S. and Foreign Corporations for Tax Purposes.....	48
C. The Current Policy Debate on Use of the Arm's Length Standard Versus Formulary Apportionment as an Allocation Method.....	52
D. The Current Debate on the Authority of the Arm's Length Standard Under Contemporary International Law .....	56

---

Copyright © 2000 by Brian D. Lepard.

\* Assistant Professor, University of Nebraska College of Law. A.B., Woodrow Wilson School of Public and International Affairs, Princeton University, 1983; J.D., Yale Law School, 1989. I am grateful to Professor Reuven Avi-Yonah of Harvard Law School, Professor William Lyons of the University of Nebraska College of Law, Professor Julie Roin of the University of Chicago Law School, and Professor Robert Schopp of the University of Nebraska College of Law for their helpful comments and advice on this Article. However, they bear no responsibility for any errors or weaknesses in the Article's arguments, which are mine alone. I also wish to thank Dean Harvey Perlman, who generously provided McCollum summer research grants to fund research for this Article and reduced my teaching responsibilities during the 1997-98 academic year to facilitate my work on it. I express my appreciation to the staff of the Marvin & Virginia Schmid Law Library, especially Kris Lauber, for their diligent assistance with my research. Finally, I thank the editors of the Duke Journal of Comparative & International Law, whose excellent suggestions greatly improved the Article.

E.	The Debate on the Arm's Length Standard as a Case Study of the Problem of Determining the Normative Authority of Treaties and Customary International Law .....	59
II.	A BRIEF HISTORY OF ATTEMPTS TO CODIFY THE ARM'S LENGTH STANDARD IN INTERNATIONAL TREATIES .....	60
III.	A CONCEPTUAL AND NORMATIVE ANALYSIS OF AUTHORITY .....	84
A.	Clarifying the Concept of Authority and Developing a Normative Theory of Authoritative International Norms .....	84
1.	<i>A Model of Authority</i> .....	84
a.	<i>Binding Authority</i> .....	90
b.	<i>Persuasive Authority</i> .....	91
2.	<i>Reasons for Accepting the Preemptive Effect of Authoritative Norms</i> .....	92
a.	<i>Compliance with Secondary Rules</i> .....	95
b.	<i>Facilitating Collective Action</i> .....	96
i.	<i>Harmony Games</i> .....	97
ii.	<i>Assurance Games</i> .....	99
iii.	<i>Dilemmas of Common Interests, Including Prisoners' Dilemmas</i> .....	100
iv.	<i>Dilemmas of Common Aversions, Including Pure and Non-Pure Coordination Problems</i> ...	102
v.	<i>Zero-Sum Games</i> .....	107
c.	<i>The Presence of Effective Sanctions Against Violators</i> ...	107
d.	<i>The Greater Knowledge, Experience, or Expertise of Authorities</i> .....	107
e.	<i>Membership in a Community</i> .....	108
f.	<i>The Moral Principles of Fidelity to Promises and of Fulfilling Legitimate Expectations of Others</i> .....	108
g.	<i>Consent</i> .....	109
h.	<i>Combinations of Reasons</i> .....	110
3.	<i>Toward a Normative Theory of Authoritative International Norms</i> .....	110
B.	The Normative Authority of the Arm's Length Standard .....	114
1.	<i>The Authority of the Arm's Length Standard in Historical Perspective</i> .....	114
2.	<i>Toward a Normative Theory of the Authority of the Arm's Length Standard</i> .....	120
IV.	THE AUTHORITY OF THE ARM'S LENGTH STANDARD UNDER INTERNATIONAL TREATIES .....	121
A.	The Normative Authority of Treaties .....	121
1.	<i>The Authority of Treaties Under Secondary Rules of International Law and U.S. Law</i> .....	121
2.	<i>Normative Theories Regarding the Authority of Treaties</i> .....	125

3.	<i>Toward a Normative Theory Regarding the Authority of Treaties</i> .....	127
B.	The Authority of the Arm's Length Standard as a Treaty Norm: A Norm with Persuasive Authority .....	128
1.	<i>The Existence and Character of an Obligation to Make an Initial Adjustment Using the Arm's Length Standard</i> .....	128
a.	<i>The Debate on the Existence and Character of an Obligation to Use the Arm's Length Standard Under Article 9(1) of the Model Treaties</i> .....	128
b.	<i>The Ordinary Meaning of Article 9(1) in Context and in Light of the Object and Purpose of Double Taxation Treaties</i> .....	132
c.	<i>Supplementary Means of Interpretation</i> .....	134
d.	<i>Supplementary Evidence Supporting an Authoritative Permission</i> .....	136
e.	<i>Supplementary Evidence Supporting a Binding Obligation</i> .....	137
f.	<i>Supplementary Evidence Supporting a Persuasive Obligation</i> .....	137
g.	<i>The Case for the Strong Persuasive Authority of the Arm's Length Standard and the Moderate Persuasive Authority of the Arm's Length Method</i> .....	143
h.	<i>Summary of Conclusions About the Permissibility of Various Allocation Methods in Making Initial Adjustments</i> ..	146
2.	<i>The Existence and Character of an Obligation to Make Correlative Adjustments</i> .....	147
3.	<i>Understanding Why the Arm's Length Standard Should Be Regarded as Having Persuasive Authority Under Tax Treaties</i> .....	151
V.	THE AUTHORITY OF THE ARM'S LENGTH STANDARD UNDER CUSTOMARY INTERNATIONAL LAW .....	154
A.	The Normative Authority of Customary International Law .....	154
1.	<i>The Authority of Customary International Law under Secondary Rules of International Law and U.S. Law</i> .....	154
2.	<i>Normative Theories Regarding the Authority of Customary International Law</i> .....	157
3.	<i>Toward a Normative Theory Regarding the Authority of Customary International Law</i> .....	162
B.	The Authority of the Arm's Length Standard as a Customary Norm: A Norm Without Binding or Persuasive Authority .....	167
VI.	CONCLUSION: WHY THE UNITED STATES IS OBLIGATED TO DRIVE ON THE RIGHT .....	175
	APPENDIX .....	179
	FIGURES .....	181

## I. THE DEBATE ON THE AUTHORITY OF THE ARM'S LENGTH STANDARD AS A CASE STUDY OF THE PROBLEM OF THE NORMATIVE AUTHORITY OF CONTEMPORARY INTERNATIONAL LAW

### A. Introduction

When driving down an open and winding two-lane highway, with no other cars in sight, some drivers may be tempted to cross the double yellow line into the left-hand lane—to enjoy a better view, perhaps, or just to experience the thrill of rounding a curve without worrying about the nuisance of staying in the right-hand lane. And some drivers may even believe, on principle, that all drivers would be better off driving on the left, like the British. Of course we know that the law requires all drivers to stay on the right (at least in the United States and most countries in the world). But if the coast seems clear, why shouldn't drivers be allowed to use their own judgment that it is safe to cross the double yellow line?

States may also experience the allure of the open road and may well ask the same question of international law. While in many cases they may see a benefit to conforming their behavior with certain norms that are prescribed by international law, in other situations they will perceive no reason to conform when their own independent judgment tells them that some other course of action will better promote their national interests. What justification is there, normatively, for states to recognize the authority of international law and comply with international legal norms—that is, stay in the right-hand lane—even when they believe that crossing the double yellow line is safe and in their best interests?

This Article explores this complex question in a very preliminary way. It does so, first, by utilizing methods and considering insights from a number of disciplines, including general legal philosophy, social psychology, international relations theory, game theory, and the philosophy of international law. Second, the Article employs this theoretical analysis in a specific case study of the authority of the arm's length standard as an international legal norm for allocating income of multinational groups of corporations to particular national taxing jurisdictions. The Article uses this issue as a lens through which to examine broader theoretical questions about the authority that treaties and customary international law ought to enjoy.

The balance of Part I reviews the problem of income allocation and alternative allocation methods, the current policy debate on the

merits of the arm's length standard compared to other allocation methods, especially "formulary apportionment," and the contemporary controversy over the authority of the arm's length standard under treaties and customary international law. Part II then briefly reviews the history of efforts to codify the arm's length standard in both model treaties and existing bilateral treaties.

Part III examines, from a conceptual perspective, what it means to speak of the "authority" of a norm, including its legal authority. This Part distinguishes among different types of authority, including "binding authority" and "persuasive authority." Most importantly, Part III explores various theories about which reasons ought to justify the acceptance of authority. It outlines a normative theory of authoritative international norms drawing on legal philosophy, international relations theory, and game theory.

Based on the conceptual and normative framework developed in Part III, Part IV sketches a normative theory of the authority of treaties. In light of this theory, it examines whether the arm's length standard should be regarded as having legal authority pursuant to the terms of U.S. tax treaties; the precise character of any such authority; and how, if at all, this authority constrains Congress' discretion to adopt an alternative method of allocation, such as formulary apportionment.

Part V develops a normative theory regarding the authority of customary international law, including a system for determining when norms rise to the level of customary international law. It applies this theory to investigate whether, in part because of its universality, the arm's length standard should be considered to have independent legal authority as a norm of customary international law.

Finally, Part VI summarizes the Article's conclusions about the authority of the arm's length standard under contemporary international law and the freedom of Congress to modify its use. The Article suggests that U.S. treaties do not impose a binding obligation to adhere to the standard and that the arm's length standard is not yet a binding norm under customary international law. Nevertheless, the Article concludes that, under current U.S. tax treaties, the arm's length standard has persuasive authority. Thus, Congress is legally obligated to give great deference to the standard and to attempt, in good faith, to make the arm's length standard work. Ultimately, this legal obligation is strengthened and supported by the value that Congress ought to place on harmonizing U.S. taxing policies with

those of other states out of recognition that the United States is a member of a community of states.

#### B. The Problem of Allocating Income Among Related U.S. and Foreign Corporations for Tax Purposes

One of the most vexing problems in international tax policy is determining how to allocate a corporate group's income among its constituent corporations where those corporations are engaged in business in diverse countries. The problem of income allocation has become even more troublesome in the new era of globalization.<sup>1</sup> The allocation of income among the constituent parts of a multinational group is important because it affects how much of the income from the group that a country will claim to tax. For example, except for particular types of income received by foreign corporations under U.S. control,<sup>2</sup> under the current rules of the U.S. Internal Revenue Code ("tax code"), the United States does not tax income allocated to a foreign corporation if the income is derived from a foreign "source" and if the corporation does not do business in the United States; the United States only taxes U.S.-source income allocated to such foreign corporations.<sup>3</sup> By contrast, the United States taxes all income, regardless of its source, allocated to a U.S. corporation, subject to the allowance of a tax credit for foreign taxes paid on income from foreign sources.<sup>4</sup>

The current international standard for allocating income among related corporations is the arm's length standard (also sometimes referred to as the "independent enterprise standard"), which is one method for implementing the "separate accounting" principle. Rather than allocating each corporation a percentage of the worldwide group's total income, the separate accounting principle treats the corporations as separate taxpayers, each earning its "own" income. A corporation's "own" income is initially determined by taking into account transactions with other members of the group at the actual "transfer prices" paid for goods or services.

---

1. See generally *Survey: Globalisation and Tax*, THE ECONOMIST, Jan. 29, 2000, at 1-22; *Transfer Pricing Tops List of International Tax Issues in Ernst & Young Survey*, 1999 TAX NOTES TODAY 213-15 (Nov. 4, 1999).

2. See, e.g., I.R.C. §§ 951-64 (rules on taxation of so-called "Subpart F income" of "controlled foreign corporations").

3. See I.R.C. §§ 881-82 (1994).

4. See I.R.C. §§ 11, 901 (1994 & 1998 Supp.).

Of course, even if a separate accounting principle is recognized, a particular method must be adopted for checking whether a corporation's separate accounts reflect its true income. The arm's length standard looks to whether a corporation dealing with a related corporation would have reported different profit figures had the related corporation been an independent enterprise. In practice, the arm's length standard is often considered identical to the "separate accounting" principle.

This broad, umbrella concept of an "arm's length standard" is distinguishable from the "arm's length method." The term "arm's length method" refers to a particular method for implementing the arm's length standard. The arm's length method focuses on the prices of individual transactions between a corporation and related corporations. Transfer prices are respected as reflecting true income so long as these prices are comparable to the prices that would have been paid by unrelated corporations dealing with one another at "arm's length." If a taxing agency, such as the IRS, determines that the actual price paid differs from the arm's length price, each corporation's "own" income will be adjusted using the agency-determined arm's length price. In the absence of a requirement that corporations use the arm's length method (or at least the arm's length standard), corporate groups may have an incentive to manipulate transfer prices to shift the group's income to corporations organized in low-tax jurisdictions.<sup>5</sup>

Application of the arm's length method ideally involves an initial search for comparable uncontrolled transactions that establish an arm's length price—a search often referred to as the "comparable uncontrolled price" ("CUP") method.<sup>6</sup> It should be emphasized that other allocation techniques, including the "comparable profits" and "profit split" methods discussed below, could be compatible with the arm's length standard, so long as their ultimate objective is to determine the amount of income that the corporation would have earned had it been independent.

---

5. See Example 1 in the attached Appendix.

6. See Example 2 in the attached Appendix. In this connection, U.S. Treasury Department regulations provide in this connection that the "comparable uncontrolled price method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction." Treas. Reg. § 1.482-3(b)(1) (1994). For this purpose, in evaluating comparability, "similarity of products generally will have the greatest effect." *Id.* § (2)(ii)(A).

An alternative to the arm's length method of allocation (and the arm's length standard/separate accounting principle) is the classic "formulary" or "fractional" apportionment method, sometimes known as the "unitary business" method. For decades, American states have used this method to allocate income of domestic corporations operating in more than one state.<sup>7</sup> The formulary apportionment method (occasionally referred to in this Article simply as the "formulary method") mandates that the income of all related corporations engaged in the same business be treated as income from a single business.<sup>8</sup> A mathematical formula is then used to allocate a portion of this total income to each corporate entity in the group. Common factors used in this formula include property value, payroll, and sales; many formulas give these factors equal weight. Unlike the arm's length method and arm's length standard, formulary apportionment eschews a focus on individual inter-corporate transactions and does not purport to allocate income among related corporations in the same way that corporations acting at arm's length would agree to do.

Other methods of allocation lie along a spectrum between classic formulary apportionment on the extreme left and the CUP method of implementing the arm's length method on the extreme right.<sup>9</sup> These methods differ: (1) in the extent to which they focus on the prices of individual taxpayer transactions rather than the overall profits of the taxpayer or related entities; (2) in the extent to which they take into account the transfer prices charged by unrelated entities engaged in similar transactions, the profits earned by unrelated entities from similar transactions, or the overall profits of unrelated entities engaged in similar businesses; and (3) in the degree of "similarity" or "comparability" they require. Many of these methods employ formulas in some way.

Moving leftward along the above-mentioned spectrum, just to the left of the CUP method lie two methods, the "resale price"<sup>10</sup> and

---

7. See generally, e.g., David M. Hudson & Daniel C. Turner, *International and Interstate Approaches to Taxing Business Income*, 6 NW. J. INT'L L. & BUS. 562, 582-606 (1984).

8. See Example 3 in the attached Appendix.

9. See Reuven Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 93 (1995) (discussing the existence of such a continuum).

10. Under the resale price method, an arm's length price is determined by subtracting an appropriate gross profit (derived from the gross profit margin earned in comparable uncontrolled transactions) from the resale price of the item involved in the controlled



“cost plus”<sup>11</sup> methods, that concentrate on establishing the arm’s length character of particular transactions and that accordingly are considered traditional arm’s length methods. If comparable uncontrolled transactions are unavailable, these two methods can be used in place of the CUP method. Unless otherwise noted, in the balance of this Article references to the “arm’s length method” include the resale price and cost plus methods as well as the CUP method.

The Treasury Department has recently endorsed other methods as consistent with the arm’s length standard, although they have not been considered “traditional” arm’s length methods. These include the “comparable profits” method and a variety of “profit split” methods. Under the comparable profits method, a transfer price must yield a level of operating profit that falls within an arm’s length range of comparable operating profits.<sup>12</sup>

Under profit split methods, the relative value of each related corporation’s contribution to the success of a business activity is determined and used to allocate the combined operating profit derived by the related corporations from particular transactions (or a business activity of which the transactions form a part). The relative value of a corporation’s contribution will depend on factors such as the functions performed, risks assumed, and resources employed by that corporation. One type of profit split method, the “comparable profit split” method, determines a profit split ratio by ascertaining the ratios of combined operating profit agreed upon by comparable uncontrolled taxpayers. This ratio is then applied to the combined operating income of the related corporations to arrive at an appropriate profit split.<sup>13</sup> As the profit split method departs from a

---

transaction. *See* Treas. Reg. § 1.482-3(c)(1)-(3) (1994). *See* Example 4 in the attached Appendix.

11. Under the cost plus method, an arm’s length price is determined by adding an appropriate gross profit (derived from the gross profit markup earned in comparable uncontrolled transactions) to a controlled taxpayer’s production costs for the property involved in the controlled transaction. *See* Treas. Reg. § 1.482-3(d)(1)-(3) (1994). *See* Example 5 in the attached Appendix.

12. To determine this range, objective measures of profitability (often referred to as “profit level indicators”) are derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. These indicators are applied to the controlled taxpayer’s own financial data to determine its comparable operating profits. Profit level indicators can include the rate of return on capital employed, the ratio of operating profit to sales, and the ratio of gross profit to operating expenses. *See* Treas. Reg. § 1.482-5 (1994). *See* Example 6 in the attached Appendix.

13. *See* Treas. Reg. § 1.482-6 (1994). *See* Example 7 in the attached Appendix.

focus on the combined operating profit from particular transactions and encompasses all of a controlled group's combined profits, it begins to resemble a form of formulary apportionment.

The methods that lie between the traditional arm's length method and classic formulary apportionment are often referred to as "empirical" methods. As discussed later in this Article, many U.S. trading partners believe that some of these empirical methods depart from the arm's length standard, particularly those methods that do not concentrate on the profit from particular transactions between related corporations (and from comparable transactions between unrelated entities), but rather focus on profits from larger business categories.

Finally, it should be emphasized that double taxation of the combined economic profits of related corporations may occur whenever countries use different allocation methods or use the same method but produce different transfer prices or different profits allocable to the corporations.<sup>14</sup> As we will soon see in more detail, the problem of potential double taxation has given rise to international efforts to adopt a common allocation norm, namely, the umbrella arm's length standard and the arm's length method of implementing that standard.

### C. The Current Policy Debate on Use of the Arm's Length Standard Versus Formulary Apportionment as an Allocation Method

While the above review of different allocation methods suggests that the issue of allocation is highly technical (which it undoubtedly is), it has simultaneously generated tremendous political heat. For the last several years, a debate had raged in the United States over whether the U.S. Government should maintain the traditional arm's length standard or adopt classic formulary apportionment to allocate the income of multinational enterprises subject to U.S. taxing jurisdiction. Although the focus of this Article is on the legal authority of the arm's length standard under contemporary international law, this section highlights some of the main policy arguments in this debate.<sup>15</sup>

---

14. See Example 8 in the attached Appendix.

15. These policy questions have already been exhaustively debated. For works emphasizing the advantages of formulary apportionment, see, for example, Benjamin F. Miller, *None Are So Blind as Those Who Will Not See*, 66 TAX NOTES 1023 (Feb. 13, 1995); Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, 60 TAX NOTES 1131 (Aug. 23, 1993); Louis M. Kauder,

Many members of the U.S. Congress have charged that the challenges of enforcing the arm's length standard have permitted foreign-owned multinational enterprises to escape U.S. tax jurisdiction by siphoning profits away from their U.S.-incorporated subsidiaries, resulting in Treasury Department losses of as much as \$40 billion annually.<sup>16</sup> Largely at the urging of Senator Byron Dorgan (D-N.D.), House and Senate conferees adopted a "Sense of the Senate" provision in a concurrent fiscal 1995 budget resolution that expressed the belief that "deficit reduction should be achieved, in part, by ending loopholes and enforcement breakdowns."<sup>17</sup> The provision suggested that the Treasury Department could reduce these loopholes by employing "a formulaic approach in cases in which the current 'arm's length' transaction rules do not work."<sup>18</sup> At the same time, Senator Dorgan attempted to delay ratification of new tax treaties until the Treasury Department conceded that it would interpret those treaties to permit the use of formulary apportionment.<sup>19</sup>

In May 1998, the Senate unanimously approved an amendment to Senator Dorgan's IRS restructuring bill that required the Treasury Department to study transfer pricing abuses.<sup>20</sup> Although the amendment was struck from the final bill by the Conference Committee, in July 1998 the Senate Appropriations Committee approved Treasury Department spending recommendations that called for the IRS to analyze revenue lost as a result of transfer

---

*Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now*, 58 TAX NOTES 485 (Jan. 25, 1993); Stanley I. Langbein, *A Modified Fractional Apportionment Proposal for Tax Transfer Pricing*, 54 TAX NOTES 719 (Feb. 10, 1992). For works advocating the retention of the arm's length standard, see, for example, William J. Wilkins & Kenneth W. Gideon, *Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment*, 65 TAX NOTES 1259 (Dec. 5, 1994); Eric J. Coffill & Prentiss Willson, Jr., *Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?*, 59 TAX NOTES 1103 (May 24, 1993). On the debate generally, see, for example, John Turro, *The Battle Over Arm's Length and Formulary Apportionment*, 65 TAX NOTES 1595 (Dec. 26, 1994). The following discussion of the main arguments in the policy debate draws on many points raised in these works.

16. See, e.g., *Dorgan Testifies at Senate Foreign Relations Hearing on Tax Treaties*, 99 TAX NOTES TODAY 218-40 (Nov. 12, 1999); *Dorgan Wants to Give IRS Ammunition to Combat Transfer Pricing Abuse*, 99 TAX NOTES TODAY 38-4 (Feb. 26, 1999).

17. H.R. Con. Res. 218, 103d Cong., H.R. REP. NO. 103-490, pt. 1, § 38 (1994).

18. *Id.*

19. See, e.g., Nancy Loubé, *Senators Grill Administration on Seven Pending Tax Accords*, 67 TAX NOTES 1570 (June 19, 1995).

20. See *JCT Compares House, Senate Versions of IRS Restructuring Bill*, 98 TAX NOTES TODAY 96-25, ¶¶ 558-61 (May 19, 1998).

pricing and to report its findings to Congress within the next year.<sup>21</sup> The following February, Senator Dorgan “once again declared war . . . on transfer pricing abuse,” and during a hearing on the Internal Revenue Service’s fiscal year 2000 budget, he called on Commissioner Charles Rossotti to report on the extent of the problem.<sup>22</sup>

A number of scholars have echoed the growing congressional sentiment that formulary apportionment is a viable solution to transfer pricing abuses that are made possible by lax enforcement of the arm’s length standard. They have maintained that formulary apportionment is both theoretically and practically superior to the arm’s length standard and, accordingly, that Congress should amend the tax code to implement formulary apportionment—unilaterally, if necessary.<sup>23</sup>

As just suggested, scholars and other observers have made several arguments for and against the arm’s length standard on policy grounds.<sup>24</sup> The above-mentioned opponents of the arm’s length standard (to the extent it is understood as generally requiring the arm’s length method) have rejected it for a variety of reasons. First, they contend that it has proven exceedingly difficult to apply in practice. Finding “comparable uncontrolled transactions” can be enormously challenging, particularly when the transactions involve intangibles such as patents and know-how. Even the resale price and cost plus methods may be difficult to apply because of the difficulties of locating appropriate comparable transactions. Further, opponents maintain that the standard’s practical deficiencies lead to intense, expensive litigation and voluminous Tax Court opinions.

Second, critics of the arm’s length standard emphasize its susceptibility to abuse. In principle, section 482 of the tax code provides a weapon against unscrupulous transfer pricing practices. Section 482 provides that in the case of organizations, trades, or businesses under common control, the Secretary of the Treasury

may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution,

---

21. See *Senate Panel Calls for IRS Study on Transfer Pricing*, 98 TAX NOTES TODAY 135-1 (July 15, 1998); *Conference Committee Explanation of IRS Restructuring Bill: Titles II-IV (Part 2 of 4)*, 98 TAX NOTES TODAY 123-11, ¶¶ 876-80 (June 26, 1998).

22. *Dorgan Wants to Give IRS Ammunition to Combat Transfer Pricing Abuse*, 99 TAX NOTES TODAY 38-4 (Feb. 26, 1999).

23. See, e.g., Avi-Yonah, *supra* note 9, at 159.

24. See generally authorities cited *supra* note 15.

apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.<sup>25</sup>

Early in the twentieth century, the Treasury Department adopted regulations providing that an adjustment could be made under the predecessor of section 482 if the IRS determined that a transfer price was not arm's length, thus formally endorsing the arm's length standard and the arm's length method. Over the years, the Treasury Department has made a number of far-reaching revisions to the regulations under section 482 in an attempt to provide greater specificity in particular contexts and to clamp down on transfer pricing abuses. Moreover, Congress has enacted rigorous penalty provisions applying to multinational corporations that adopt transfer prices that are sufficiently removed from arm's length prices.<sup>26</sup> Nevertheless, critics argue that these attempts to deter transfer price manipulation are inadequate.

Supporters of formulary apportionment also emphasize that it has, in their view, a number of strengths. First, they argue that it is simpler than the arm's length method. Formulary apportionment focuses on identifying the existence and income of a unitary business, rather than on trying to find a market price for each and every transaction between members of a multinational group. Advocates contend that this system is better suited to the realities of the global economy, where numerous cross-border transactions occur daily between economically-integrated multinational businesses. Second, they maintain that formulary apportionment can avoid manipulation of transfer prices, and many suggest that it therefore would produce more tax revenue for the United States.

Formulary apportionment supporters can also point to the practice of American state governments, which have long used the method. California, for example, has successfully employed it to tax the worldwide income of a multinational group. In its 1994 *Barclays Bank* decision, the U.S. Supreme Court held that formulary apportionment was a reasonable method for California and other states to use in computing the income of a foreign-based multinational corporate group, rejecting challenges based on the Commerce and Due Process Clauses of the Constitution.<sup>27</sup> Eleven years earlier, in *Container Corp. of America v. Franchise Tax Board*,

---

25. I.R.C. § 482 (1994 & 1998 Supp.).

26. See I.R.C. § 6662(e) (1994).

27. *Barclays Bank v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

the Supreme Court sustained the constitutionality of California's system as it applied to a U.S.-based multinational corporate group with foreign subsidiaries.<sup>28</sup> In both these cases, the Court found that tax treaties did not regulate state taxation and that Executive Branch pronouncements in favor of the arm's length standard were not sufficient to override Congress' failure to prohibit states from using formulary apportionment.

Supporters of formulary apportionment argue that its adoption at the federal level would be permissible under the existing language of section 482.<sup>29</sup> They point out that section 482 even mentions "apportionment" of gross income and deductions.<sup>30</sup>

On the other side of the policy debate, defenders of the arm's length standard contend that the standard's widespread acceptance facilitates coordination with trading partners and reduces the risk of double taxation, whether economic or juridical.<sup>31</sup> They further maintain that even if other countries eventually agree to use formulary apportionment, uniform approaches and conflict resolution mechanisms would have to be devised to avoid multiple taxation resulting from different definitions of a "unitary business," different ways of computing the income of a unitary business, and different formulas for allocating the income of a unitary business. Each country would also be tempted to develop and apply a formula that allocates more income to it. In light of the huge potential compliance costs of collecting information from foreign businesses, arm's length standard supporters also question the purported simplicity of the formulary method. Finally, supporters argue that the arm's length standard is more flexible.

#### D. The Current Debate on the Authority of the Arm's Length Standard under Contemporary International Law

While critical, the policy debate among scholars and politicians about the benefits and weaknesses of the arm's length standard takes place in a legal context. The balance of this Article focuses on the following question: Even if formulary apportionment is desirable from a policy viewpoint, does contemporary international law grant

---

28. 463 U.S. 159 (1983).

29. *See generally* authorities cited *supra* note 15.

30. *See* I.R.C. § 482.

31. "Economic double taxation" results when the same item of income is taxed more than once, although in the hands of different corporations; "juridical double taxation" occurs when the same income is taxed more than once in the hands of the same corporation.

the arm's length standard (and the arm's length method) authority that limits the discretion of Congress to move to a formulary apportionment system? This problem, too, has elicited a robust debate between the defenders of the arm's length standard and its detractors.

The Treasury Department has been one of the staunchest advocates for the proposition that the United States is obligated to use the arm's length standard, regardless of its policy merits or shortcomings. The Treasury Department has contended that numerous U.S. tax treaties mandate use of the arm's length standard and method. In its 1988 "White Paper" on inter-company pricing, the Treasury Department argued in favor of continued adherence to the arm's length standard because the standard "is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; [and] it is incorporated into most tax treaties to which the United States is not a party."<sup>32</sup> At a one-day conference on formulary apportionment organized by the Treasury Department in 1996, Deputy Treasury Secretary Lawrence H. Summers "summarily dismissed the notion that the United States should make a unilateral move to formulary apportionment and hope that the rest of the world would follow, because such a move would severely affect world trade and destroy the U.S. network of tax treaties."<sup>33</sup> Indeed, Treasury Department officials have consistently maintained that the adoption of formulary apportionment is simply prohibited by U.S. tax treaties.<sup>34</sup>

The 1988 White Paper not only cited the widespread use of the arm's length standard in tax treaties, but also emphasized that "it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues . . . and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases . . . ."<sup>35</sup> The Treasury Department has apparently not, however, gone so far as to assert that the status of the arm's length standard, as the world de facto standard, gives it the force of customary international law. Nonetheless, as Part V of this

---

32. A Study of Intercompany Pricing under Section 482 of the Code, I.R.S. Notice 88-123, 1988-2 C.B. 458, 475 [hereinafter 1988 White Paper].

33. *Dorgan Blasts Arm's Length Transfer Pricing Method*, 96 TAX NOTES TODAY 249-4 (Dec. 24, 1996).

34. See, e.g., John Turro, *Treasury Continues to Champion Worldwide Arm's Length Standard*, 66 TAX NOTES 316 (Jan. 16, 1995).

35. 1988 White Paper, *supra* note 32, at 475.

Article discusses in detail, some defenders of the arm's length standard have made this claim.<sup>36</sup>

Opponents of the arm's length standard dispute its status as an authoritative norm under either international treaties or customary international law. Some argue that U.S. tax treaties do not mandate continued adherence to the arm's length standard and, by their terms, permit the United States to adopt a system of formulary apportionment.<sup>37</sup> Others contend that mere uniformity of international practice should not constrain U.S. policy-making,<sup>38</sup> and that the arm's length standard has not achieved the status of customary international law. These opponents conclude that the United States may unilaterally adopt formulary apportionment under international law.

For example, Professor Reuven Avi-Yonah, while apparently conceding that existing U.S. tax treaties mandate the use of the arm's length standard, has urged that

[a]s an initial matter, the solution [to any treaty-related problems] would be to propose the formulary approach as a discussion draft and invite other countries to enter negotiations, but announce that the approach will be adopted unilaterally if no agreement is reached within a specified time period (e.g., five years).<sup>39</sup>

Along with other proponents of formulary apportionment, Professor Avi-Yonah supports Congress' freedom unilaterally to change the tax law and casts doubt on the authority of the arm's length standard under contemporary international law, either as a treaty rule or as a customary norm.

---

36. See, e.g., Chantal Thomas, *Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method*, 14 BERK. J. INT'L L. 99 (1996).

37. See, e.g., Louis M. Kauder, *The Unspecific Federal Tax Policy of Arm's Length: A Comment on the Continuing Vitality of Formulary Apportionment at the Federal Level*, 60 TAX NOTES 1147 (Aug. 23, 1993). Senator Dorgan has persistently argued that treaties should be interpreted as permitting formulary apportionment. See, e.g., *Dorgan Testifies at Senate Foreign Relations Hearing on Tax Treaties*, *supra* note 16; *Interview with Sen. Byron Dorgan on Formulary Apportionment*, 65 TAX NOTES 1598 (Dec. 26, 1994). And this argument was supported by Senator Claiborne Pell, D-R.I., who until 1995 was Chairman of the Senate Foreign Relations Committee. See *Recently Approved Treaties Do Not Prevent Formulary Apportionment*, 61 TAX NOTES 1513, 1513 (Dec. 20, 1993).

38. See, e.g., Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 670-71 (Feb. 17, 1986).

39. Avi-Yonah, *supra* note 9, at 159.



E. The Debate on the Arm's Length Standard as a Case Study of the Problem of Determining the Normative Authority of Treaties and Customary International Law

The debate on the authority of the arm's length standard under international treaties and customary international law raises a number of challenging questions about the authority of international law that go beyond the specific issues associated with the problem of income allocation. For example, how should treaty language be interpreted? Can treaties impose different levels of legal obligations, including what might be called "persuasive obligations" (defined in Part III below) as well as binding obligations? And, even if treaties do impose legal obligations of some kind, why should these obligations be allowed to displace the independent judgment of states about what course of action (for example, adopting classic formulary apportionment as opposed to the arm's length standard) is best from a policy standpoint?

Similar questions can be asked about customary international law. How should we in practice determine whether a norm, like the arm's length standard, ought to be considered to have achieved the status of customary international law? And, again, even if a norm is part of customary international law, why should states recognize an obligation to follow it?

This Article critically examines the contentions made by both proponents and opponents about the arm's length standard's authority, or lack of authority, under contemporary international law. As noted in the Introduction, it engages in this examination as a means of probing, using tools from a variety of disciplines, the above types of questions about the degree of authority treaties ought to enjoy, and when and how norms ought to be treated as acquiring authority under customary international law. It thus has two interrelated purposes. First, the Article attempts to develop the broad outlines of a normative theory regarding the authority of treaties and customary international law, including a methodology for identifying the existence of customary international legal norms. This theory takes into account existing rules on the interpretation of treaties, their binding force, and the identification of customary international law.

Second, the Article applies this theory to the particular problem of determining the degree of authority the arm's length standard ought to be considered to have under contemporary international

law—that is, of determining the extent to which treaties and customary international law limit the discretion of Congress to replace the standard with a system of formulary apportionment. Examination of this particular problem in turn sheds light on the broader theoretical problem of determining the normative authority of treaties and customary international law.<sup>40</sup>

To begin to address these complex issues, the Article now turns to a brief survey of the history of attempts to codify the arm's length standard and arm's length method in international treaties.

## II. A BRIEF HISTORY OF ATTEMPTS TO CODIFY THE ARM'S LENGTH STANDARD IN INTERNATIONAL TREATIES

At the beginning of the twentieth century, few countries had adopted rules for the allocation of corporate income.<sup>41</sup> After World War I, however, this situation quickly changed. Trading activity between countries expanded and gave rise to new claims of extra-territorial tax jurisdiction. A number of countries, particularly former states of the Austro-Hungarian and German Empires, concluded bilateral treaties aimed at eliminating double taxation based on rival claims.<sup>42</sup> And in 1921, Austria, Hungary, Italy, Poland, Romania, and the Kingdom of the Serbs, Croats, and Slovenes signed a multilateral convention in Rome; however, only Italy and Austria actually ratified the treaty.<sup>43</sup>

---

40. The scope of this Article's study is limited in a few respects. First, with respect to its theoretical analysis of the authority of international law, the Article can only scratch the surface of an extraordinarily complex and vast subject; its conclusions therefore must necessarily be viewed as preliminary and tentative in character. Second, because the focus of the Article is on the status of the arm's length standard under international law, it pays only brief attention to relevant norms under the U.S. Constitution regarding the status of international law in relation to congressional legislation. Third, the Article concentrates on the role of the arm's length standard in allocating income among related corporations, rather than among branches or permanent establishments of a single corporation. Finally, although the Article briefly discusses the status of certain other allocation methods, its primary concern is the authority of the general arm's length standard and the arm's length method.

41. See generally Langbein, *supra* note 38, at 629-30.

42. One of the first bilateral treaties apparently was an 1899 agreement to prevent double taxation between Austria-Hungary and Prussia. See MITCHELL B. CARROLL, *GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER* 11 (1978).

43. See *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee of the League of Nations*, League of Nations Doc. F.212 (1925) [hereinafter *1925 Report on Double Taxation*], reprinted in 4 JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *LEGISLATIVE HISTORY OF UNITED STATES TAX*

In response to pressure from the international business community, the League of Nations Financial Committee appointed several panels of experts to study the problem of double taxation. Commenting on the issue of income allocation, an influential 1923 study noted that “the experience of more advanced countries in these matters could profitably be collected and collated and used as the basis of conventions for countries to whom they are more or less novel.”<sup>44</sup> The authors of the report declined, however, to endorse particular allocation criteria.<sup>45</sup>

These early League of Nations initiatives focused primarily on the allocation of income of a single corporation between its head office located in one state and one or more branches or permanent establishments located in other states. With respect to this problem, in a 1925 report on double taxation, a committee of technical experts supported the principle of division of income between affected states and acknowledged the existence of formulary methods in several treaties, including those between Austria and Czechoslovakia and between Danzig and Poland. But it expressed no preference for either the formulary or arm’s length methods.<sup>46</sup>

In a 1927 report,<sup>47</sup> a newly constituted and enlarged committee of technical experts drafted a “Convention for the Prevention of Double Taxation” (the “1927 Model Convention”), which was framed as a bilateral treaty. The committee defended its decision to propose a bilateral convention as opposed to a multilateral one, “signed by as many States as possible,” on the ground that, while it would eventually be desirable to conclude one or more multilateral conventions, “the fiscal systems of the various countries are so fundamentally different that it seems at present practically impossible to draft a collective convention, unless it were worded in such general terms as to be of no practical value . . . .”<sup>48</sup> The committee expressed

---

CONVENTIONS 4057, 4071-72 (1962) [hereinafter CONVENTIONS LEGISLATIVE HISTORY]; CARROLL, *supra* note 42, at 30.

44. *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Addendum, at 52, League of Nations Doc. E.F.S.73.F.19. (1923).

45. *See id.* at 52-53.

46. *See 1925 Report on Double Taxation*, *supra* note 43, at 4076, 4091.

47. *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216.M.85.1927.II. (1927), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4111 [hereinafter *1927 Report on Double Taxation*].

48. *Id.* at 4122.

the view that through model bilateral treaties “a certain measure of uniformity will be introduced in international fiscal law and, at a later stage of the evolution of that law, a system of general conventions may be established which will make possible the unification and codification of the rules previously laid down.”<sup>49</sup>

Article 5 of the 1927 Model Convention provided principles for allocating income of one corporation among permanent establishments in different states. It provided generally that

each of the two States shall tax the portion of the income produced in its territory. *In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment.*<sup>50</sup>

Again, the committee did not recommend a specific allocation method. Instead, it suggested establishing a standing committee on taxation to draw up model allocation rules.<sup>51</sup>

Following submission of the committee’s report, the League Council requested the Secretary-General to convene a General Meeting of Government Experts to discuss the 1927 Model Convention. Although the 1928 General Meeting endorsed the Model Convention, it also recommended certain changes and developed three versions of the text to accommodate differences in the fiscal systems of the two countries party to the conventions (collectively known as the “1928 Model Conventions”).<sup>52</sup> On the question of allocation, article 5 of the first 1928 Model Convention closely corresponded with article 5 of the 1927 Model Convention.<sup>53</sup>

Also in 1928, Congress added to the tax code the predecessor of what is now section 482. In the intervening seven decades, only a few

---

49. *Id.*

50. Draft of a Bilateral Convention for the Prevention of Double Taxation art. 5, *reprinted in* CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4124-25 (emphasis added).

51. *See 1927 Report on Double Taxation*, *supra* note 47, at 4145.

52. *See Double Taxation and Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562.M.178.1928.II. (1928), *reprinted in* CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4151, 4159-61 [hereinafter *1928 Report on Double Taxation*].

53. *See* Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes, Text of Draft Convention No. 1a art. 5, *reprinted in* CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4161, 4162. However, unlike its 1927 predecessor, the 1928 Model Convention provided generally that the “competent administrations” of the two states “shall come to an arrangement as to the basis for apportionment” and did not limit such agreement to cases where the corporation failed to keep accounts showing the separate income of the two permanent establishments in proper form. *See id.* Because of similarities among the allocation provisions of the 1928 Model Conventions, only the first convention is discussed here.

changes have been made to the text of that section.<sup>54</sup> The original section did not provide a particular method for determining the permitted “distribution, apportionment, or allocation,” and for the next seven years, no Treasury Department regulations indicated a specific method.<sup>55</sup>

In 1929, a newly-constituted League Fiscal Committee began to consider how to deal with rules for income allocation, but it “soon came to the conclusion that, in order to do any useful work, it would be essential to have a detailed knowledge of the present practice in various countries.”<sup>56</sup> It asked Professor Thomas S. Adams of Yale University to prepare a report based on information supplied by member countries.<sup>57</sup>

In his report, Professor Adams observed that in the case of allocations to local subsidiaries, “[p]ractically all the replies state categorically that the local company, which is a subsidiary of a foreign corporation, is a separate legal entity and enjoys the same treatment as other national companies. It is therefore taxed on the basis of its own accounts.”<sup>58</sup> Adams noted, however, that some countries used empirical or formulary methods if the separate accounts were inadequate or misleading. For example, he stated that in such a case some national taxing authorities ascribed profits “to the subsidiary company based on a comparison with the profits of other companies engaged in a similar business.”<sup>59</sup> In Germany and Spain, “[w]hen the subsidiary and the foreign parent constitute a ‘single economic unit,’ the subsidiary may be treated as a branch,”<sup>60</sup> while in the United States “the fiscal authorities may allocate income as between the foreign parent company and the local subsidiary.”<sup>61</sup> In Great Britain and Spain, “[w]here the profits of a subsidiary are artificially concealed, a charge may be made upon the parent company based

---

54. See generally Avi-Yonah, *supra* note 9, at 95-97 (discussing the history of this provision).

55. See *id.* at 96-97.

56. *Report to the Council on the Work of the First Session of the Committee, Held in Geneva from October 17th to 26th, 1929*, League of Nations Doc. C.516.M.175.1929.II. (1929), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4195, 4199.

57. See *id.*; *Report to the Council on the Work of the Second Session of the Committee, Held in Geneva from May 22nd to 31st, 1930*, League of Nations Doc. C.340.M.140.1930.II. (1930), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4203, 4207, 4212 [hereinafter *1930 Committee Report*].

58. *Id.* at 4214.

59. *Id.*

60. *Id.*

61. *Id.*

upon the true profits of the subsidiary.”<sup>62</sup> Professor Adams also reported, at least with respect to the allocation of profits to permanent establishments, that Austria proposed the adoption of conventional percentages as an international allocation method, while other countries, such as the United States, considered “the method of ‘separate accounting’ as decidedly preferable to any hard-and-fast formula for allocation.”<sup>63</sup>

Based in part on Professor Adams’ report, the Fiscal Committee recommended the adoption of a multilateral convention on double taxation, arguing that “it would materially encourage the movement to reduce double taxation by uniform law—a method which in important respects is obviously superior to the method of reducing double taxation through the instrumentality of bilateral conventions.”<sup>64</sup> The Committee appointed a subcommittee to prepare a study and to draft a multilateral convention.<sup>65</sup>

Following Professor Adams’ death, the subcommittee gave responsibility for the study to his assistant, Mitchell B. Carroll. At its 1933 session, the Fiscal Committee discussed Carroll’s final report on allocation issues (the “Carroll Report”), which succeeded a preliminary report released in 1931.<sup>66</sup> Carroll obtained information on allocation methods used in twenty-seven countries and three U.S. states (Massachusetts, Wisconsin, and New York). He found that with respect to the allocation of the income of a single corporation among its branches, “[a] predilection for the method of separate accounting is evinced by the great majority of countries.”<sup>67</sup> In particular, he characterized the typical practice of countries as “complete liberty of methods of assessment, but recourse in the first instance to the declaration and separate accounts, subject to verification and adjustment, or, if this [was] impossible, to the making

---

62. *Id.*

63. *Id.* at 4218-19.

64. *Id.* at 4210.

65. *See id.*

66. MITCHELL B. CARROLL, *TAXATION OF FOREIGN AND NATIONAL ENTERPRISES (VOLUME IV): METHODS OF ALLOCATING TAXABLE INCOME* (1933). On the 1931 preliminary report, see *Report to the Council on the Work of the Third Session of the Committee, Held in Geneva from May 29th to June 6th, 1931*, League of Nations Doc. C.415.M.171.1931.II.A. (1931), reprinted in *CONVENTIONS LEGISLATIVE HISTORY*, *supra* note 43, at 4225, 4229-30. For a personal account by Carroll of his work, see CARROLL, *supra* note 42.

67. CARROLL, *supra* note 66, ¶ 293, at 88.

of an assessment by employing empirical methods or the method of fractional apportionment.”<sup>68</sup>

On the other hand, Carroll’s review of state practice regarding allocation of income between related corporations “expressed no conclusion as to preferred methods.”<sup>69</sup> He described three common methods: (1) “readjustment on [the] basis of independent persons—i.e., the legal fiction is respected, but the relations between the two are examined in order *to divide the joint profit between them in the measure that each would have earned had the two been dealing with each other as independent persons;*”<sup>70</sup> (2) “assessment of the parent in the name of the subsidiary as agent;”<sup>71</sup> and (3) “assessment on [the] basis of economic unity” of the parent and subsidiary.<sup>72</sup> Carroll noted that the United States adopted the first “independent persons” method under the predecessor of section 482, and that Canada’s law contained a similar provision, permitting the redetermination of income based on fair market prices.<sup>73</sup> He also observed that Austrian practice called for the adjustment of prices between a subsidiary and a parent “based on a comparison with information furnished by similar enterprises, at existing market prices, or, in the absence of such evidence, on the opinion of experts.”<sup>74</sup>

In his conclusion, Carroll indicated as a matter of policy a strong preference for the separate accounting method of allocating income between branches of a single corporation, because he viewed it as more consistent with the principle that a state should only have authority to tax income from sources within its own territory.<sup>75</sup> He also cited many of the practical difficulties with formulary apportionment previously discussed, including the problem that states would likely choose formulas that allocate more income to their tax jurisdiction.<sup>76</sup> In addition, Carroll argued that the separate accounting method was “preferred by the great majority of Governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups.”<sup>77</sup>

---

68. *Id.* ¶ 288, at 87.

69. Langbein, *supra* note 38, at 633. See CARROLL, *supra* note 66, ¶¶ 384-406, at 109-15.

70. CARROLL, *supra* note 66, ¶ 386, at 110 (emphasis added).

71. *Id.*

72. *Id.*

73. See *id.* ¶¶ 387-88, at 110.

74. *Id.* ¶ 389.

75. See *id.* ¶ 666, at 187-88.

76. See *id.* ¶¶ 666-70, at 187-89.

77. *Id.* ¶ 671, at 189.

Presumably on similar grounds, Carroll recommended that corporations be treated as independent legal entities and that allocations between related corporations be based on an independent enterprise standard: “[I]f it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.”<sup>78</sup> Carroll contended that “the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation.”<sup>79</sup>

Legal scholar Stanley Langbein has faulted the Carroll Report for what he contends is its bias in favor of the arm’s length standard. According to Langbein, the report ignores the statutory imposition of formulary methods among certain countries or states. Langbein argues that “Carroll conceived his role to be one of developing an international approach which would truncate any movement of the international community to the development, on a general scale, of working rules of fractional apportionment, rather than one of evaluating, in an unbiased way, alternative approaches to the problem.”<sup>80</sup>

In light of the Carroll Report, the subcommittee on allocation issues recommended adoption of a draft convention specifying methods of allocation, and the entire Fiscal Committee approved the text of this convention (the “1933 Draft Convention”).<sup>81</sup> The Committee proposed to the League Council that its draft could serve as the basis for a multilateral convention. It recommended that the draft be transmitted to governments so that they could submit comments and indicate their interest in such a multilateral convention.<sup>82</sup>

---

78. *Id.* ¶ 628, at 177.

79. *Id.*

80. Langbein, *supra* note 38, at 637-38.

81. *See* Draft Convention Adopted for the Allocation of Business Income between States for the Purposes of Taxation [hereinafter 1933 Draft Convention], in *Report to the Council on the Fourth Session of the Committee, Held at Geneva from June 15th to 26th, 1933*, League of Nations Doc. C.399.M.204.1933.II.A. (1933), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4241, 4243 [hereinafter *1933 Committee Report*]; *see also* *1933 Committee Report* at 4241-42.

82. *See* *1933 Committee Report*, *supra* note 81, at 4242.



Regarding the problem of allocating the income of a single company to particular permanent establishments, the 1933 Draft Convention provided in article 3:

If an enterprise with its fiscal domicile in one contracting State has permanent establishments in other contracting States, there *shall* be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.<sup>83</sup>

Further, the 1933 Draft Convention called for adjustments of accounts to reflect arm's length prices, thus formally adopting the arm's length standard and the arm's length method:

The fiscal authorities of the contracting States *shall*, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or *to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.*<sup>84</sup>

The 1933 Draft Convention permitted the use of various empirical methods as fallback methods, including a percentage of turnover "fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country."<sup>85</sup> It provided that, if neither these empirical methods nor the arm's length method could be applied, the "net business income of the permanent establishment" could be determined by various formulaic factors based on the "*total income derived by the enterprise from the activities in which such establishment has participated . . . provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting.*"<sup>86</sup>

The 1933 Draft Convention was the first model treaty to contain a specific provision on the allocation of profits from one company (including a subsidiary) to a related company. Article 5 provided:

When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation

---

83. *Id.* at 4244 (art. 3) (emphasis added).

84. *Id.* (emphasis added).

85. *Id.*

86. *Id.* (emphasis added).

there exists [sic], *in their commercial or financial relations*, conditions different from those which would have been made between *independent enterprises*, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, *shall be* entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.<sup>87</sup>

It should be noted that while the 1933 Draft Convention clarified that the use of formulary apportionment as a fallback method was permissible with respect to allocations to permanent establishments under article 3, it did not clarify whether formulary apportionment was permissible with respect to inter-corporate allocations under article 5.

The 1933 Draft Convention was never formally promulgated as an official model. The Fiscal Committee circulated it to governments for their comments,<sup>88</sup> and based on the responses of thirty-three governments, the Committee reported in 1935 that the general sentiment was favorable to the text.<sup>89</sup> Nevertheless, only a small number of governments expressed an immediate desire to become party to a multilateral convention along the lines of the 1933 Draft Convention.<sup>90</sup> In view of this meager response, the Fiscal Committee concluded that “progress is more likely to be achieved by means of bilateral agreements . . . . Governments consider . . . that bilateral agreements are likely to prove more appropriate.”<sup>91</sup> The Committee endorsed this bilateral approach, believing that the promulgation of the model convention as the basis for bilateral treaties would “automatically [create] a uniformity of practice and legislation,” while remaining “sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries,”<sup>92</sup> since it could be modified in particular bilateral agreements.

The genesis of article 5 of the 1933 Draft Convention is unclear. The first bilateral convention incorporating a provision on the

---

87. *Id.* at 4245 (art. 5) (emphasis added).

88. *See Report to the Council on the Fifth Session of the Committee, Held at Geneva from June 12th to 17th, 1935*, League of Nations Doc. C.252.M.124.1935.II.A. (1935), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4249, 4251 [hereinafter *1935 Committee Report*].

89. *See id.*

90. *See* CARROLL, *supra* note 42, at 70 (discussing relative lack of interest in a multilateral convention).

91. *1935 Committee Report*, *supra* note 88, at 4251-52.

92. *Id.* at 4252.

allocation of profits between related corporations appears to have been the 1932 treaty between the United States and France, the first such bilateral tax convention entered into by the United States.<sup>93</sup>

Article IV of the treaty provided:

When an American enterprise, by reason of its participation in the management or capital of a French enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with a third enterprise, any profits which should normally have appeared in the balance sheet of the French enterprise, but which have been in this manner, diverted to the American enterprise, *are*, subject to the measures of appeal applicable in the case of the tax on industrial and commercial profits, incorporated in the taxable profits of the French enterprise.<sup>94</sup>

Under the treaty, the same principle applied in the case of profits similarly diverted from an American enterprise to a French enterprise.<sup>95</sup>

Carroll has observed that the language of article IV of the 1932 U.S.-France treaty was “modeled on” the statutory predecessor of section 482.<sup>96</sup> Further, article 5 of the 1933 Draft Convention may have been inspired by article IV of the 1932 U.S.-France treaty, as evidenced by textual similarities between the two provisions. Importantly, both imply some form of obligation: the 1932 U.S.-France treaty provided that diverted profits “are” to be included in the profits of the enterprise from which they have been diverted, and the 1933 Draft Convention provided that they “shall” be so included.

The adoption of the 1933 Draft Convention, and perhaps the ratification of the 1932 U.S.-France treaty, apparently prompted other countries to include provisions similar to article 5 of the 1933 Draft Convention in their bilateral treaties, with one significant modification—they changed the imperative “shall” in the 1933 Draft Convention to the permissive “may.” For example, in their tax treaty concluded on June 17, 1936, Hungary and Sweden included an article with such a modification.<sup>97</sup> Indeed, nearly all bilateral tax treaties

---

93. See Convention Concerning Double Taxation, Apr. 27, 1932, U.S.-Fr., art. IV, 49 Stat. 3145, 3146-47 (1935) (the United States ratified the treaty in 1932, France in 1935).

94. *Id.* (emphasis added).

95. See *id.*

96. See Mitchell B. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income, Part II*, 3 INT'L LAW. 129, 150 (1968).

97. See Agreement for the Avoidance of Double Taxation in the Matter of Direct Taxes, June 17, 1936, Hung.-Swed., Final Protocol, ¶ 9, reprinted in 1 WALTER H. DIAMOND & DOROTHY B. DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS 210, 214 (1975).

concluded after 1933 that contain provisions on the allocation of income among related enterprises have used the permissive term “may” (except for certain successors to the 1932 U.S.-France treaty).<sup>98</sup>

Perhaps not coincidentally, just two years after the Carroll Report had recommended adoption of the arm’s length standard, the U.S. Treasury Department, in 1935, promulgated regulations under the predecessor of section 482 calling for the use of the arm’s length standard. Those regulations provided in part that “[t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.”<sup>99</sup> Until major revisions were made in 1994, this language remained essentially unchanged in subsequent regulations issued under section 482.<sup>100</sup>

In the next decade and a half, the provisions of the 1933 Draft Convention relating to profit allocation found their way into two model bilateral conventions formulated under the auspices of the League Fiscal Committee, the “1943 Mexico Model” and the “1946 London Model.”<sup>101</sup> Article VII of the Protocol to both Models, dealing with the allocation of profits between related enterprises, was essentially identical to article 5 of the 1933 Draft Convention.<sup>102</sup>

The League of Nations Fiscal Committee recommended the continued conclusion of bilateral tax treaties in its 1946 report:

[I]t is becoming increasingly evident that the conclusion by an increasing number of States of bilateral treaties along the lines of the Model Conventions of London and Mexico constitutes the most adequate means of removing the existing serious tax obstructions to the international flow of capital and foreign trade.<sup>103</sup>

Following the 1943 Mexico and 1946 London Models, the next major model treaty was the Organisation for Economic Co-operation and Development (OECD) draft convention, adopted in 1963 (“1963

---

98. See generally the collected treaties reproduced in the multi-volume series including 1 DIAMOND & DIAMOND, *supra* note 97.

99. Treas. Reg. 86, art. 45-1(b) (1935).

100. Compare *id.* with Treas. Reg. § 1.482-1 (as amended by T.D. 8552, 59 Fed. Reg. 34,990 (1994)).

101. See *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations Doc. C.88.M.88.1946.II.A. (1946), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4319 [hereinafter *London and Mexico Models*].

102. Compare article VII of both models in *London and Mexico Models*, *supra* note 101, at 4402-3, with article 5 of the 1933 Draft Convention in *1933 Committee Report*, *supra* note 81, at 4245.

103. *Report on the Work of the Tenth Session of the Committee, Held in London from March 20th to 26th, 1946*, League of Nations Doc. C.37.M.37.1946.II.A. (1946), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4295, 4315.

OECD Model”).<sup>104</sup> This draft convention was the product of several years of work by the Fiscal Committee of the OECD’s predecessor, the Organisation for European Economic Co-operation (OEEC).<sup>105</sup> In its 1958 report, the OEEC Fiscal Committee recommended the elaboration of a new model bilateral convention acceptable to all OEEC member states<sup>106</sup> and envisioned additional harmonization by replacing the existing bilateral conventions with one multilateral convention.<sup>107</sup>

In 1960, the OEEC Fiscal Committee proposed model articles (articles XV and XVI) relating to the allocation of profits to permanent establishments and associated enterprises. These provisions closely tracked the 1943 Mexico and 1946 London Models. Article XV reiterated application of the independent enterprise standard to the allocation of profits to permanent establishments, but provided that it would not prohibit a state’s use of formulary apportionment where the state had a custom of doing so.<sup>108</sup> At the same time, the article affirmed that “the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this Article.”<sup>109</sup>

Article XVI, on the allocation of profits to associated enterprises, also reiterated the independent enterprise standard:

Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
  - b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
- and in either case conditions are made or imposed between the two enterprises *in their commercial or financial relations* which differ from those which would be made between *independent enterprises*, then any profits which would, but for those conditions, have

---

104. See DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL: REPORT OF THE O.E.C.D. FISCAL COMMITTEE (1963) [hereinafter 1963 OECD MODEL].

105. See *id.* at 7.

106. See *The Elimination of Double Taxation: Report of the Fiscal Committee of the O.E.E.C.* (1958), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4445, 4460 [hereinafter *1958 Report of the Fiscal Committee*].

107. See *id.*

108. See *The Elimination of Double Taxation: Third Report of the Fiscal Committee*, art. XV (1960), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4565, 4587 [hereinafter *Third Report of the Fiscal Committee*].

109. *Id.* art. XV(4).

accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, *may* be included in the profits of that enterprise and taxed accordingly.<sup>110</sup>

In the Commentary to article XVI, the OEEC Fiscal Committee indicated that the taxation authorities of a particular country “may” re-write the accounts of the enterprises for purposes of calculating tax liabilities

[i]f as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that country. It is evidently appropriate that rectification should be sanctioned in such circumstances, and the Article seems to call for very little comment. It should perhaps be mentioned that the provisions of the Article apply only if special conditions have been made or imposed between the two enterprises.<sup>111</sup>

The Fiscal Committee went on to emphasize that “no re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms.”<sup>112</sup>

Article XVI departed from the language of the 1933 Draft Convention and the 1943 Mexico and 1946 London Models by providing that a reallocation of profits “may” be made rather than “shall” be made. This change paralleled the use of “may” in the vast majority of actual bilateral treaties, as noted above.<sup>113</sup> The Fiscal Committee did not explain this change in its Commentary, however.<sup>114</sup> The Fiscal Committee simply reiterated that it had attempted to reflect standards that already had found their way into state practice and bilateral tax conventions among European countries.<sup>115</sup>

At its 1961 meeting, the OEEC Fiscal Committee adopted the text of an article on a mutual agreement procedure.<sup>116</sup> Generally, this article permitted taxpayers to present their cases to the relevant “competent authority” of their home state if they believed they would be subjected to double taxation not in accordance with the Convention.<sup>117</sup> The relevant competent authority was directed to

---

110. *Id.* art. XVI, at 4588 (emphasis added).

111. *Id.* at 4606.

112. *Id.*

113. For further discussion, see *infra* Part IV.

114. See *Third Report of the Fiscal Committee*, *supra* note 108, at 4581, 4606.

115. See *id.* at 4597-98.

116. See *The Elimination of Double Taxation: Fourth Report of the Fiscal Committee*, art. XXV (1961), reprinted in CONVENTIONS LEGISLATIVE HISTORY, *supra* note 43, at 4619, 4651 [hereinafter *Fourth Report of the Fiscal Committee*].

117. See *id.*

attempt to solve the problem on its own, but if this was not possible, it was to work toward a resolution “by mutual agreement with the competent authority of the other Contracting State.”<sup>118</sup> In its Commentary on this provision, the Fiscal Committee recommended that the mutual agreement procedure could be applied in cases involving the allocation of profits among associated enterprises.<sup>119</sup>

After the OECD superceded the OEEC in 1961 (at which time the United States and Canada joined its ranks) the above-mentioned articles on the allocation of profits to permanent establishments, on the allocation of profits between associated enterprises, and on the mutual agreement procedure were incorporated in nearly identical form in the 1963 OECD Model as articles 7, 9, and 25 respectively.<sup>120</sup> The portions of the final Commentary prepared in connection with the 1963 OECD Model relevant to articles 7, 9, and 25 were also virtually identical to the Commentaries quoted above in the original reports of the Fiscal Committee.<sup>121</sup>

In the 1960s and 1970s, the United States, by now the world’s largest commercial actor, began to fear revenue losses from transfer pricing abuses, because there were still no clear rules for allocation.<sup>122</sup> The U.S. Treasury Department thus acted to promote the adoption of an international norm in this area: the arm’s length standard.<sup>123</sup> Congress, however, also considered the idea of endorsing formulary apportionment as a means of preventing transfer pricing abuses. In 1962, a proposed amendment to section 482 would have explicitly authorized the Treasury Department to use a formula to reallocate income in the case of sales or purchases between a U.S. corporation and its controlled foreign subsidiary.<sup>124</sup> Although approved by the House of Representatives, the provision was not included in the Senate version of the bill (or in the ultimately enacted law). Nevertheless, the Conference Committee report indicated that both the House and the Senate conferees believed that the objectives of the House bill could be realized by amending the regulations under

---

118. *Id.*

119. *See id.* at 4697-98.

120. *Compare Third Report of the Fiscal Committee, supra* note 108, at 4587-88 *and Fourth Report of the Fiscal Committee, supra* note 116, at 4651 *with* 1963 OECD MODEL, *supra* note 104, at 45-47, 56.

121. For the relevant portions of the Commentary on the 1963 OECD Model, see 1963 OECD MODEL, *supra* note 104, at 79-89, 93, 155-56.

122. *See* Langbein, *supra* note 38, at 642-43.

123. *See id.* at 643.

124. *See* H.R. REP. NO. 1447, at 28-29 (1962).

section 482.<sup>125</sup> They expressed the view that “the Treasury should explore the possibility of developing and promulgating regulations under [the] authority [of section 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.”<sup>126</sup>

At least partly in response to this invitation, the Treasury Department began to develop additional substantive guidelines under section 482 and adopted new regulations in 1968.<sup>127</sup> These regulations did not endorse a formulary approach, as originally suggested by the 1962 Conference Committee report. Rather, they reiterated, almost verbatim, the original language from the 1935 regulations promulgating the arm’s length standard. They then specified particular methods for applying that standard to different types of transactions, including the CUP, cost plus, and resale price methods.<sup>128</sup>

A few years before the issuance of the 1968 section 482 regulations, the U.S. Treasury Department began an international campaign to persuade other countries to adopt similar allocation principles. In a 1965 speech before the Tax Institute of America, Assistant Secretary of the Treasury Stanley Surrey explained why the United States sought worldwide acceptance of its version of the arm’s length standard. Emphasizing that “a unilateral approach by the United States, or any country, is not sufficient,” and that “the ultimate goal [must be] an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions,” assistant Secretary Surrey suggested that the new U.S. section 482 regulations “may prove helpful as a starting point [for the OECD’s efforts to establish allocation standards] and as a way of focusing attention on a wide range of issues.”<sup>129</sup> It is noteworthy that Surrey highlighted the problems stemming from the general lack of clear international norms of any sort, not the particular shortcomings of formulary apportionment or other allocation methods.<sup>130</sup>

In 1971, Stanley Surrey and David Tillinghast co-authored a general report on responses to a questionnaire circulated by the

---

125. See H.R. CONF. REP. NO. 2508, at 18-19 (1962), *reprinted in* 1962-3 C.B. 1129, 1146-47.

126. *Id.* at 1147.

127. See Treas. Reg. § 1.482-1, -2 (as amended in 1968).

128. See *id.*

129. *Secretary Surrey Reports on Developments in Treasury’s Foreign Tax Program*, 24 J. TAX’N 54, 56 (1966).

130. See Langbein, *supra* note 38, at 648.



International Fiscal Association (IFA).<sup>131</sup> While alleging that “virtually all of the reporting countries utilize an ‘arm’s length’ standard,” Surrey and Tillinghast emphasized that countries varied in the extent to which they addressed allocation issues in statutory rules or regulations.<sup>132</sup> Their report acknowledged that, in many cases, governments were spurred to address the issue of allocation only because the United States more aggressively applied its own version of the arm’s length standard in the 1968 regulations, resulting in negative adjustments to the taxable income of foreign subsidiaries of U.S. corporations.<sup>133</sup>

Probably under the influence of the United States, the OECD in the 1970s publicly advocated the arm’s length standard and decisively rejected formulary apportionment. In 1967, the OECD Fiscal Committee, renamed the Committee on Fiscal Affairs in 1971, began reviewing and revising the 1963 OECD Model. In 1977, the OECD promulgated a new model tax treaty (the “1977 OECD Model”) that essentially replicated the provisions of the 1963 OECD Model addressing allocation and the mutual agreement procedure.<sup>134</sup> Significantly, the 1977 OECD Model added a new paragraph to Article 9, which became paragraph 2. Paragraph 2 dealt with correlative (or “corresponding”) adjustments to the income of related corporations. It provided:

Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State *and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises*, then that other State *shall* make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this

---

131. See Stanley Surrey & David Tillinghast, *General Report, Allocation of Income and Expenses Between Related Entities Under Common Control*, 56b CAHIERS DE DROIT FISCAL INTERNATIONALE I/1 (1971).

132. *Id.* at I/12-13.

133. See *id.* at I/12.

134. See MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL: REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS 11 (1977) [hereinafter 1977 OECD MODEL]. The 1977 version of paragraph 1 of article 9 was identical to the 1963 version of article 9; the 1977 version of article 7 was nearly identical to the 1963 version. The 1977 version of article 25, however, made certain changes to the mutual agreement procedure. Compare *id.* arts. 7, 9, 25 with 1963 OECD MODEL, *supra* note 104, arts. 7, 9, 25.

Convention and the competent authorities of the Contracting States *shall if necessary consult each other*.<sup>135</sup>

Two years later, the OECD issued a detailed report on transfer pricing (the “1979 OECD Report”).<sup>136</sup> The report first maintained that “there is a broad consensus among governments of developed and developing countries and MNEs that *arm’s length pricing is the appropriate approach* to adopt in arriving at profits for tax purposes. Modern bilateral double taxation conventions between OECD Member States and between OECD Members and other States have accordingly *adopted this principle*.”<sup>137</sup> In general, the 1979 OECD Report recommended that member states adopt an approach similar to the U.S. regulations.

Perhaps most importantly, the 1979 OECD Report adamantly rejected the permissibility of formulary apportionment under the OECD Models. The Report asserted that the use of alternatives that moved away from the arm’s length approach and towards “global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates [was] incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention.”<sup>138</sup> The 1979 OECD Report also criticized formulary apportionment on a number of policy grounds. These included the fact that the

uncoordinated use [of formulary apportionment] by the tax authorities of several countries would involve the danger that, overall, the MNE affected would suffer double taxation of its profits. *This is not to say, however, that in seeking to arrive at the arm’s length price in a range of transactions, some regard to the total profits of the relevant MNE may not be helpful, as a check on the assessment of the arm’s length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available*.<sup>139</sup>

In the emphasized sentence, the OECD Report appeared to admit the possibility of some use of transactional profit split methods and, perhaps, classic formulary apportionment in very special circumstances where two countries could agree on their use.<sup>140</sup> The

---

135. 1977 OECD MODEL, *supra* note 134, art. 9(2) (emphasis added).

136. *See generally* TRANSFER PRICING AND MULTINATIONAL ENTERPRISES: REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS (1979) [hereinafter 1979 OECD REPORT].

137. *Id.* ¶ 3, at 8-9 (emphasis added).

138. *Id.* ¶ 14, at 14.

139. *Id.* at 14-15 (emphasis added).

140. *See id.*

1979 OECD Report also suggested that the limited use of the comparable profits method could be helpful, but that comparisons of profits should be used “only as pointers to further investigation.”<sup>141</sup>

While the OECD revised its model and drafted the 1979 OECD Report, the U.S. Treasury Department developed its own model conventions, issuing versions in 1976, 1977, and 1981.<sup>142</sup> The model conventions were based largely on the 1977 OECD Model. However, the model conventions included a new paragraph 3 in article 9 on associated enterprises. For example, in the 1981 version (“1981 U.S. Model”), paragraph 3 stated that the provisions of the paragraph setting forth the arm’s length standard (paragraph 1) “shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between [related] persons . . . when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.”<sup>143</sup> This provision was apparently added to ensure that the IRS could continue to apply the provisions of section 482 and the 1968 regulations in determining an arm’s length price.

Meanwhile, the United Nations was developing its own model tax treaty between developed and developing countries. In 1967, the U.N. Economic and Social Council (ECOSOC) requested the Secretary-General to appoint a Group of Experts on Tax Treaties between Developed and Developing Countries (“Group of Experts”).<sup>144</sup> In the summary of the deliberations at its seventh session in 1978, the Group of Experts unanimously recognized the “validity of the arm’s length principle” and affirmed that governments “should” apply the principle “wherever appropriate.”<sup>145</sup> The Group of Experts further stated that

for the time being it did not seem feasible to initiate preparatory

---

141. *Id.* ¶ 71, at 42-43.

142. See United States Model Convention on Income and Capital, May 13, 1976, *reprinted in* 10 WALTER H. DIAMOND & DOROTHY B. DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS, 417 (1976); Treasury Department Model Income Tax Treaty of May 17, 1977, *reprinted in* 1 TAX TREATIES (CCH) ¶ 208 (Dec. 1999); Treasury Department’s Model Income Tax Treaty of June 16, 1981, *reprinted in* 1 TAX TREATIES (CCH) ¶ 211 (Dec. 1999) [hereinafter 1981 U.S. Model].

143. 1981 U.S. Model, *supra* note 142, art. 9(3), ¶ 211.09.

144. See E.S.C. Res. 1273, U.N. ESCOR, 43rd Sess., Supp. No. 1, at 5, U.N. Doc. E/4429 (1967).

145. U.N. DEP’T OF ECONOMIC & SOCIAL AFFAIRS, REPORT OF THE GROUP OF EXPERTS ON TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES ON THE WORK OF ITS SEVENTH MEETING at 62, U.N. Doc. ST/ESA/79, U.N. Sales No. E.78.XVI.1 (1978) [hereinafter SEVENTH REPORT].

work for the conclusion of a multilateral agreement that could cover all the controversial issues involved in transfer pricing. The Group agreed that at the present time the matter of transfer pricing arrangements should be settled . . . in the course of the negotiations on bilateral tax treaties.<sup>146</sup>

It further “expressed its readiness to consider a draft model convention between developed and developing countries.”<sup>147</sup>

In his report to ECOSOC in 1978, the Secretary-General endorsed this idea,<sup>148</sup> and the Group of Experts began developing a model. In 1979, the Group of Experts adopted the final text of the model convention (“U.N. Model”).<sup>149</sup>

Article 9 of the U.N. Model was essentially identical to article 9 of the 1977 OECD Model.<sup>150</sup> The Group of Experts’ Commentary on article 9 replicated much of the 1977 OECD Commentary.<sup>151</sup> It reiterated that, under paragraph 1, “the tax authorities of a Contracting State *may*, for the purpose of calculating tax liabilities . . . ‘rewrite the accounts of the [separate] enterprises if . . . the accounts do not show the true taxable profits . . . .’”<sup>152</sup>

Article 25, which dealt with the mutual agreement procedure, was also very similar to the 1977 OECD Model, with some minor differences.<sup>153</sup> In its Commentary on paragraph 4 of article 25, the Group of Experts affirmed that “transactions between related entities *should* be governed by the standard of ‘arm’s length dealing’; as a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard, the taxable profits *may* be redetermined.”<sup>154</sup> Finally, the report on the U.N. Model saw the conclusion of bilateral treaties as paving the way ultimately for a worldwide convention and also for regional or subregional conventions.<sup>155</sup>

146. *Id.*

147. *Id.* at 61.

148. *Work of the Group of Experts on Tax Treaties Between Developed and Developing Countries: Report of the Secretary-General* ¶ 15, U.N. Doc. E/1978/36 (1978).

149. *See* U.N. DEP’T OF INT’L ECONOMIC & SOCIAL AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES at 4, 13, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. MODEL].

150. *See id.* at 27, 105.

151. *See id.* at 105-08.

152. *Id.* at 106 (emphasis added).

153. *See id.* at 40, 234.

154. *Id.* at 234 (emphasis added).

155. *See id.* at 12.

In the United States, a 1981 report prepared by the General Accounting Office (GAO) disputed the 1979 OECD Report's categorical rejection of formulary methods. It acknowledged, however, that formulary apportionment would be incompatible with the OECD Models and recommended that the United States not adopt formulary apportionment unilaterally, but instead educate other states about its benefits.<sup>156</sup>

During the mid-1980s, the U.S. Congress expressed renewed concern about transfer pricing abuses. In 1986, Congress noted that “[m]any observers have questioned the effectiveness of the ‘arm’s length’ approach of the regulations under section 482. A recurrent problem is the absence of comparable arm’s length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm’s length concept in the absence of comparables.”<sup>157</sup> Congress found that the most serious problems involved the case of “transfers of high-profit potential intangibles,” such as intellectual property.<sup>158</sup> In response to a congressional request for “a comprehensive study of intercompany pricing rules,” the Treasury Department issued the 1988 White Paper.<sup>159</sup> After reviewing the history of model and bilateral tax treaties and the practices of major trading partners, the 1988 White Paper concluded:

The arm’s length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm’s length standard as its frame of reference in transfer pricing cases. This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm’s length standard. It is equally clear as a policy matter that, in the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm’s length standard.<sup>160</sup>

---

156. See UNITED STATES GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS BY THE COMPTROLLER GENERAL OF THE UNITED STATES: IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL CORPORATIONS 56-57 (1981).

157. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION AND RELEASED MAY 7, 1987 1014 (1987).

158. *Id.*

159. See 1988 White Paper, *supra* note 32.

160. *Id.* at 475.

Despite its defense of the arm's length standard as an international norm, the Treasury Department, like Congress, was concerned about the difficulty of finding comparable transactions. It sought to revise the 1968 regulations in order to refine the general methods for determining an arm's length price. In January 1992 it proposed amendments to the regulations. Importantly, and controversially, the Treasury Department introduced a mandatory "comparable profit interval" test (reflecting a "comparable profit method") designed to serve as a check on the result indicated by the traditional methods for determining an arm's length price.<sup>161</sup> However, U.S. treaty partners and the OECD protested that an overly strict application of the comparable profit interval test would violate the arm's length standard.<sup>162</sup>

The Treasury Department issued temporary and proposed regulations in January 1993 that significantly restructured the 1968 regulations and also attempted to allay some concerns of the OECD and U.S. treaty partners about the 1992 proposed regulations by retracting mandatory use of the comparable profit method. The regulations reaffirmed the arm's length standard and required that the results of a transaction be consistent with arm's length results.<sup>163</sup> An important innovation of the temporary regulations was the establishment of a more flexible "'best method rule' for selecting the method to be applied to test the arm's length character of a controlled transaction."<sup>164</sup> In July 1994, the Treasury Department promulgated final regulations, which essentially followed the 1993 temporary regulations with a few minor changes.<sup>165</sup> Consistent with these new regulations, in March 1998 the Treasury Department released proposed regulations on the allocation of income from global securities dealing operations that permitted the use of the profit split method.<sup>166</sup>

---

161. See the Treasury Department's Explanation of Provisions in 57 Fed. Reg. 3574 (1992); Prop. Treas. Reg. § 1.482-2(d)(5), (e)(1)(iii)-(iv), *in id.* at 3583-84, 3586. For the rules on applying the comparable profit interval test, see Prop. Treas. Reg. § 1.482-2(f), *in id.* at 3586-95.

162. See, e.g., ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAX ASPECTS OF TRANSFER PRICING WITHIN MULTINATIONAL ENTERPRISES: THE UNITED STATES PROPOSED REGULATIONS: A REPORT BY THE COMMITTEE ON FISCAL AFFAIRS ON THE PROPOSED REGULATIONS UNDER SECTION 482 IRC 26-36 (1993).

163. Temp. Treas. Reg. § 1.482-1T(b)(1) (as amended in 1993).

164. 58 Fed. Reg. 5263, 5265-66 (1993); see Temp. Treas. Reg. § 1.482-1T(b)(2)(iii)(A) (as amended in 1993).

165. See Intercompany Transfer Pricing Regulations Under Section 482, 59 Fed. Reg. 34,971, 34,975 (1994); Treas. Reg. §§ 1.482-1 - 1.482-8 (1994).

166. See 63 Fed. Reg. 11,177, 11,181-82 (1998); Prop. Treas. Reg. § 1.482-8(e), *in id.* at

During the 1990s, the Treasury Department also promoted the use of “advance pricing agreements” or “APAs.”<sup>167</sup> APAs are agreements under which a U.S. taxpayer, the Internal Revenue Service, and, in certain cases, authorities of other countries agree in advance on a particular methodology for establishing transfer prices. The objective of the program is to satisfy the concerns of all parties, while avoiding the costs and uncertainties of future litigation over transfer pricing issues.<sup>168</sup>

Meanwhile, the Treasury Department and the GAO continued to study transfer pricing problems and abuses.<sup>169</sup> In an appendix attached to a 1992 report, the Treasury Department reproduced a joint statement from the tax administrations of France, Germany, the United Kingdom, and the United States. The statement rejected the use of formulary methods “as a general substitute for the arms length approach” but indicated that the “use of formulae should not . . . be entirely ruled out. In some industries and in some circumstances the use of a formula might be appropriate assuming that the formula attempted to approximate an arms length result.”<sup>170</sup>

In the first half of the decade, the OECD undertook a comprehensive, systematic effort to update the 1977 OECD Model and the transfer pricing guidelines of the 1979 OECD Report. It issued a revised model in 1992, which the Committee on Fiscal Affairs decided to review on an ongoing basis, revising the text or commentary as it deemed advisable. The most recent major revision was conducted in 1997 (the “1997 OECD Model”).<sup>171</sup> In 1995, the OECD issued new transfer pricing guidelines (the “1995 Transfer Pricing Guidelines”)<sup>172</sup> that reiterated the organization’s vehement

---

11,192-95 (1998).

167. See Rev. Proc. 91-22, 1991-1 C.B. 526; Rev. Proc. 96-53, 1996-2 C.B. 375.

168. See *id.*

169. See, e.g., Treasury Department, *Report on the Application and Administration of Section 482*, reprinted in 92 TAX NOTES INT’L 16-42 (Apr. 15, 1992) [hereinafter *1992 Report on Section 482*]; U.S. General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices*, reprinted in 92 TAX NOTES TODAY 147-46 (July 20, 1992) (discussing the advantages and disadvantages of formulary apportionment).

170. Report of Agreed Discussions Between the Tax Administrations of France, Germany, the United Kingdom and the United States ¶¶ 3.4-3.5, in *1992 Report on Section 482*, *supra* note 169, Appendix E.

171. See 1 OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (UPDATED AS OF 1ST NOVEMBER 1997) I-4 (1997) [hereinafter 1997 OECD MODEL]. For the text of the model, see *id.* at M-1 to M-57.

172. See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (1995) [hereinafter 1995 TRANSFER PRICING GUIDELINES].

opposition to formulary apportionment.<sup>173</sup> In particular, the OECD affirmed that the

most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question . . . . Reaching such agreement would be time-consuming and extremely difficult.<sup>174</sup>

Further, the OECD argued that by “disregarding intra-group transactions for the purpose of computing consolidated profits, a global formulary apportionment method . . . would involve a rejection of a number of rules incorporated in bilateral tax treaties” (presumably including rules patterned after article 9 of the OECD Models).<sup>175</sup>

However, the 1995 Transfer Pricing Guidelines did give a limited endorsement to what they called “‘transactional profit methods’ . . . that examine the profits that arise from particular transactions among associated enterprises,” and, in particular, the profit split method.<sup>176</sup> They also cautiously endorsed the “transactional net margin method,” which is similar to the comparable profits method.<sup>177</sup> The Guidelines emphasized, however, that such profit-based methods

can be accepted only insofar as they are compatible with Article 9 of the OECD Model Tax Convention, especially with regard to comparability. *This is achieved by applying the methods in a manner that approximates arm’s length pricing*, which requires that the *profits arising from particular controlled transactions* be compared to the profits arising from comparable transactions between independent enterprises.<sup>178</sup>

In 1996, the Treasury Department issued a new model U.S. tax treaty (the “1996 U.S. Model”). In the model’s technical explanation, the Treasury Department explained that it based the model on both the 1981 U.S. Model and the latest (1995) revision of the OECD Model.<sup>179</sup> The 1996 U.S. Model made a number of relevant revisions

173. *See id.* ¶ 3.1, at III-1, ¶¶ 3.58-3.74, at III-19-24.

174. *Id.* ¶ 3.64, at III-21.

175. *Id.* ¶ 3.72, at III-23-24.

176. *Id.* ¶¶ 3.1, 3.5-3.25, at III-1-9.

177. *See id.* ¶¶ 3.1, 3.26-3.48, at III-1, III-9-16.

178. *Id.* ¶¶ 3.1-3.4, at III-1-2 (emphasis added).

179. *See* Treasury Department Technical Explanation of the United States Model Income Tax Convention (Sept. 20, 1996), reprinted in 1 TAX TREATIES (CCH), *supra* note 142, ¶ 214A (Dec. 1999) [hereinafter 1996 Technical Explanation].



to the 1981 U.S. Model.<sup>180</sup> For example, it eliminated paragraph 3 of article 9, which had reserved to contracting states the right to apply their own internal laws on allocation. It also modified the text of paragraph 2 on correlative adjustments.

Today, most countries apparently allocate profits between related enterprises based on the umbrella arm's length standard, with a strong preference for the arm's length method in particular.<sup>181</sup> And there are more than one thousand bilateral treaties among various countries incorporating the arm's length standard based on article 9 of the OECD and U.N. Models.<sup>182</sup>

As this historical account demonstrates, a number of problems and issues exist concerning the authority of the arm's length standard under international law. To what degree are states obligated to use the broad arm's length standard under article 9 of the OECD, U.N., and U.S. Models? Beyond the traditional arm's length method, what particular methods qualify as consistent with the standard? How far can states go in using classic formulary apportionment or empirical methods that depart from the arm's length method, such as the comparable profits method or profit split methods, without violating their treaty obligations? Moreover, the history of attempts to codify the arm's length standard raises the question of whether the vast network of bilateral tax treaties that incorporate provisions closely tracking article 9 has helped to establish the arm's length standard as a norm of customary international law.

As indicated in Part I, these questions provide an opportunity to explore, at a more theoretical level, the reasons why treaties or customary international law should be treated as authoritative, and how standards evolve to become binding treaty or customary international law norms. In this connection, Part III will first attempt to clarify the concept of "authority," and to develop a normative theory regarding the authority of international norms.

---

180. Compare United States Model Income Tax Convention of September 20, 1996, reprinted in 1 TAX TREATIES (CCH), *supra* note 142, ¶ 214 (Dec. 1999) [hereinafter 1996 U.S. Model], with 1981 U.S. Model, *supra* note 142.

181. For a modern-day survey of transfer pricing practices, including information on use of the arm's length standard, see, e.g., CROSS-BORDER TRANSACTIONS BETWEEN RELATED COMPANIES: A SUMMARY OF TAX RULES (William R. Lawlor ed., 1985).

182. These treaties are reproduced in the multi-volume series including 1 DIAMOND & DIAMOND, *supra* note 97.

### III. A CONCEPTUAL AND NORMATIVE ANALYSIS OF AUTHORITY

This Part begins by developing a conceptual model of authority and a general normative theory of authoritative international norms, drawing on philosophical and political literature, including insights from game theory. It then applies this model and theory to the history of the arm's length standard to determine in what ways the standard has been claimed to be authoritative and to suggest, normatively, what degree of authority it generally ought to enjoy.

#### A. Clarifying the Concept of Authority and Developing a Normative Theory of Authoritative International Norms

1. *A Model of Authority.* The immense amount of philosophical literature exploring the nature of “authority” is rife with controversy.<sup>183</sup> Nevertheless, almost all philosophers and legal theorists who have studied the notion of authority agree that it conveys a relationship in which an actor acts in accordance with a directive or norm out of a *sense of obligation*. To act out of a sense of obligation means that an actor allows its own decision-making process—that is, the actor's own “independent judgment”—to be preempted by an authoritative norm. In this sense, the actor can be said to “obey” the norm.<sup>184</sup>

One way of understanding the concept of authority is through a model of decision making elaborated by Oxford University legal philosopher Joseph Raz.<sup>185</sup> Raz posits that actors normally make decisions to act in accordance with the “balance” of what he calls “first-order reasons” for and against an action.<sup>186</sup> Raz implicitly defines “first-order reasons” as including reasons “on the merits” for or against the action. They also can include threats or requests.<sup>187</sup> To take a relevant example, we can consider all the substantive policy

---

183. For examples of influential essays on the nature of authority, see generally AUTHORITY (Joseph Raz ed., 1990).

184. On the central significance of preemption in distinguishing authority from other types of relationships, see Joseph Raz, *Introduction*, in *id.* at 1, 5.

185. While the author does not subscribe to all of the details of Raz's model (or his philosophy generally), Raz's model helps to provide insights into the nature of the authority of international legal norms in general and of the arm's length standard in particular.

186. See JOSEPH RAZ, PRACTICAL REASON AND NORMS 36 (1990).

187. See Figure 1. For reasons “on the merits,” see Raz's example in RAZ, *supra* note 186, at 37. On “content-independent” reasons such as threats or requests, see JOSEPH RAZ, THE MORALITY OF FREEDOM 35-37 (1986).

arguments (other than those invoking some notion of an “obligation”) made in the income allocation debate as first-order reasons for or against retention of the arm’s length standard. The weight that these reasons receive depends on their merits.

Raz also notes that the particular first-order reasons an actor considers in deciding how to act may be affected by what he calls “second-order reasons.”<sup>188</sup> A second-order reason is “any reason to act for a reason or to refrain from acting for a reason.”<sup>189</sup> In particular, what he calls an “exclusionary reason” is a “second-order reason to refrain from acting for some reason.”<sup>190</sup> Raz argues that exclusionary reasons will cause actors to exclude some, but not necessarily all, first-order reasons for or against a specific action.<sup>191</sup> According to Raz, exclusionary reasons are not weighed against the strength of first-order reasons; rather, by their nature, exclusionary reasons always prevail over first-order reasons that they exclude.<sup>192</sup>

Raz uses this model of first-order and second-order reasons to elucidate the preemptive effect of an authoritative norm. According to Raz’s theory, an authoritative norm is both an additional first-order reason in favor of the norm’s prescribed action and a second-order reason to exclude some or all of the actor’s existing first-order reasons against, or in favor of, the action.<sup>193</sup> The weight of the norm as a first-order reason will depend on “the strength of the reasons for the norm which are reasons for doing what is required by the norm . . . except those [reasons] which justify its character as an exclusionary reason.”<sup>194</sup>

---

188. RAZ, *supra* note 186, at 36.

189. *Id.* at 39.

190. *Id.*

191. *Id.* at 39-40.

192. *See id.* at 40.

193. *See* J. Raz, *Authority and Justification*, in *AUTHORITY*, *supra* note 183, at 115, 124. Although Raz’s conception of authority has been subject to debate, a number of other scholars have generally concurred with it. *See, e.g.*, J.M. Finnis, *Authority*, in *AUTHORITY*, *supra* note 183, at 174, 176; H. L. A. Hart, *Commands and Authoritative Legal Reasons*, in *AUTHORITY*, *supra* note 183, at 92, 93. However, other philosophers argue that Raz’s concept of second-order reasons is faulty and that all decisions involve a “first-order” consideration and weighing of all reasons for and against an action. Under this account, an authoritative norm prescribing an action is simply another first-order reason in favor of the action. It thus has no “preemptive effect” in the sense of reducing the weight that existing reasons otherwise deserve. *See, e.g.*, Chaim Gans, *Mandatory Rules and Exclusionary Reasons*, 15 *PHILOSOPHIA* 373 (1986).

194. RAZ, *supra* note 186, at 77; *see* Figure 2. Note that Raz views it as appropriate to exclude even reasons in favor of the action, apart from the norm, because under Raz’s conception these existing favorable reasons are taken into account in determining the weight of the norm as a remaining first-order reason in favor of the action. The resulting weight must

For example, under Raz's model, if the arm's length standard were treated as an authoritative norm under existing treaties or under customary international law, Congress would exclude most of the existing first-order policy reasons for or against the arm's length standard in determining whether to retain it, rather than weigh these considerations against the additional "weight" of the norm. The weight of the first-order policy reasons in favor of the arm's length standard (such as its alleged greater flexibility and lower compliance costs) would in turn determine the weight of the arm's length norm. This weight, however, would not include those reasons that may justify treating the norm as authoritative (that is, as an exclusionary reason) under treaties or customary international law. Such reasons would include, as analyzed in the next section, the norm's ability to facilitate coordination of income allocation policies so as to avoid economic double taxation.

Some legal philosophers, such as Stephen R. Perry, have refined Raz's conception of authority.<sup>195</sup> Perry regards a norm as authoritative so long as it has any effect on an actor's own judgment of *how much weight* to give to a first-order reason, even if the norm does not entirely exclude the first-order reason.<sup>196</sup> Thus, some authoritative norms may "only partially" preempt one's judgment of the balance of first-order reasons.<sup>197</sup> In addition, while Raz maintains that authoritative norms affect (and indeed exclude) the weight that certain first-order reasons objectively merit,<sup>198</sup> Perry views authoritative norms as affecting an actor's *subjective perception* of the weight of various first-order reasons.<sup>199</sup>

In particular, Perry generalizes the notion of a "subjective second-order reason" to mean "a reason to treat a reason as having a greater or lesser weight than the agent would otherwise judge it to possess in his or her subjective determination of what the objective balance of reasons requires."<sup>200</sup> Perry considers an exclusionary reason to be "just the special case of a reason to treat a reason as having zero weight," and redefines second-order reasons as

---

then be compared with the weight of non-excluded reasons against the action in order to determine what action to take. See RAZ, *supra* note 186, at 76-80.

195. See Stephen R. Perry, *Second-Order Reasons, Uncertainty and Legal Theory*, 62 S. CAL. L. REV. 913, 932-33 (1989).

196. See *id.*

197. See *id.* at 932.

198. See Joseph Raz, *Facing Up: A Reply*, 62 S. CAL. L. REV. 1153, 1178 (1989).

199. See Perry, *supra* note 195, at 927-32.

200. *Id.* at 932.

“reweighting” reasons.<sup>201</sup> Perry maintains that this conception of second-order reasons helps explain such phenomena as legal presumptions and the doctrine of precedent.<sup>202</sup> In short, Perry persuasively argues that a claim in favor of *any* reduction in the weight of an existing reason interferes with the independent reasoning of an actor and therefore asserts a degree of obligation.<sup>203</sup> Raz has acknowledged the merits of Perry’s argument and views his notion of second-order “reweighting” reasons as simply a generalization of the concept of an exclusionary reason.<sup>204</sup>

Using Raz’s model of decision making and authority, as refined by Perry, authority may be distinguished from pure persuasion and coercion. This distinction is commonly made by many social scientists who regard authority, persuasion, and coercion as alternative means of “social influence.”<sup>205</sup> Persuasion differs from authority in that it does not have preemptive effect. An actor’s own decision-making process incorporates and accommodates a persuasive argument. Social psychologists often say that the target actor has “internalized” the persuasive argument.<sup>206</sup> Once actors are persuaded by an argument, they change their assessment of the balance and weight of first-order reasons. The essence of persuasion is that this process of “rethinking” first-order reasons is entirely voluntary.<sup>207</sup>

While persuasion, unlike authority, does not endow a norm with preemptive effect, persuasion still plays a role in authority relations. From the perspective of a target actor, the act of allowing a norm to preempt one’s own decision making is still a voluntary act. That is, an actor must be voluntarily persuaded (for some reason or reasons) to give preemptive effect to a particular norm by treating it as a second-order reason for excluding or affecting the weight she would otherwise give to first-order reasons.<sup>208</sup> Thus, we might perceive the “paradox” of authority: it represents an *obligation* one *voluntarily* agrees to accept.<sup>209</sup>

---

201. *Id.*

202. *See id.* at 933.

203. *See id.* at 932-33.

204. *See Raz, supra* note 198, at 1178-79.

205. *See, e.g.,* ELLIOTT ARONSON, *THE SOCIAL ANIMAL* 1-11 (7<sup>th</sup> ed. 1995). On authority and obedience, *see id.* at 40-46; on persuasion, *see id.* at 57-117; on coercion, *see id.* at 103-4.

206. *See, e.g., id.* at 36.

207. *See* Figure 3.

208. *See, e.g., Raz, supra* note 193, at 119-20.

209. On the “paradox” of authority, *see, for example, Raz, supra* note 184, at 6.

As will be discussed below, a threat of coercion often is part of an authority claim. A particular actor who chooses not to allow such a claim to have preemptive effect over her own decision making may nevertheless conform because of the threat of coercion. In such a case, however, the actor is not conforming because she voluntarily accepts the claim of authority, but because of the threatened coercion.

Although it is common to speak of many norms, or perhaps the advice of experts, as having “authority,” what is often meant is that the norms or advice in question are persuasive. They have what might be called “persuasive weight” or, more simply, “persuasiveness” as good first-order reasons for taking an action or for changing one’s view of the balance of first-order reasons. But such norms are not authoritative in the sense just described if they do not preempt an actor’s own decision-making process, or, in other words, if they do not also constitute second-order reasons.<sup>210</sup>

At the other extreme, coercion prompts an actor to act in a certain way because of a threat of severe harm, which becomes an overwhelming first-order reason for the demanded action that outweighs any existing first-order reasons against the action. The actor does not voluntarily reduce the weight of these reasons, as in the case of an authoritative norm.<sup>211</sup> Of course, in the case of any particular authority claim, the claim may be paired with coercive threats—indeed, the essence of government is just such a union. And target actors may demand that in order for them to be willing to recognize an obligation to obey, an actor claiming authority must also have the power to coerce others—a nuance explored below. Yet the concepts of authority and coercion have too often been regarded as synonymous, as legal philosopher H. L. A. Hart emphasized in his 1960 classic analysis, *The Concept of Law*.<sup>212</sup>

The above conception of authority helps identify two dimensions of authority on which this Article will focus. The first is the *degree of preemptive effect* exercised by an authoritative norm. The second dimension involves the *reasons for a norm’s preemptive effect*—the subjective reasons why an actor voluntarily gives a norm some degree of preemptive effect. These reasons may be referred to as *legitimacy criteria*, because a norm that is considered legitimate by an actor is

---

210. Raz seems to concur with this distinction by acknowledging that theoretical (i.e., expert) authorities “do not impose obligations and there is no obligation to obey them.” *Id.*

211. See RAZ, *supra* note 186, at 83.

212. See H. L. A. HART, *THE CONCEPT OF LAW* 18-20 (1961).

actually given preemptive effect by that actor.<sup>213</sup> Of course, a target actor can give a norm different degrees of legitimacy, that is, different degrees of preemptive effect on her decision making.

It is also possible to distinguish among three forms of authority based on the perspectives of different actors. The first form is *claimed authority*. This is the authority claimed by an actor for herself or on behalf of a norm. The perspective involved is that of the claiming actor. A claim usually asserts that the norm has a certain degree of preemptive effect and that there are particular reasons why the target actor should give it such preemptive effect. Relevant illustrations of claimed authority are the OECD's and the Treasury Department's claims on behalf of the arm's length standard as an authoritative norm.

The second form of authority is *empirical authority*. Empirical authority involves the actual acceptance of authority by a target actor. The perspective involved is that of the target actor. Empirical authority relates to the actual degree of preemptive effect a target actor gives a norm and the reasons the actor actually adopts for giving it such preemptive effect.

The third form of authority is *normative authority*. This is authority that *ought* to be recognized by a target actor. The perspective involved is that of an outside observer establishing normative standards for accepting authority. Normative authority includes an assertion about the degree of preemptive effect that should be given to a norm and the reasons that support giving it such preemptive effect. The purpose of this Part is to develop a theory of the normative authority of international norms such as the arm's length standard.

It should be noted that the degree of preemptive effect that is claimed for, that is actually given, or that ought to be given to a norm (including which types of first-order reasons are to be altered or excluded) may be affected by the *character* of the norm as legal, moral, or social. This character is usually attributable to the intended domain of the norm.<sup>214</sup> It is thus possible to distinguish between legal, moral, and social authority.

---

213. See, e.g., Raz, *supra* note 193, at 120.

214. See G. E. M. Anscombe's emphasis in her definition of authority that authority involves a claim to a right to be obeyed in a particular "domain of decision." G. E. M. Anscombe, *On the Source of the Authority of the State*, in *AUTHORITY*, *supra* note 183, at 142, 144.

a. *Binding Authority.* Returning to a closer examination of the concept of preemptive effect, according to Raz, a “mandatory” norm, as noted earlier, is one that is intended to be adopted not only as an additional first-order reason for the target actor to take the desired action (whose weight will depend on the reasons already favoring that action), but also as a second-order reason for that actor to exclude (give zero weight) to some or all of the other reasons the actor already had against or in favor of that action.<sup>215</sup>

We might refer to mandatory norms as having “binding authority” and imposing “binding obligations.” The “degree” of their preemptive effect will obviously depend on which other reasons, and how many of them, are excluded. Thus, there is room for vast variation in the actual effect of recognizing even “binding” obligations. Further, norms imposing binding obligations may delegate certain powers to particular actors or prescribe, prohibit, or permit certain conduct.<sup>216</sup> In the case of binding prohibitions, for example, the prohibition is a reason to exclude all (or at least most) first-order reasons in favor of the prohibited action. For this reason, too, all binding obligations that require a particular action (and therefore exclude all or most reasons against the action, including reasons in favor of contrary actions) incorporate a binding prohibition of contrary actions.

Norms that permit certain conduct may be referred to as *authoritative permissions*. Authoritative permissions may in some cases authorize action that is otherwise prohibited by a norm with binding authority. Yet they need not always serve this function. For example, norms conferring rights may also be viewed as authoritative permissions, even in cases where there is no other norm prohibiting the conduct that is a right. Regardless of whether or not there is a preexisting prohibition, the key feature shared by all authoritative permissions is that they impose *binding obligations* on certain other actors (who may be specified or unspecified) to respect the permitted action and not to interfere with it.<sup>217</sup> One should note that binding obligations logically incorporate authoritative permissions to perform

---

215. See Raz’s discussion of mandatory norms in RAZ, *supra* note 186, at 73-84; Figure 2.

216. See Raz’s description of norms in RAZ, *supra* note 186, at 49-106. Raz distinguishes among mandatory (or prescriptive) norms, permissive norms, and power-conferring norms.

217. See, e.g., Jack Donnelly, *How Are Rights and Duties Correlative?*, 16 J. VALUE INQUIRY 287, 292-93 (1982) (noting that negative liberties, which constitute authoritative permissions, such as freedom of speech, entail at least a “duty not to interfere with the behavior authorized and protected by the right”).



the obligatory act, which in turn require that other actors respect and permit the performance of the act.

*b. Persuasive Authority.* In accordance with Perry's analysis, it becomes apparent that there is a second category of authoritative norms, which, unlike mandatory norms, do not impose binding obligations. Instead, norms in this category only partially preempt an actor's judgment of the balance of first-order reasons as reasons for action. Such norms might be said to have "persuasive authority" and impose "persuasive obligations." The distinguishing characteristic of these norms is that they do not claim entirely to exclude certain first-order reasons. Instead, they require an actor to reduce the relative weight of reasons against the action called for by the norm and increase the relative weight of reasons supporting the action.<sup>218</sup> The net effect is the same as maintaining the original weight of first-order reasons and considering the norm as an additional first-order reason favoring the action with a weight equal to the net change in weight of first-order reasons under the conception just described.<sup>219</sup> Accordingly, later this Article will often characterize such a norm as imposing an obligation to give the norm "great weight" in decision making.<sup>220</sup>

The degree to which the weight of existing first-order reasons must be reduced or increased (or, under this alternative conception, the weight of the norm) will often vary. Where the proportionate reduction and increase are relatively large, we might refer to the norm as having "strong" persuasive authority. It is important to note that, in some cases, if the original weight of reasons against an action prescribed by a norm with persuasive authority was sufficiently high, even their "discounted" weight will be enough to overcome the weight accorded to reasons favoring the action prescribed by the norm and thus will justify contrary action. Finally, it should be emphasized that persuasive obligations, like binding ones, logically entail an authoritative permission to carry out the obligatory act. Part IV will argue that, under tax treaties, the arm's length standard has strong persuasive authority but not binding authority.

Norms having "persuasive authority" must be distinguished from norms having "persuasive weight." Even though a target actor's

---

218. See Figure 4.

219. See Figure 5.

220. This characterization of a persuasive obligation is similar to certain legal presumptions, as Perry notes. See Perry, *supra* note 195, at 932-33.

acceptance of norms having persuasive authority and norms having persuasive weight is in both cases ultimately “voluntary,” an actor feels a certain “tension” when it grants a norm persuasive authority. The actor would prefer to give certain first-order reasons a particular weight in the absence of the norm, but chooses to discount (or increase) this weight because of the norm.<sup>221</sup> When an actor grants a norm persuasive weight, it is more willing to incorporate the norm as part of its own preferences.<sup>222</sup>

2. *Reasons for Accepting the Preemptive Effect of Authoritative Norms.* We now turn to a more detailed examination of the reasons (which themselves may be considered second-order reasons) that an actor may accept for voluntarily giving authoritative norms some degree of preemptive effect. In particular, it is helpful to clarify some of the more common reasons that actors *actually adopt* when deciding whether to recognize the authority of a norm. Similarly, various normative theories provide recommendations about the reasons that actors *normatively should adopt*. This Part focuses on such normative theories, but because the reasons they put forward overlap with empirical reasons for accepting authority, the empirical reasons are discussed first.

Social and political scientists have asserted that actors adopt, empirically, a variety of reasons for accepting authority. We must first distinguish between reasons for accepting the authority of a norm (“obedience to a norm”) and the entire class of reasons that may exist for taking a particular action that is required by a norm (“conformity to a norm”). Obedience to a norm is thus a special case of conformity to a norm.<sup>223</sup>

There are several empirical reasons, other than obedience, why an actor may conform to a norm. These include:

- the target actor independently judges the action demanded by the norm to be the course it thinks “best” according to its value system. It is pure coincidence that the resulting action happens to be the action required by a norm with claimed authority;<sup>224</sup>
- the target actor takes the action out of *habit* or *custom*, without a sense of obligation;

---

221. See Figure 4.

222. See Figure 3.

223. On this distinction, see, for example, 2 MAX WEBER, *ECONOMY AND SOCIETY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY* 946 (Guenther Roth & Claus Wittich eds., 1978).

224. See, e.g., Hart, *supra* note 193, at 104.

- the target actor takes the action because of *identification* with other actors that are supportive of the norm or to win social approval;<sup>225</sup>
- the target actor is *persuaded* that taking the action is the “best” course of action in light of its value system; or
- the target actor is *coerced* (or persuaded) to take the action through the threat of a penalty or the offer of a reward.

In each of the above cases of conformity, the actor does not act out of a sense of obligation. That is, according to Raz’s and Perry’s theories, it does not accept the norm as a second-order reason for altering the weight it has decided to give to particular first-order reasons.

For what reasons, then, might an actor choose to obey a norm and accept it as authoritative? Such reasons, which will be referred to as “empirical legitimacy criteria,” are many and varied. In general, they all take the following form: a target actor has a reason to obey authority to the extent that such obedience is seen as *instrumentally* or *intrinsically* furthering particular values held by the target actor. The values of the target actor may be (1) *self-oriented*—relating only to the target actor’s self-interest; (2) *other-oriented*—relating to the interest of other actors, such as members of a community;<sup>226</sup> or (3) *principle-oriented*—relating to what are regarded by the target actor as transcendent and universalizable principles. The latter two of these categories will be referred to as “moral” values and principles.

There are various ways in which the actor may perceive that the acceptance of authority instrumentally furthers particular values, and these become empirical reasons for obeying authority. For example, an actor may believe that obedience to a norm can facilitate collective action, which in turn may be in the target actor’s self-interest or the interests of others (such as a community). In some cases, collective action may be perceived as requiring effective sanctions against violators of the norm. In these cases, the power of an authority to impose such sanctions may be adopted as a reason for obeying the authoritative norm. In addition, an actor may believe that it is to its benefit or to the benefit of others to obey an authoritative norm if that norm is the product of deliberation by individuals with greater knowledge, experience or expertise.

---

225. See, e.g., ORAN R. YOUNG, COMPLIANCE AND PUBLIC AUTHORITY: A THEORY WITH INTERNATIONAL APPLICATIONS 22-23 (1979).

226. This nomenclature has been adapted from philosopher Nicholas Rescher. See NICHOLAS RESCHER, INTRODUCTION TO VALUE THEORY 17-18 (1969).

An actor may also obey a norm with claimed authority for the reason that doing so directly and intrinsically realizes certain values, which in this case are usually moral values or principles. For example, one posited reason for obeying such a norm is that it directly fulfills a value of membership in a community; as a precondition for membership, each must accept the moral authority of norms accepted by other members. A second possible reason is that obedience to an authoritative norm may be mandated by a moral rule or principle, such as fidelity to promises or fulfilling legitimate expectations of others created by one's own behavior.

On the other hand, some target actors may obey authority only if it does not frustrate an important value to them—most notably, their autonomy. Thus, they may require that they have given their consent to the norm as a precondition to their obedience to it. Others may believe that *any* interference with the autonomy of their own decision making is never justified, and thus summarily reject all authority.

A target actor may have many motives for obeying an authoritative norm or directive, including some combination of the above reasons. Often the direct motivation for obeying an authoritative norm is the norm's compliance with other rules ("secondary rules") for determining the authority of the norm. These secondary rules in turn may incorporate or be justified by one or more of these other reasons.

For all of the above reasons for obedience to a norm, an actor may treat the norm as a second-order reason not to act on its own independent judgment of the balance of first-order reasons. At the same time, in any case where they are not counted as second-order reasons for giving a norm preemptive effect, these reasons should then at least count as first-order reasons supporting action in conformity with the norm. For example, in a case where (under a given normative theory) facilitating collective action is not viewed as a valid reason for giving a norm preemptive effect, it may nevertheless be treated as a first-order reason for following the norm and thus as having persuasive weight. The same conclusion follows if Raz's distinction between first-order and second-order reasons is rejected on philosophical grounds, and all reasons (and all authority claims) are treated simply as first-order reasons.<sup>227</sup>

---

227. As noted above, Chaim Gans has argued that all reasons are first-order reasons. See Gans, *supra* note 193, at 381-94.

Having initially surveyed some of the empirical reasons that actors employ when deciding whether to accept the authority of a norm, this section reviews reasons suggested by various normative theories as reasons that actors ought to consider when deciding how to respond to authority claims. These reasons might be referred to as “normative legitimacy criteria.” The list of reasons proposed by prominent normative theories tends to coincide with the list of empirical legitimacy criteria just explored. The following analysis examines normative theories by reference to each of these reasons that they may endorse, beginning with the last-mentioned empirical legitimacy criterion: compliance with secondary rules.

*a. Compliance with Secondary Rules.* Empirically, the preemptive effect of a norm may be accepted because the norm complies with certain secondary rules, including a “rule of recognition,” to use the term developed by H. L. A. Hart.<sup>228</sup> Secondary rules can include rules identifying the actor promulgating the norm as having the authority to do so and rules prescribing a “correct” procedure for formulating, issuing, applying, or interpreting authoritative norms.<sup>229</sup> While secondary rules may be viewed as a legitimacy criterion for any type of authority, they are especially important in defining *legal* authority.<sup>230</sup> Indeed, Hart has identified the existence of secondary rules regarding primary obligations as the key prerequisite for classifying both primary and secondary rules as law.<sup>231</sup>

A number of normative theorists have endorsed the use of such secondary rules to determine the legitimacy of a claimed authoritative norm, whether legal or not.<sup>232</sup> These theorists have commonly done so on the ground that obedience to secondary rules either facilitates collective action<sup>233</sup> or directly serves the value of membership in a community. Because secondary rules must themselves be justified by

---

228. See generally HART, *supra* note 212. Hart refers to a “rule of recognition” as providing private persons and officials “with authoritative criteria for identifying primary rules of obligation. The criteria so provided may . . . take any one or more of a variety of forms: these include reference to an authoritative text; to legislative enactment; to customary practice; to general declarations of specified persons, or to past judicial decisions in particular cases.” *Id.* at 97.

229. See *id.* at 91-96.

230. See, e.g., *id.* at 91.

231. See *id.*

232. See, e.g., Finnis, *supra* note 193, at 188-91.

233. See, e.g., *id.* at 186-91.

other legitimacy criteria, and the particular types of secondary rules endorsed by a normative theory will depend on its view of these other criteria, the discussion now turns to these more “substantive” criteria as advocated by various normative theories.

*b. Facilitating Collective Action.* A problem of “collective action” arises whenever two or more actors must somehow cooperate in order to improve an outcome that might result from their independent decision making. A number of international relations theorists have attempted to explain the evolution of authoritative norms in global politics and international law as a response to perceived problems of collective action among states. In particular, they have made use of game theory to explicate different collective action dilemmas, focusing on how states may resort to the development and acceptance of authoritative norms to help reach a solution to these dilemmas.<sup>234</sup> Under these empirical theories, various domains of international politics may be assimilated to particular “games,” including “harmony” games, “assurance” games, dilemmas of common interests such as “prisoners’ dilemmas,” dilemmas of common aversions, such as “pure” or “non-pure” coordination games, and “zero-sum” games. In almost all of these theories, states are assumed to be motivated solely by self-interest rather than by moral principles. Based on this empirical understanding, many international political theorists have made certain normative recommendations about when states ought to accept authoritative norms in order to facilitate the resolution of collective action dilemmas.

For example, political scientist Arthur Stein has engaged in a very useful analysis of how problems of collective action can lead states to accept the authority of certain norms.<sup>235</sup> In particular, Stein argues that international “regimes,” a term used loosely by many international political theorists to refer to common principles, norms

---

234. See, e.g., Kenneth A. Oye, *Explaining Cooperation under Anarchy: Hypotheses and Strategies*, in *COOPERATION UNDER ANARCHY* 1 (Kenneth A. Oye ed., 1986).

235. See Arthur A. Stein, *Coordination and Collaboration: Regimes in an Anarchic World*, in *INTERNATIONAL REGIMES* 115 (Stephen D. Krasner ed., 1983).

and rules,<sup>236</sup> can best be conceptualized as patterns of inter-state relations that serve “to circumscribe national behavior.”<sup>237</sup>

As an empirical proposition, Stein assumes that “[i]nternational politics is typically characterized by independent, self-interested decision making, and states often have no reason to eschew such individualistic behavior.”<sup>238</sup> Stein argues that a regime (and therefore the empirical authority of an international norm) exists only “when the interaction between the parties is not unconstrained or is not based on independent decision making.”<sup>239</sup> Despite Stein’s assumption, it is important to recognize as a theoretical matter that nothing precludes states from using any scale to rank the desirability of outcomes, including scales that incorporate moral values or principles.<sup>240</sup>

*i. Harmony Games.* Stein first identifies situations in which a regime—that is, an authoritative norm—is not considered “necessary” and is therefore not created by states.<sup>241</sup> The first is a case in which “each state obtains its most preferred outcome by making independent decisions.”<sup>242</sup> Here, there is “simply no conflict” and consequently “no need for a regime.”<sup>243</sup> This can be referred to as a “harmony” game.<sup>244</sup>

To illustrate a harmony game, consider a simple game model in which there are two states (A and B), each of which can choose between two courses of action (1 and 2).<sup>245</sup> We can label the respective actions taken by A and B as A1 and A2 and B1 and B2.<sup>246</sup> In a pure harmony game, each state has a “dominant strategy” or

236. According to a widely-accepted definition, “international regimes” are “principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue-area.” Stephen D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, in INTERNATIONAL REGIMES, *supra* note 235, at 1.

237. Stein, *supra* note 235, at 115.

238. *Id.* at 117.

239. *Id.*

240. See, e.g., ROBERT O. KEOHANE, AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY 74-75, 120-32 (1984).

241. See Stein, *supra* note 235, at 117.

242. *Id.*

243. *Id.*

244. See *id.* at 117-18; KEOHANE, *supra* note 240, at 51-53.

245. See Figure 6.

246. Note that action A1 need not be the same as action B1; the same is true for actions A2 and B2. On this point see DAVID K. LEWIS, CONVENTION: A PHILOSOPHICAL STUDY 10-12 (1969).

dominant action. This means that, in its view, pursuing either action 1 or action 2 will maximize its values regardless of which action the other state chooses. For example, “A prefers A1 whether B chooses B1 or B2, and B prefers B1 regardless of A’s decision.”<sup>247</sup> Furthermore, the result of each state pursuing its dominant strategy (that is, A1 + B1) is the best outcome for each state compared to the other possible combinations of actions.<sup>248</sup> We can refer to A1 + B1 as an “equilibrium outcome” because “neither actor can shift unilaterally to better its own position.”<sup>249</sup> That is, if A abandons action 1 and instead pursues action 2, it will be worse off, given B’s choices.<sup>250</sup> The same is true for B. Furthermore, A1 + B1 is a “coordination equilibrium” as defined by philosopher David K. Lewis, or an outcome “in which no one would have been better off had *any one* agent alone acted otherwise, either himself or someone else.”<sup>251</sup>

If the optimal outcome, A1 + B1, is defined as “cooperation” by both A and B, which can be represented as “CC” where the first letter denotes the action of the actor in question and the second letter denotes the action of the other actor, then mutual cooperation (CC) results from the independent choices of A and B because both prefer C (action 1) regardless of what the other actor does. Even if the other actor “defects” (i.e., chooses action 2, which we can represent as “D”), each actor will still choose to cooperate (i.e., perform action 1). This is because each actor’s preference ordering is CC > CD > DD or DC. In a harmony game, then, all actors “prefer unrequited cooperation (CD) to unilateral defection (DC),” so “no incentive to cheat exists.”<sup>252</sup> The key point is that both states reach their optimum outcomes (as perceived by them) through independent decision making. Accordingly, they would see no need to establish an authoritative norm requiring them to adopt their dominant strategies. Normatively, one could argue, no authoritative norm consequently ought to be established, assuming that the states’ own values are regarded as legitimate.

---

247. Stein, *supra* note 235, at 117.

248. *See id.* at 117-18.

249. *Id.* at 118.

250. On the definition of an equilibrium, see LEWIS, *supra* note 246, at 8.

251. *Id.* at 14 (emphasis in original).

252. Oye, *supra* note 234, at 6.



*ii. Assurance Games.* The so-called “assurance” game is another situation where states do not recognize the need for an authoritative norm and where therefore, arguably, an authoritative norm should not be established. An assurance game can be pictured using the story of the “stag hunt.”<sup>253</sup> The stag hunt, and its payoff structure, is described by political scientist Kenneth A. Oye as follows:

A group of hunters surround a stag. If all cooperate to trap the stag, all will eat well (CC). If one person defects to chase a passing rabbit, the stag will escape. The defector will eat lightly (DC) and none of the others will eat at all (CD). If all chase rabbits, all will have some chance of catching a rabbit and eating lightly (DD). Each hunter’s preference ordering is: CC > DC > DD > CD. The mutual interest in plentiful venison (CC) relative to all other outcomes militates strongly against defection. However, because a rabbit in the hand (DC) is better than a stag in the bush (CD), cooperation will be assured only if each hunter believes that all hunters will cooperate. In single-play Stag Hunt, the temptation to defect to protect against the defection of others is balanced by the strong universal preference for stag over rabbit.<sup>254</sup>

It is important to note that in a stag hunt, or any assurance game, “the actors share a most preferred outcome but neither has a dominant strategy.”<sup>255</sup> Each actor prefers to cooperate only if the other does so. If they both cooperate, they achieve their best outcome, CC. But if there is uncertainty about whether the other actor will cooperate, each actor will have an incentive to maximize its minimum gain by defecting, which will produce either DC or DD, either of which is preferable to the worst outcome, CD. However, if both actors follow this strategy, they will achieve a second equilibrium outcome, DD, that is less desirable than their optimum equilibrium outcome, CC. Accordingly, “as long as both actors are aware of the other’s preferences, they will converge on the [CC] outcome that both most prefer” and again, “[n]o regime is needed since both actors agree on a most preferred outcome, one that they can reach by acting autonomously.”<sup>256</sup>

Philosopher Edna Ullmann-Margalit suggests that one example of a stag hunt situation is the problem of whether states should adopt

---

253. See Figure 7.

254. Oye, *supra* note 234, at 8.

255. Stein, *supra* note 235, at 118.

256. *Id.* at 118-19.

policies of free trade or economic isolationism.<sup>257</sup> A stag hunt problem would emerge where all states would be better off by adopting free trade policies, but where each state also has an incentive to “play it safe” by defecting and adopting an isolationist policy. The analogy has its weaknesses. For example, even if some countries engage in isolationism (i.e., defect), it may still be to the advantage of the others to pursue free trade policies (i.e., cooperate).<sup>258</sup>

The key to achieving mutual cooperation in any assurance game is the provision of adequate information to each party about the other’s preferences—the conveyance of “assurances”—so that both parties know the optimum outcome and can achieve it through independent decision making. One way that states can provide assurances to one another about their preferences is by entering into treaties. Stein gives the example of extradition treaties as a type of agreement designed to provide assurances about how another state will behave when faced with an extradition request.<sup>259</sup>

*iii. Dilemmas of Common Interests, Including Prisoners’ Dilemmas.* In contrast to the above situations in which states can achieve desirable outcomes through independent decision making, there are situations “in which all the actors have an incentive to eschew independent decision making: situations, that is, in which individualistic self-interested calculation leads them to prefer joint decision making because independent self-interested behavior can result in undesirable or suboptimal outcomes.”<sup>260</sup> There are two categories of such situations: “dilemmas of common interests” and “dilemmas of common aversions.”<sup>261</sup>

Dilemmas of common interests arise “when independent decision making leads to equilibrium outcomes that are Pareto-deficient—outcomes in which all actors prefer another given outcome to the equilibrium outcome.”<sup>262</sup> The foremost example of such a dilemma is the “prisoners’ dilemma.”<sup>263</sup> The term “prisoners’

---

257. See EDNA ULLMANN-MARGALIT, *THE EMERGENCE OF NORMS* 124-27 (1977).

258. See *id.*

259. See Stein, *supra* note 235, at 120.

260. *Id.*

261. *Id.*

262. *Id.*

263. See *id.* at 120-21; Figure 8.

dilemma” (sometimes abbreviated “PD”) takes its name from the following hypothetical scenario:

Two prisoners are suspected of a major crime. The authorities possess evidence to secure conviction on only a minor charge. If neither prisoner squeals, both will draw a light sentence on the minor charge (CC). If one prisoner squeals and the other stonewalls, the rat will go free (DC) and the sucker will draw a very heavy sentence (CD). If both squeal, both will draw a moderate sentence (DD). Each prisoner’s preference ordering is:  $DC > CC > DD > CD$ . If the prisoners expect to “play” only one time, each prisoner will be better off squealing than stonewalling, no matter what his partner chooses to do ( $DC > CC$  and  $DD > CD$ ). The temptation of the rat payoff and fear of the sucker payoff will drive single-play Prisoners’ Dilemmas toward mutual defection. Unfortunately, if both prisoners act on this reasoning, they will draw a moderate sentence on the major charge, while cooperation could have led to a light sentence on the minor charge ( $CC > DD$ ). In single-play Prisoners’ Dilemmas, individually rational actions produce a collectively suboptimal outcome.<sup>264</sup>

As this description makes clear, a key feature of a prisoners’ dilemma is that each actor has an incentive to cheat once the unstable alternative outcome (CC) is achieved in order to obtain its most preferred outcome (DC). The problem is that if both actors cheat they will return to the equilibrium outcome (DD), which is worse for both of them than the unstable alternative outcome (CC).

Raz has argued that authoritative norms can help solve prisoners’ dilemma problems.<sup>265</sup> Raz maintains that giving a norm merely persuasive weight is not sufficient to achieve collective action in these situations. Instead, the involved actors must give the norm preemptive effect.<sup>266</sup> Further, Ullmann-Margalit has contended that in any prisoners’ dilemma, “a norm, backed by appropriate sanctions, could solve this problem. In this sense it can be said that such situations ‘call for’ norms. It can further be said that a norm solving the problem inherent in a situation of this type is *generated* by it.”<sup>267</sup> According to Ullmann-Margalit, it is important that the

sanctions [be] so severe as to outweigh the temptation to violate [the norm or agreement] which each participant must experience . . . . [I]t is the supplement of sanctions which is

---

264. Oye, *supra* note 234, at 7-8.

265. See Raz, *supra* note 193, at 128.

266. See Raz, *supra* note 184, at 7-8; Raz, *supra* note 193, at 138-39.

267. ULLMANN-MARGALIT, *supra* note 257, at 22. However, Ullmann-Margalit makes clear that her thesis concerning how norms may arise out of prisoners’ dilemma-type situations is empirical, not normative. See *id.* at 60.

decisive; an explicit agreement which is not binding in the sense that it is not backed by appropriate sanctions is an insufficient condition for solving a PD problem satisfactorily.<sup>268</sup>

It should be noted that the stag hunt game described earlier bears a close resemblance to a prisoners' dilemma problem because, in both cases, cooperation results in an outcome that is good for all. However, in the case of a stag hunt, the outcome is a stable coordination equilibrium. Thus, if there is general confidence that it can be achieved, there is no temptation to deviate.<sup>269</sup> But the development of cooperation requires either the existence of trust, a sense of "obligation to keep co-operating (such as keeping a promise—explicit or tacit, reciprocating fair play, etc.), or, alternatively, . . . effective external sanctions."<sup>270</sup> Accordingly, norms similar to prisoners' dilemma norms may be generated, but they can be weaker norms.<sup>271</sup>

*iv. Dilemmas of Common Aversions, Including Pure and Non-Pure Coordination Problems.* Dilemmas of common aversions constitute the second category of situations in which states have an incentive to avoid independent decision making and to accept the authority of norms. According to Stein:

Unlike dilemmas of common interests, in which the actors have a common interest in *insuring* a particular outcome, the actors caught in the dilemma of common aversions have a common interest in *avoiding* a particular outcome. These situations occur when actors [without dominant] strategies do not most prefer the same outcome but do agree that there is at least one outcome that all want to avoid. These criteria define a set of situations with multiple equilibria (two equilibria if there are only two actors each with two choices) in which coordination is required if the actors are to avoid that least preferred outcome.<sup>272</sup>

One example of a dilemma of common aversions is a "pure" coordination problem.<sup>273</sup> In a pure coordination problem, there are two outcomes (say, A1 + B1 and A2 + B2) that both A and B value equally and two outcomes (say, A1 + B2 and A2 + B1) that both want to avoid. The outcomes A1 + B1 and A2 + B2 are both coordination equilibria because either A or B will make itself worse off by

---

268. *Id.* at 116-17.

269. *See id.* at 121-23.

270. *Id.* at 124.

271. *See id.*

272. Stein, *supra* note 235, at 125.

273. *See* Figure 9.

unilaterally changing its strategy. Neither state has a dominant strategy because A prefers action 1 only if B prefers it and B prefers action 1 only if A prefers it. Similarly, A will prefer action 2 only if B prefers it and vice versa. To use the “C” and “D” notation introduced above, each state’s preference ordering is  $CC = DD > DC$  or  $CD$ . Because neither has a dominant strategy, but rather the preferred strategy of each is contingent on the strategy adopted by the other, “they cannot be certain that they will arrive at one of [their preferred] outcomes if they act independently and simultaneously. Without coordination they may well end up with one of the outcomes that neither wants.”<sup>274</sup>

A pure coordination problem can be solved through any method of allowing the actors’ expectations to converge on a particular equilibrium outcome, for example, through the use of “conventions.” Conventions are “accepted and established solutions to past recurrent co-ordination problems which—with time—assume the status of norms.”<sup>275</sup> They arise organically, over time, through the development of shared expectations of regular behavior among the participants.<sup>276</sup> Conventions are typically not codified as law, “are neither issued nor promulgated by any identifiable authority,” and “involve in the main non-institutionalized, non-organized, and informal sanctions (i.e., punishments or rewards).”<sup>277</sup>

An example of a convention is the norm of driving on the right-hand side of the road. We can assume that many drivers (although not drivers like those mentioned in the Introduction) would be willing to drive on either the right-hand side or the left-hand side so long as all other drivers do so as well. The worst outcome for all drivers (which may be recognized by most of them, but not necessarily all of them) would be if some choose to drive on the left and others on the right. An arbitrary convention can achieve coordination in such a situation where the actors do not prefer one equilibrium outcome to another.<sup>278</sup> Conventions can be particularly useful in solving dilemmas of common aversions arising among many actors; they can “provide rules of thumb that can diminish transaction and information costs.”<sup>279</sup>

---

274. Stein, *supra* note 235, at 125.

275. ULLMANN-MARGALIT, *supra* note 257, at 76.

276. *See id.*

277. *Id.* at 97.

278. *See* Stein, *supra* note 235, at 125.

279. Oye, *supra* note 234, at 20.

According to Ullmann-Margalit, an agreement can solve a coordination problem particularly well.<sup>280</sup> “Indeed it is perhaps the best method of solving co-ordination problems that can be wished for: an explicit agreement is undoubtedly the firmest rallier of the participants’ expectations regarding each other’s actions.”<sup>281</sup> What is important is producing shared expectations. Shared promises are not necessary. In the words of David K. Lewis, “[n]o one need bind himself to act against his own interest.”<sup>282</sup> For this reason, agreements to solve coordination problems are generally self-enforcing.<sup>283</sup>

Do conventions impose obligations? Some conventions do not. In the words of Ullmann-Margalit, “conceptually, there is nothing normative about a regularity which solves a recurrent co-ordination problem.”<sup>284</sup> Nevertheless, many conventions become authoritative norms. That is, a “*repeated* pattern of behaviour . . . [may] turn into a *binding* pattern of behaviour.”<sup>285</sup>

Why might a convention give rise to an authoritative norm with binding or persuasive authority? Ullmann-Margalit posits at least three factors that can explain such an empirical transmutation.<sup>286</sup> First, “a norm is capable of regulating and channeling the expectations—and hence the choice of actions—of anonymous participants.”<sup>287</sup> It can increase the likelihood that newcomers will engage in the regular practice.<sup>288</sup> Second, a “norm, by fixing on a unique fitting description of the regularity, provides a unique guidance for action in normal future cases.”<sup>289</sup> Third, “there is a higher degree of articulation and explicitness associated with a norm than with a mere regularity of behaviour.”<sup>290</sup> Finally,

the fact that a norm is taught and told, and its being supported by social pressure, enhance the salience of the particular co-ordination equilibrium it points to; in a sense it even slightly changes the corresponding pay-off matrix so as to make this particular co-

---

280. See ULLMANN-MARGALIT, *supra* note 257, at 116.

281. *Id.*

282. LEWIS, *supra* note 246, at 34.

283. See ULLMANN-MARGALIT, *supra* note 257, at 116.

284. *Id.* at 85; see also LEWIS, *supra* note 246, at 97.

285. ULLMANN-MARGALIT, *supra* note 257, at 85.

286. See *id.* at 85-87.

287. *Id.* at 85.

288. See *id.*

289. *Id.* at 87.

290. *Id.*

ordination equilibrium a somewhat more worthwhile outcome to be aimed at than it would otherwise have been.<sup>291</sup>

According to Ullmann-Margalit, a norm may be established through the adoption by some “authority” of a “decree” (which can include an explicit agreement) that specifies action producing a particular equilibrium outcome. Indeed, decrees tend to arise as “solutions to novel recurrent co-ordination problems which from the outset are being decreed as norms.”<sup>292</sup> Decrees can include decisions of intergovernmental bodies like the United Nations.<sup>293</sup> Moreover, decree-type coordination norms often form “the substance of international treaties, conventions, and law.”<sup>294</sup>

Raz has similarly urged that authoritative norms can reinforce conventions supported by a majority, and encourage the conformity of a minority that does not see the situation as a coordination problem:

[O]ne important function of authoritative directives is to help establish and sustain conventions. Conventions are here understood in a narrow sense in which they are solutions to coordination problems, that is, to situations in which the vast majority have sufficient reason to prefer to take that action which is (likely to be) taken by the vast majority. Where there is a coordination problem the issuing of an authoritative directive can supply the missing link in the argument. It makes it likely that a convention will be established to follow the authoritatively designated act.<sup>295</sup>

Agreements, decrees, and authoritative norms instituted to solve coordination problems may be accompanied by sanctions, which may, in turn, be “organized, institutionalized, and formal, even physical.”<sup>296</sup> How can such sanctions be justified in the case of coordination norms? Ullmann-Margalit suggests that “[t]heir existence, and the general awareness of their existence, might enhance the salience of the particular co-ordination equilibrium the norm is aimed at attaining, thereby increasing the effectiveness of the norm itself.”<sup>297</sup>

---

291. *Id.*

292. *Id.* at 76.

293. *See id.* at 91.

294. *Id.* at 93.

295. Raz, *supra* note 193, at 127-28. Raz specifically argues that authorities and authoritative norms can play an important role in achieving coordination when particular actors might not subjectively perceive that a coordination problem exists. *See* Raz, *supra* note 184, at 10.

296. ULLMANN-MARGALIT, *supra* note 257, at 97.

297. *Id.* at 120.

But she emphasizes that “above all the mere act of non-conformity to a co-ordination norm (when the others do conform) is its own punishment, since it entails failure to meet the others at the prescribed co-ordination equilibrium.”<sup>298</sup> Agreements to solve coordination problems may also be supported by the moral force of mutual promises, although the agreements may serve their coordinating functions even without such promises.<sup>299</sup>

Whether coordinating norms take the form of conventions, agreements or decrees, what reasons do actors recognize for accepting their authority? The first is the promotion of the actors’ own interests. At the same time, the satisfaction of individual wants and desires can be seen as the “joint collective interests of the community in question.”<sup>300</sup> And a particular coordination problem may involve the realization of certain moral ends or values.<sup>301</sup>

The preceding analysis has focused on pure coordination problems in which the alternative equilibria are equally preferred by the actors (or at least a majority of them). “Non-pure” coordination problems exist when actors agree on which outcome or outcomes are the worst, but each prefers a different equilibrium outcome.<sup>302</sup> One actor’s preference ordering might be  $CC > DD > CD$  or  $DC$  and the other’s might be  $DD > CC > CD$  or  $DC$ .<sup>303</sup> For instance, some drivers like those described in the Introduction might prefer that all drivers drive on the left, while most drivers prefer that all drive on the right. In such a case, actors can achieve coordination through arbitrary conventions that ensure the attainment of one of the preferred equilibria.<sup>304</sup>

Although conventions are generally self-enforcing, in a non-pure coordination problem one actor may unilaterally defect in order to induce other actors to accept its deviant behavior as a new convention. For example, if A prefers  $CC$  to  $DD$  and B prefers  $DD$  to  $CC$ , and the current equilibrium is  $CC$ , B may unilaterally defect in an attempt to force A also to defect, thereby moving to B’s preferred equilibrium of  $DD$ . Such defections, however, do not constitute “cheating.” In the words of Arthur Stein:

---

298. *Id.*

299. See LEWIS, *supra* note 246, at 34-35, 84.

300. ULLMANN-MARGALIT, *supra* note 257, at 102.

301. See *id.* at 132-33.

302. See *id.* at 78, 82.

303. See Figure 10.

304. See Stein, *supra* note 235, at 127.



Defections do not represent cheating for immediate self-aggrandizement, but are expressions of relative dissatisfaction with the coordination outcome. An actor will *threaten* to defect before actually doing so; it may choose to go through with its threat only if the other actor does not accede to its demands. Again, such defection is never surreptitious cheating; it is a public attempt, made at some cost, to force the other actor into a different equilibrium outcome.<sup>305</sup>

v. *Zero-Sum Games*. It is important to underscore that in some types of games, collective action cannot be achieved. If the actors' aim is not simply to maximize self-interest, but to maximize the difference between their gains and those of others, no collective action will result. Pure conflict results from such "zero-sum" games, where one actor's gain is *ipso facto* another actor's loss.<sup>306</sup> Even if the other actor cooperates, an actor achieves nothing by cooperating too.

c. *The Presence of Effective Sanctions Against Violators*. As noted in the preceding discussion of collective action problems, many normative theorists have argued that sanctions are necessary to address prisoners' dilemma situations in which there are strong incentives for defection. In these cases, the role of sanctions is not always one of coercion. Instead, many actors may fear defection by others. The existence of a sanctions regime allows the actors to obey the norm out of "trust" that violators cannot take unfair advantage of their obedience. Raz has accordingly expressed the view that, unless an actor claiming authority can successfully obtain general compliance, including through coercion if necessary, in some cases there may be no justification for accepting the authority of the actor.<sup>307</sup>

d. *The Greater Knowledge, Experience, or Expertise of Authorities*. Among others, Raz has argued that obedience to an authority is warranted if, by reason of the greater knowledge or expertise of that authority, one can better achieve the goals one otherwise ought to achieve.<sup>308</sup> Raz further maintains that,

---

305. *Id.* at 130; *see also id.* at 131.

306. *See id.* at 134.

307. "Coordination may fail altogether if it does not enjoy a sufficient level of cooperation, and those who cooperate may face greater burdens than would be otherwise required because some people prefer to free ride. In such cases it may be that the right to command depends on the right to coerce which is necessary to assure all of compliance by all (or nearly so)." Raz, *supra* note 184, at 15-16.

308. *See, e.g., id.* at 9-10.

normatively, “experts of all varieties are to give advice based on the very same reasons which should sway ordinary people who wish to form their minds independently. The experts’ advantage is in their easy access to the evidence and in their better ability to grasp its significance.”<sup>309</sup> The same reasons may justify the granting of authority to a norm developed by experts.

*e. Membership in a Community.* Some “communitarian” theorists, such as Ronald Dworkin, have argued that, in Raz’s words, “there is inherent value in conforming to communal authorities just because in doing so one recognizes the good of community, or recognizes the duty one owes to one’s community, or to one’s rulers.”<sup>310</sup> Dworkin has contended that there are “obligations of community,” or “associative obligations,” and that “political obligation—including an obligation to obey the law—is a form of associative obligation.”<sup>311</sup> According to Dworkin, associative obligations arise from membership in a community meeting certain tests and therefore constituting a “true” community.<sup>312</sup> A number of international law theorists have adopted this analysis, asserting that based on their participation in a community of states, states have certain obligations to one another.<sup>313</sup>

In contrast, Raz believes membership in a community is only a “secondary” reason for accepting authority. While accepting authority can be regarded as expressing trust in the authority, that very trust is justified only when the authority discharges its duties to the group properly and does not betray the group.<sup>314</sup> For example, because a national community’s government may behave despotically and persecute community members, membership alone may not be a good reason to accept the government’s authority.

*f. The Moral Principles of Fidelity to Promises and of Fulfilling Legitimate Expectations of Others.* Many political and legal theorists, such as philosopher and legal scholar Fernando R. Tesón, emphasize

---

309. Raz, *supra* note 193, at 129.

310. Raz, *supra* note 184, at 13.

311. RONALD DWORKIN, *LAW’S EMPIRE* 206 (1986).

312. *See id.* at 195-202.

313. *See, e.g.*, THOMAS M. FRANCK, *THE POWER OF LEGITIMACY* 195-207 (1989). The work of these theorists will be referred to at greater length in Parts IV and V.

314. *See* Raz, *supra* note 193, at 130-31.

moral principles such as fidelity to promises or fulfillment of legitimate expectations of others based on one's own conduct. They argue that in order for a norm to enjoy authority and legitimacy, these moral principles must support its acceptance.<sup>315</sup> In this connection, Tesón has contended that game theory (and its analysis of how states use norms to facilitate collective action and thereby maximize self-interest) can explain why states accept the persuasiveness of certain norms, but not why states give the norms persuasive or binding authority.<sup>316</sup> Such authority, he maintains, can only be based on moral duties and values.<sup>317</sup> Tesón's views on the authority of treaties and customary international law will be discussed in greater detail in Parts IV and V.

*g. Consent.* Throughout history, many political theorists have insisted that unless government enjoys the consent of the citizens, it has no authority and thus no right to be obeyed.<sup>318</sup> In the sphere of inter-state relations, and consistent with the "positivist" approach to international law, many theorists have argued that international legal rules only have legal authority over particular states insofar as those states have expressed their consent to them. Consent may be granted either explicitly, through the conclusion of treaties, or implicitly, through conduct out of a sense of legal obligation, which gives rise to customary international law.<sup>319</sup> Consent theorists often assume that consent is a relevant legitimacy criterion because of the value of state autonomy or state "sovereignty."

As noted above, however, other theorists question whether consent alone constitutes a necessary or sufficient normative justification for government or the authority of international law. In the domestic sphere, for example, Raz maintains that people may have "a duty to obey an authority to the authority of which they did not consent" if "compliance with [the authority] will ensure that they stand a better chance of discharging their moral obligations, and

---

315. See, e.g., FERNANDO R. TESÓN, *A PHILOSOPHY OF INTERNATIONAL LAW* 89 (1998).

316. See generally *id.* at 73-103.

317. See *id.*

318. See, e.g., JOHN LOCKE, *TWO TREATISES OF GOVERNMENT* 374-75 (Peter Laslett ed., Cambridge Univ. Press 1960).

319. See, e.g., 1 L. OPPENHEIM, *INTERNATIONAL LAW: A TREATISE* 15-20 (1905) (describing consent as the basis of obligation in international law); see also ARTHUR NUSSBAUM, *A CONCISE HISTORY OF THE LAW OF NATIONS* 121-22, 222-30 (1947) (reviewing the historical development of positivism in international law).

generally will better achieve what they ought to achieve.”<sup>320</sup> He admits, however, that “an argument for a limited role for consent” can be made in certain areas.<sup>321</sup> Likewise, in the domain of inter-state relations, Tesón has criticized consent-based theories of international legal obligation, arguing that consent may be immoral. In particular, he has contended that “the view that consent is the basis of international legal obligation is implausible [because] . . . states may conclude immoral agreements and participate in immoral customs,”<sup>322</sup> and thus, “consent alone cannot be the basis of obligation.”<sup>323</sup>

*h. Combinations of Reasons.* Some normative theories advocate obedience to authority for a combination of the above reasons. For example, a normative theory of law may argue that legal norms have normative authority because they comply with secondary rules that are supported by the goal of facilitating collective action.

3. *Toward a Normative Theory of Authoritative International Norms.* Thus far, this section has discussed the reasons for accepting authority that have been promoted by various normative theories in the case of international norms such as the arm’s length standard. The question remains as to which of these normative theories, or some other theory, ought to be adopted. As emphasized in Part I, this Article cannot fully resolve this complicated question. Based on certain foundational principles, however, it will sketch the outlines of such a theory.

One of these foundational principles is that, other things being equal, it is desirable to maximize the welfare (short-term or long-term self-interest) of individual states, within certain moral bounds, as well as the welfare of people in all states. Accordingly, where global interdependence makes the welfare of one state, or of residents of one state, dependent on the actions of other states, recognition of the authority of international norms can, by facilitating collective action, help states further their interests or the welfare of their residents, therefore justifying the authority of these norms.<sup>324</sup> But a concomitant principle is that the decision-making autonomy of states ought to be respected to the greatest extent possible. Thus, if feasible, collective

---

320. Raz, *supra* note 184, at 14.

321. *Id.*

322. TESÓN, *supra* note 315, at 92.

323. *Id.*

324. See ULLMANN-MARGALIT, *supra* note 257, at 102.

action should be achieved through persuasion or through the establishment of authoritative norms according to secondary rules to which states have freely consented.

These principles are complemented by other foundational principles of a moral character. One such principle is that in general promises are to be honored. Without elaborating on the philosophical, religious, and moral bases for holding to such a principle, it suffices to observe that this principle is widely accepted and has been promulgated in the revered moral texts of the world religions and philosophies.<sup>325</sup> A related foundational moral principle is that all human beings are members of one human community that ought to function in union and harmoniously. Identification with the whole of the human race ought to complement identification with a national or state community. In light of the moral ideal of a community of humankind, states morally ought to regard themselves as participants in a community of states. At the same time, to the extent that they have recognized their ongoing interdependence and used international law to develop a sophisticated set of rules for the regulation of their mutual relations, states are already participants in an empirical inter-state community.<sup>326</sup>

In light of these foundational principles, one may draw certain general conclusions about the relative merits of prominent normative theories for accepting authority. All of the reasons advocated by these theories have validity in certain contexts. In the international arena, for example, because states should be regarded as participants in a community of states, both empirically and ideally, they ought to defer to secondary rules for identifying authoritative international legal norms that have been developed by that community. Such secondary rules must provide the primary criterion for determining the legitimacy of claimed authoritative norms, including the arm's length standard.<sup>327</sup>

---

325. For examples of this principle in revered moral texts, see Joshua 9, in TANAKH: A NEW TRANSLATION OF THE HOLY SCRIPTURES ACCORDING TO THE TRADITIONAL HEBREW TEXT 349-51 (1985); BUDDHIST SCRIPTURES 89 (Edward Conze trans., 1959); E. BRUCE BROOKS & A. TAEKO BROOKS, THE ORIGINAL ANALECTS: SAYINGS OF CONFUCIUS AND HIS SUCCESSORS 2:13 at 112 (1998); Matthew 5:33-37, in THE HOLY BIBLE: NEW REVISED STANDARD VERSION WITH APOCRYPHA 5 (1977); THE KORAN INTERPRETED 2:173 at 50-51 (A.J. Arberry trans., 1955); BAHÁ'U'LLÁH, GLEANINGS FROM THE WRITINGS OF BAHÁ'U'LLÁH 266 (Shoghi Effendi trans., 2d rev. ed. 1976).

326. See FRANCK, *supra* note 313, at 195-207.

327. For a discussion of these secondary rules, see Parts IV and V.

At the same time, the desirability of facilitating collective action may provide independent reasons for accepting the authority of international norms like the arm's length standard. This factor can strengthen legal obligations established under secondary rules. In keeping with the emphasis that ought to be placed on state autonomy within a framework of community, however, the legitimacy and authority of norms instituted to help resolve what states perceive as dilemmas of common interests should be stronger than norms addressing situations best characterized as games of "harmony" or "assurance." In the case of situations resembling assurance games, in the absence of obligations established by secondary rules involving treaties or customary international law, it usually suffices for states to signal to other states their intention of taking a particular cooperative action. Other states will then have confidence that their preferred equilibrium outcome will be reached, making it unnecessary to preempt state decision making.

Likewise, norms established to resolve dilemmas of common interests, like a prisoners' dilemma, should have greater legitimacy and authority than norms established to resolve pure or non-pure coordination problems. This is the case for the simple reason that in dilemmas of common interests acceptance of the preemptive effect of norms is more critical to the resolution of the problem.

Of course, based on the analyses of Ullmann-Margalit and Raz, there may be good reasons to accept the binding authority of a coordination norm.<sup>328</sup> But in light of the value accorded to state autonomy and the natural incentive states have to conform with coordination norms, these reasons should be regarded as less compelling than in the case of norms that resolve dilemmas of common interests. Thus, except to the extent relevant secondary rules already establish their binding authority, coordination norms should not be given such binding authority without careful consideration.

On the other hand, there is a greater justification for recognizing the binding authority of a coordination norm in the case of a non-pure coordination problem, precisely because some states would clearly prefer another coordination equilibrium and may be tempted unilaterally to defect from a current equilibrium if they believe that other states can be induced to follow their lead. Moreover, coordination norms with binding authority can be useful where it is

---

328. See *supra* text accompanying notes 284-99.

not clear that all states perceive a coordination problem in the same way, or recognize that a coordination problem in fact exists. The imposition of binding obligations may also be helpful where there is a risk that states currently perceiving a coordination problem may not continue to do so in the future.

The above analysis of the concept of persuasive authority suggests that norms with persuasive authority, as opposed to binding authority, may be particularly useful in solving coordination problems. This is because they can provide the added certainty of convergence on a convention, and also more easily establish a new convention, without going so far as to impose a binding obligation to follow the convention. Norms with persuasive authority may be especially effective in resolving non-pure coordination problems. They can authoritatively “nudge” those states that may be tempted to threaten unilateral action to establish a new, more favorable equilibrium to adhere to a current convention. They can also nudge states that do not happen to perceive the situation as a coordination problem to conform with a convention, thus making those states better off than they would have been had they defected from the convention. At the same time, norms with persuasive authority avoid imposing binding obligations on the majority of states who see the situation as a coordination problem and therefore have a natural incentive to conform. But they do help discourage such states from arbitrarily abandoning the convention should they “change their minds” in the future and decide that the situation no longer constitutes a coordination problem.

In situations with the characteristics of a prisoners’ dilemma, in general it would be desirable for states to establish a system of sanctions. The existence of sanctions should be regarded as a factor further enhancing the legitimacy of international legal norms that have been accepted by states under relevant secondary rules of international law to deal with such prisoners’ dilemma situations. Nonetheless, sanctions should not be regarded as a prerequisite for recognizing the authority and legitimacy of legal norms established under relevant secondary rules. This is especially true in the case of coordination norms, precisely because such norms are usually self-enforcing.

If secondary rules of international law already identify particular norms as having legal authority, then their authority should be enhanced to the extent the norms have been developed by experts with significant knowledge, experience, or expertise in the fields to

which the norms relate. Of course, such involvement of experts ought to be a reason for at least giving such norms persuasive weight, if not persuasive or binding authority.

As previously noted, states should not only value autonomy; they should also regard themselves as members of a community of states. This is the basis for the acceptance of relevant secondary rules of international law. Further, the moral principle of fidelity to promises should be regarded as sacrosanct. It can serve as a powerful reason for recognizing the authority of norms contained in treaties that represent mutual promises. For example, where coordination norms are embodied in treaties, the moral principle of fidelity to promises independently necessitates granting authority to those norms, even if in the absence of a promise there would be weaker reasons for recognizing their authority. The same reasoning may apply where morally it would be unjust to defeat the legitimate expectations of other states based on a state's conduct.

Finally, consent can certainly strengthen the legitimacy of a norm based on the principle of state autonomy. Moreover, it can form the basis under relevant secondary rules for recognizing a norm's legitimacy and authority. However, state consent is not a necessary or sufficient condition for accepting the legitimacy of a norm, because it is limited both by moral principles, like fidelity to promises, and by states' membership in a community of states. Accordingly, the simple withdrawal of consent does not legitimize the violation of a norm supported by other reasons.

## B. The Normative Authority of the Arm's Length Standard

1. *The Authority of the Arm's Length Standard in Historical Perspective.* The above conceptual framework helps illuminate historical attempts to codify the arm's length standard in international treaties and various historical views about its authority under international law. During the League of Nations era, states pursued very different policies regarding the allocation of profits of a single enterprise or between associated enterprises, although at least a majority of states gave preference to the principle of separate accounting. Nevertheless, states disagreed about how to rectify accounts that did not reflect true profits.

States adopted various methods to rectify the accounts of related enterprises to reflect true profits. Some states used an "independent enterprise" or "arm's length" standard, however those terms were



interpreted.<sup>329</sup> In applying this standard, some used a transaction-based “arm’s length method,”<sup>330</sup> while others used empirical methods.<sup>331</sup> Still others used outright formulary apportionment of total combined profits rather than purporting to follow the separate accounting principle.<sup>332</sup>

Thus, regarding allocation methods, states were not playing a “harmony” game in which they all “automatically” converged on use of the same allocation method based on their perceived interests and values. However, to the extent there was some consensus among an apparent majority of states on the preferred use of methods consistent with the arm’s length standard, with empirical and formulary methods as fallback methods, this consensus did reflect a limited game of “harmony” among these states. In any case, before the issuance of the Carroll Report,<sup>333</sup> there was no single standard for which either persuasive or binding authority over states was claimed, and the arm’s length standard was never claimed to have either form of authority.

Because the incentives to defect were not very strong, states did not apparently perceive allocation issues as a prisoners’ dilemma. In particular, it does not appear that each state believed that its best outcome was achieved when it used formulary apportionment (which we can consider defection, or D) while all other states adopted the arm’s length standard (which we can consider cooperation or C). This is not surprising. The lack of a clear incentive to “cheat” by unilaterally using formulary apportionment can be explained, in part, by the competing self-interests that each state had with regard to allocation. The interest each state had in allocating as much of the profit from a multinational corporate group to itself was offset to a greater or lesser degree by the opposite interest in restraining an excessive allocation in order not to result in double taxation and thereby dissuade foreign investment. Thus, states’ perceived self-interest did not always pull in favor of “overallocation” to themselves. Neither the arm’s length standard nor formulary apportionment was seen as always producing comparatively more revenue. Accordingly, neither method appeared uniformly attractive to all states and the international community did not perceive an urgent need to prevent

---

329. *See supra* notes 69-77 and accompanying text.

330. *See id.*

331. *See id.*

332. *See id.*

333. *See id.*

states from unilaterally adopting a particular method based on calculations of self-interest, as would have been the case in a prisoners' dilemma.

According to theorists such as Ullmann-Margalit, we also expect that states that perceive a prisoners' dilemma will advocate multilateral solutions and enforcement mechanisms to deter and punish defectors.<sup>334</sup> No such enforcement mechanisms were proposed during the League period (or thereafter) with respect to income allocation issues.

At first blush, it appears that the League-era debate on allocation methods might be viewed as a "stag hunt" assurance game, in which all (or at least most) states did prefer universal use of the arm's length standard (CC), but in which their second-best preference was unilateral use of formulary apportionment (DC), followed by universal use of formulary apportionment (DD), and, in last place, use of the arm's length standard while other states use formulary apportionment (CD). Given the history of the League's efforts, however, it is not at all clear that states necessarily preferred DC to DD. Indeed, as we have seen, the evidence does not show any tendency on the part of states to prefer unilateral use of formulary apportionment over universal use of formulary apportionment. As noted in Professor Adams' report, those states, like Austria, that used formulary apportionment argued that it should be universally adopted.<sup>335</sup> It also is not clear that all states viewed CD (continued use of the arm's length standard in the face of defection by some states to formulary apportionment) as inferior to DD (universal use of formulary apportionment), even if many of them did.<sup>336</sup>

Finally, income allocation during the League era was not evidently perceived by states as a zero-sum game. The very desire for coordination of allocation methods implies that states saw the adoption of uniform rules as producing benefits (particularly in the form of enhanced investment through the limitation of double taxation) and not as inevitably benefiting other states at their expense. States were not attempting to outwit each other in a high-stakes game to use either the arm's length standard or formulary apportionment in their income allocation policies. On the contrary, whatever "game" existed was singularly low-key.

---

334. See ULLMANN-MARGALIT, *supra* note 257, at 116-17.

335. See 1930 *Committee Report*, *supra* note 57, at 4218.

336. Recall that Ullmann-Margalit pointed out a similar weakness in regarding trade practices as a stag hunt game. See ULLMANN-MARGALIT, *supra* note 257, at 124-27.

So what type of “game” best explains the behavior of states during the League of Nations period? The League’s efforts can best be understood as reflecting state perceptions of a pure or non-pure coordination game. States did not have strong preferences about the use of the arm’s length standard or formulary apportionment. This lack of a strong preference is confirmed by the model treaty provisions dealing with allocations to permanent establishments, which explicitly permitted the use of empirical or formulary methods as fallback methods.<sup>337</sup> Rather, states perceived the need for coordination. The worst outcome for each was if it used one general allocation method (such as the arm’s length standard or formulary apportionment) while trading partners used other methods, thereby posing a high risk of double taxation. Equilibrium outcomes occurred when all states used compatible allocation methods, whether based on the arm’s length standard, formulary apportionment, or some combination of methods that would avoid double taxation.

The evidence does suggest, however, that some states preferred the arm’s length standard based on certain policy considerations, while others preferred formulary apportionment.<sup>338</sup> This implies that a “non-pure” coordination game was involved. The Carroll Report argued in favor of the arm’s length standard both on certain policy grounds (namely, that it was more easily applied and accurate) and because most states already used it.<sup>339</sup>

In any case, after the issuance of the Carroll Report, states did evince a preference that all states should use the arm’s length standard as the primary allocation method, allowing expectations to converge around it. The Carroll Report and the League models represented an attempt to establish the arm’s length standard and the arm’s length method as conventions, ideally through agreements. Even if, as Stanley Langbein has argued, Carroll was somehow biased against formulary apportionment,<sup>340</sup> such a bias is irrelevant to the desirability of having some convention. To a large extent, the choice of any convention is always arbitrary. What matters historically is that states desired to arrive at some equilibrium point, by whatever means. The resemblance of the allocation issue to a non-pure coordination problem also helps account for the flexible system of

---

337. *See supra* text accompanying note 86.

338. *See supra* text accompanying notes 66-77.

339. *See supra* text accompanying notes 75-79.

340. *See* Langbein, *supra* note 38, at 637-38; *supra* text accompanying note 80.

model treaties and bilateral treaties developed during the League of Nations era.

Nevertheless, during the League years, there was no recognition of the arm's length standard as a norm *binding* on all states. Instead, the Carroll Report and the League of Nations models were attempts to *persuade* states that coordination was desirable and could best be achieved through the adoption of a single general allocation standard, namely, the arm's length standard. Neither the Carroll Report nor the League of Nations Fiscal Committee claimed that the arm's length standard had either binding or even persuasive authority except, possibly, as to states adopting the models. The League's rejection of a multilateral treaty indicates an attempt to be flexible and to rely on persuasion, rather than the assertion of any preemptive effect for the arm's length standard as to all states. On the other hand, perhaps in an effort to establish firmly the arm's length standard as a new broad convention, the League of Nations-era model treaties provided that parties "shall" use the arm's length standard. This implied the imposition of a binding obligation on parties to an actual convention adopting this language. However, it is important to recognize that the model treaties did not mandate a particular method for implementation of this umbrella standard.

The promulgation of the OECD and U.N. Models, like the League of Nations models, represented an attempt to persuade governments to adopt bilateral treaties incorporating similar provisions, such as those calling for use of the arm's length standard to allocate income between associated enterprises. Neither the OECD nor the United Nations claimed that the Models had binding or even persuasive authority in and of themselves. Rather, they asserted that the "authority" (if any) of the Models was attributable to their persuasive weight as models developed by government officials and tax experts with wide-ranging experience in tax issues and income allocation problems in particular.<sup>341</sup> Moreover, the vast majority of the treaties themselves provided only that states "may" make an adjustment in accordance with the arm's length standard, in contrast to the imperative "shall" of the League models. Part IV will suggest that such a softening of the obligation might have seemed feasible because the arm's length standard, and the arm's length method, had already become conventions permitting the achievement of a coordination equilibrium.

---

341. See, e.g., 1977 OECD MODEL, *supra* note 134, ¶ 26, at 14.

Turning to U.S. policy, U.S. legislation and proposed legislation manifested ambivalence by the United States regarding the use of the arm's length standard versus formulary apportionment. This ambivalence is reflected in the language of section 482 as well as the unsuccessful section 482 legislation proposed by the U.S. House of Representatives in 1962.<sup>342</sup> Such ambivalence again points to the absence of clear self-interested incentives for adopting either formulary apportionment or the arm's length standard. The United States did not see itself as having an incentive to defect unilaterally from the arm's length norm. The Treasury Department eventually opted to maintain and promote the arm's length standard and a transaction-based arm's length method in its 1968 regulations.<sup>343</sup> But, as manifested in the public speeches and writings of Stanley Surrey, the Treasury Department's emphasis was more on the need for international coordination, as opposed to the intrinsic merits of the arm's length standard itself.<sup>344</sup> This confirms that the central problem was perceived as one of coordination.

The U.S. campaign to "export" the arm's length standard relied fundamentally on persuasion, rather than the assertion that the arm's length standard was already authoritative. That is, the United States attempted to convince its trading partners in the OECD and elsewhere that it would be a good idea to adopt a uniform standard and that the arm's length standard made the most sense for this purpose. Again, the emphasis was on reaching a particular coordination equilibrium around the arm's length standard, even if its choice was somewhat arbitrary.

The current attempt by some U.S. political leaders, such as Senator Dorgan, to have the United States defect from the arm's length standard suggests that these officials may also perceive the situation as a coordination game.<sup>345</sup> But leaders advocating defection may see this coordination game as a non-pure one in which universal adoption of formulary apportionment is a clearly preferable equilibrium outcome for the United States that a unilateral defection could help establish.<sup>346</sup> Alternatively, they may not perceive the issue of income allocation as a coordination game at all, but rather as a

---

342. *See supra* text accompanying notes 124-26.

343. *See* Treas.Reg. §§ 1.482-1, 1.482-2 (as amended in 1968).

344. *See supra* text accompanying notes 129-30.

345. *See supra* text accompanying notes 16-22.

346. *See* Stein, *supra* note 235, at 130-31; *see also supra* text accompanying note 305.

dilemma of common interests in which the United States can better its position by unilaterally abandoning the arm's length standard.

2. *Toward a Normative Theory of the Authority of the Arm's Length Standard.* The general normative theory sketched earlier and the above analysis of the history of the arm's length standard suggest certain preliminary conclusions about the authority that the arm's length standard ought to enjoy as an international norm. In particular, the existence of the norm facilitates collective action to harmonize allocation methods among states. Because the norm has arisen primarily in response to perceptions of a coordination problem rather than a dilemma of common interests, however, it is important to be cautious about concluding based on this factor alone that the arm's length standard ought to be treated as having persuasive or binding authority.

Of course, to the extent that the arm's length standard was agreed upon as a solution to a non-pure coordination problem, there is greater justification for treating it as having persuasive, if not binding, authority. There is also greater justification for recognizing its authority to the extent that some dissenting states or leaders—like the drivers described in the Introduction—fail to perceive income allocation as a coordination problem at all. As argued earlier, norms with persuasive authority can be helpful in “nudging” such dissenters toward conformity with a convention like the arm's length standard.

Moreover, the arm's length standard's development and endorsement by fiscal experts over a period of many decades may warrant giving it either persuasive or binding authority, or at least persuasive weight. However, as just noted, because the arm's length norm serves as a solution to a coordination problem in which most states already have great incentives to maintain the norm as a convention using their own independent judgment, it should not be treated as authoritative in the absence of other reasons. By the same token, precisely because the norm is a solution to a coordination problem rather than a prisoners' dilemma, the absence of effective sanctions for departures from the arm's length standard should not adversely affect whatever authority the norm might otherwise be justified as having based on other reasons.

The primary justification for treating the arm's length standard as authoritative depends on secondary rules that establish its authority under international law, either as a persuasive or binding obligation under treaties or customary international law. The moral

principles of fidelity to promises and fulfillment of legitimate expectations may support such secondary rules. In addition, the participation of the United States in a community of states provides ultimate support for these rules. In light of the general principles outlined here, the next two Parts will develop a normative theory of the authority of treaties and customary international law that gives deference to and interprets existing secondary rules, and will apply this theory to the determination of the authority of the arm's length standard.

#### IV. THE AUTHORITY OF THE ARM'S LENGTH STANDARD UNDER INTERNATIONAL TREATIES

##### A. The Normative Authority of Treaties

Before analyzing in detail the authority of the arm's length standard in bilateral tax treaties, this section examines, from a more legal and theoretical perspective, the normative authority of treaties that is claimed under secondary rules of international law and U.S. law as well as under various normative theories. It then delineates the broad outlines of a normative theory of the authority of treaties that takes account of the analysis in Part III.

1. *The Authority of Treaties under Secondary Rules of International Law and U.S. Law.* Secondary rules regarding treaties are found in relevant customary rules of international law, now codified and expanded in the 1969 Vienna Convention on the Law of Treaties ("Vienna Convention").<sup>347</sup> According to customary international law and the Vienna Convention, treaties bind ratifying states, under the principle of *pacta sunt servanda* ("treaties are to be obeyed"). The Vienna Convention proclaims in article 26: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."<sup>348</sup> In general, therefore, a treaty norm has authority in accordance with its terms, which may lay down a binding obligation (including a prohibition), a persuasive obligation, or an

---

347. Vienna Convention on the Law of Treaties, May 23, 1969, art. 26, U.N. Doc. A/CONF.39/27 (1969) [hereinafter Vienna Convention]; see FRANCK, *supra* note 313, at 183-207 (characterizing customary rules of treaty formation, interpretation and termination as secondary rules); see also SIR IAN SINCLAIR, THE VIENNA CONVENTION ON THE LAW OF TREATIES 153 (2d ed. 1984) (describing the status of the Vienna Convention as a "general expression of the principles of customary international law relating to treaty interpretation").

348. Vienna Convention, *supra* note 347, art. 26.

authoritative permission. In any of these cases, binding obligations exist at some level for the parties to the treaty, even if the obligation is only to give altered weight to first-order reasons for action. Under international law, the primary claimed reason for giving preemptive effect to treaties is compliance with these secondary rules under either customary international law or the Vienna Convention.

The Vienna Convention also lays down secondary rules for the interpretation of treaty provisions. In particular, article 31 states that a “treaty shall be interpreted in good faith in accordance with the *ordinary meaning* to be given to the terms of the treaty *in their context* and in the light of its *object and purpose*.”<sup>349</sup> For this purpose, the “context” of a treaty has a specialized meaning; it encompasses the text, the treaty’s preamble and any annexes, and any supplementary agreement between all the parties made in connection with the treaty’s adoption.<sup>350</sup> The Vienna Convention further provides:

There shall be taken into account, together with the context:

- (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
- (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
- (c) any relevant rules of international law applicable in the relations between the parties.<sup>351</sup>

In addition, a “special meaning shall be given to a term if it is established that the parties so intended.”<sup>352</sup>

Importantly, the records of the drafting history of a treaty (the *travaux préparatoires*) do not figure in these primary rules of interpretation. Article 32 of the Vienna Convention provides that the *travaux* and other “supplementary means of interpretation” may be used only in order “to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.”<sup>353</sup> The International Law Commission, which had originally prepared these provisions, took “the view that what matters is the intention of the parties *as expressed in the text*, which is the best guide to the more recent common intention of the

---

349. *Id.* art. 31(1) (emphasis added).

350. *See id.* art. 31(2).

351. *Id.* art. 31(3).

352. *Id.* art. 31(4).

353. *Id.* art. 32.



parties.”<sup>354</sup> However, the Commission simultaneously indicated that articles 31 and 32 should be treated as dynamically interrelated and not applied sequentially or mechanically.<sup>355</sup>

Turning briefly to the authority of treaties under secondary rules of U.S. domestic law, the “Supremacy Clause” of the U.S. Constitution provides in part that “all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land.”<sup>356</sup> Early in the nation’s history, the Supreme Court distinguished between “self-executing” treaties, which automatically became the law of the land, and were thus enforceable by the courts, and “non-self-executing” treaties, which required some act of Congress in order to be enforceable by the courts.<sup>357</sup> Thus, congressional legislation always prevails over a non-self-executing treaty that has not been implemented by congressional legislation.<sup>358</sup> In general, treaties are presumed to be self-executing.<sup>359</sup>

The Supreme Court has further held that treaties cannot contravene the U.S. Constitution<sup>360</sup> and that if there is a direct conflict between a congressional enactment and a self-executing treaty, the instrument that was most recently adopted will govern.<sup>361</sup> Under this “last in time” rule, no self-executing treaty norm has any preemptive effect as to a later federal statute. It is important to recognize, however, that the “last in time” rule is solely a rule for determining the status of treaties under U.S. law; international secondary rules regarding the authority of treaties do not admit that U.S. treaties can be overridden by subsequent congressional legislation.<sup>362</sup> Although a later statute may preempt an earlier treaty if it directly conflicts with the treaty, the U.S. Supreme Court has ruled that national legislation is to be construed, if at all possible, so as to comply with U.S. treaty obligations.<sup>363</sup>

---

354. IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 627 (4th ed. 1990).

355. *See id.* at 628.

356. U.S. CONST. art. VI, cl. 2.

357. *See Foster v. Neilson*, 27 U.S. (2 Pet.) 253, 314 (1829).

358. *See* LOUIS HENKIN, *FOREIGN AFFAIRS AND THE UNITED STATES CONSTITUTION* 209 n.\* (2d ed. 1996).

359. *See id.* at 198-204.

360. *See Reid v. Covert*, 354 U.S. 1, 16-19 (1957); *see also Geofroy v. Riggs*, 133 U.S. 258, 267 (1890).

361. *See Whitney v. Robertson*, 124 U.S. 190, 194-95 (1888). On the Supreme Court’s decisions in this area, see generally HENKIN, *supra* note 358, at 209-11.

362. *See Vienna Convention*, *supra* note 347, art. 27, which reads in part: “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”

363. *See, e.g., Whitney*, 124 U.S. at 194.

The current version of section 894 of the tax code<sup>364</sup> embraces Congress' commitment to the "last in time" rule with respect to tax legislation and tax treaties. It provides, as the general rule, that the provisions of the tax code "shall be applied to any taxpayer *with due regard* to any treaty obligation of the United States which applies to such taxpayer."<sup>365</sup> The "due regard" language was added by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).<sup>366</sup> Under prior law, income was exempt from U.S. tax to the extent "required" by a treaty.<sup>367</sup> Section 7852(d)(1) of the tax code, also revised in 1988, similarly clarifies that for "purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."<sup>368</sup> The Senate Report on this revision makes clear that section 7852(d)(1) was intended to codify the "last in time" rule.<sup>369</sup> In effect, the "due regard" language of section 894 and the current version of section 7852(d)(1) combine to claim only persuasive authority for existing tax treaty obligations, rather than binding authority, vis-à-vis congressional tax legislation.

In the United States, although tax treaties are considered self-executing,<sup>370</sup> they have not often been given their claimed preemptive effect, largely because of the congressional policy of considering treaties as having only persuasive authority. Congress has frequently availed itself in recent years of the opportunity to overturn certain treaty principles through subsequent legislation. These legislative acts have explicitly abrogated particular treaty rules and thus have become known as "treaty overrides."<sup>371</sup> In keeping with this trend, any future tax legislation that would institute some form of formulary

---

364. I.R.C. § 894 (1994).

365. *Id.* § 894(a)(1) (emphasis added).

366. See Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, § 1012(aa)(6), 102 Stat. 3342, 3533 (1988).

367. See I.R.C. § 894(a) (1986); see also Richard L. Doernberg, *Overriding Tax Treaties: The U.S. Perspective*, 9 EMORY INT'L L. REV. 71, 81 (1995) (observing that the "change to the 'due regard' language serves as a warning by Congress that the existence of a treaty obligation exempting an item from income may be given due regard but that it nevertheless will give way to subsequent legislation").

368. I.R.C. § 7852(d)(1) (1994), as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, § 1012(aa)(1)(A), 102 Stat. 3342, 3531 (1988).

369. See S. REP. NO. 100-445, at 316-28 (1988).

370. See Doernberg, *supra* note 367, at 120 n.170.

371. See *id.* at 82-85 (providing examples of treaty overrides in tax legislation, including proposed legislation involving income allocation).

apportionment at the federal level would undoubtedly purport to override existing U.S. treaties.<sup>372</sup>

It should be pointed out that with respect to treaty interpretation, U.S. courts have not followed the Vienna Convention's treatment of legislative history as merely a supplementary means of interpretation. Rather, U.S. courts tend to place far more emphasis on legislative history in determining the meaning to be given to treaty provisions, including provisions in tax treaties.<sup>373</sup>

2. *Normative Theories Regarding the Authority of Treaties.* Prominent normative theories differ sharply about what degree of preemptive effect states should accord to treaty norms and what reasons are valid for regarding treaty norms as legitimate and thus authoritative. For example, "realists" often maintain that states should accord treaties persuasive authority, at most, and perhaps no authority at all. These realists argue that political leaders ought to take only calculations of self-interest into account.<sup>374</sup> Under the realist perspective, a treaty may be violated at will if it purports to require state conduct that runs counter to the state's perceived self-interest. In direct contrast lie the views of "society of states" theorists, who perceive and emphasize the existence of an interdependent community of states in the international system. "Society of states" theorists often argue that states should grant treaties full preemptive effect in accordance with their terms, as required by customary international legal norms and the norms of the Vienna Convention.<sup>375</sup>

Those normative theories that endorse at least some preemptive effect for treaties differ in the reasons they proffer for doing so. Many theorists emphasize compliance with secondary rules.<sup>376</sup> Some theorists justify granting authority to treaties on self-oriented prudential grounds, such as the fact that treaties can help resolve dilemmas of collective action.<sup>377</sup> For example, such theorists may

---

372. *See id.* at 109.

373. *See, e.g.,* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 28-29 (1992).

374. *See, e.g.,* HANS J. MORGENTHAU, POLITICS AMONG NATIONS: THE STRUGGLE FOR POWER AND PEACE 12 (5th ed. 1973).

375. *See, e.g.,* FRANCK, *supra* note 313, at 183-94.

376. *See, e.g., id.*

377. *See* Stein, *supra* note 235.

believe that if states find themselves in a dilemma of common aversions, they should adopt a treaty “to *signal* to each other which of the available means of cooperation they will adopt: [states thereby] . . . coordinate their actions.”<sup>378</sup> A treaty or other agreement may thus become, according to Ullmann-Margalit, “the firmest rallier of the participants’ expectations regarding each other’s actions.”<sup>379</sup> Many “game” and “regime” theorists also maintain that acceptance of the authority of treaties can help resolve prisoners’ dilemmas.<sup>380</sup> The “parties will need the treaty to deter potential violators and free riders tempted to take advantage of those who comply.”<sup>381</sup>

Other international law theorists stress that the obligation to obey treaties derives from consent itself.<sup>382</sup> The problem with relying on consent alone, however, is that to the extent the consent requirement furthers a value of state autonomy and choice, it could be interpreted to mean, as some realists have suggested, that a state ought to be as free to violate treaties as it is to enter into them voluntarily.<sup>383</sup> Accordingly, other theorists maintain that a state’s obligation to comply with its treaty commitments must flow ultimately from its participation in a community of states, just as under Dworkin’s conception of national law, members of a national community may have “associative” obligations to obey the law that do not derive from their free consent.<sup>384</sup>

Finally, some theorists emphasize that the moral principles of fidelity to promises and fulfillment of the legitimate expectations of other states must be the ultimate reason for giving treaties preemptive effect. For example, Tesón has contended that

*[p]acta sunt servanda* is a moral rule, not a customary rule. It stems from two related moral intuitions. The first is that, other things being equal, keeping one’s word is the right thing to do, regardless of interest and especially when it is against interest. The second is that, other things being equal, it is morally wrong to *exploit* those who in good faith rely on our promised behavior.<sup>385</sup>

---

378. TESÓN, *supra* note 315, at 82 (describing this view).

379. ULLMANN-MARGALIT, *supra* note 257, at 116.

380. *See, e.g.*, Stein, *supra* note 235, at 128-129.

381. TESÓN, *supra* note 315, at 82 (describing this view).

382. Such a view is described in OPPENHEIM, *supra* note 319, at 519.

383. On the limitations of consent as a basis of obligation, see, for example, FRANCK, *supra* note 313, at 187.

384. *See id.* at 195-207. *See supra* text accompanying notes 311-312 (discussing Dworkin’s approach).

385. TESÓN, *supra* note 315, at 89 (emphasis in original).

In this connection, Tesón argues that the pursuit by a state of its long-term interests “does not create an *obligation* to obey the treaty. The would-be offender refrains from violating the treaty for prudential reasons, so *pacta sunt servanda* plays no role whatsoever.”<sup>386</sup> He concludes that “[g]ame theory cannot explain obligation, come what may.”<sup>387</sup>

3. *Toward a Normative Theory Regarding the Authority of Treaties.* It would be impossible here to develop a comprehensive normative theory regarding the authority of treaties. Nevertheless, some broad principles can be recognized based on the general theory of authoritative international norms put forward in Part III. First, secondary rules of international law governing the formation, interpretation, and binding character of treaties ought to be respected, both prudentially and morally. They should be respected for prudential reasons because these rules can help facilitate collective action to achieve values that are in the immediate and long-term self-interest of states. These rules should also be respected for moral reasons because they likewise can facilitate collective action to implement moral values, they have been developed by a community of states, and they reflect the essential moral principles of fidelity to promises and fulfillment of the legitimate expectations of other states. Thus, the obligation to respect treaties rests in part on the consent of states. But the above-mentioned moral principles place limits on the extent to which the withdrawal of consent to a treaty can legitimize its violation.

While secondary rules and moral principles provide sufficient reasons for respecting the authority of treaties, to the extent that particular treaties represent a solution to dilemmas of collective action, these particular treaties should acquire enhanced legitimacy and authority. For example, when a treaty norm has been developed as a solution to a dilemma of common aversions, allowing the treaty norm some degree of preemptive effect can ensure that coordination will be achieved, as noted by theorists such as Ullmann-Margalit.<sup>388</sup> The argument for granting preemptive effect and legitimacy to treaties is even stronger when states face a prisoners’ dilemma in which, based on perceived self-interest, there are strong incentives for states to defect. In this case, it may also be desirable to institute some

---

386. *Id.* at 84 (emphasis in original).

387. *Id.*

388. *See supra* text accompanying notes 284-99.

form of sanctions against violators of the treaty norm. These normative principles will be applied in the following analysis of the authority of the arm's length standard under tax treaties.

B. The Authority of the Arm's Length Standard as a Treaty Norm:  
A Norm with Persuasive Authority

The normative model of the authority of treaties outlined above can shed light on the authority that the arm's length standard ought to be regarded as having as a treaty norm. The balance of this section focuses on three potential obligations of states parties to bilateral treaties:

(1) the obligation of an "initiating state party" making an "initial adjustment" to the income of a corporation resident in its own territory to use the arm's length standard;

(2) the obligation of an initiating state party making an initial adjustment to the income of a corporation resident in the *other* state to use the arm's length standard; and

(3) the obligation of the other state party to make a "correlative adjustment" to the income of a corporation related to the corporation whose income is subject to an initial adjustment under (1) to avoid economic double taxation.

This section first discusses potential obligations (1) and (2), and then analyzes potential obligation (3).

1. *The Existence and Character of an Obligation to Make an Initial Adjustment Using the Arm's Length Standard.*

a. *The Debate on the Existence and Character of an Obligation to Use the Arm's Length Standard under Article 9(1) of the Model Treaties.* The starting point for an analysis of the first two of the above-mentioned potential obligations is article 9(1) of the 1997 OECD Model, which uses language very similar to article 9(1) of the U.N. and U.S. Models. To recall, article 9(1) of the 1997 OECD Model provides that where conditions

are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, *may* be included in the profits of that enterprise and taxed accordingly.<sup>389</sup>

---

389. 1997 OECD MODEL, *supra* note 171, art. 9(1) (emphasis added).

On its face, article 9(1) simply entitles a state party to use the arm's length standard to adjust the profits of an enterprise resident in its own territory or in another contracting state (potential obligations (1) and (2)). It does not obligate a state party to do so. Further, the text itself makes no reference to the arm's length method in particular. But by referring to the "commercial or financial relations" between the enterprises and to an "independent enterprise" standard, article 9(1) could be read as supporting the arm's length method, which focuses on determining an arm's length price for particular transactions. On the other hand, its reference to inclusion of "profits" implies that profit-based empirical methods (such as the comparable profits method or profit split method) might be permissible.

As noted in Part I, despite the permissive language of article 9(1), many government officials and courts have claimed that bilateral treaties prohibit the use of formulary apportionment by *mandating* the use of the arm's length standard.<sup>390</sup> A number of scholars have also argued that notwithstanding article 9(1)'s facially permissive language, treaties incorporating language similar to article 9(1) in fact impose binding obligations to use the arm's length standard. To arrive at this conclusion, they often interpret article 9(1) in light of the "object and purpose" of double taxation conventions, as required by the Vienna Convention, as well as by making reference to supplementary sources of interpretation, including the OECD Commentary. For example, German scholar Klaus Vogel and his co-authors have argued the following:

[Article 9] is designed to avoid economic double taxation. This can be achieved only if the delimitation of profits is subjected to a firm rule, i.e. one which is *binding on both contracting States*. The fact that the arm's length clause is more elaborate in Art. 7 [relating to the allocation of income to permanent establishments] than in Art. 9, cannot be taken to imply that Art. 9 is less binding or not binding at all . . . Art. 9 is no less definite than sec. 482 I.R.C . . . the direct applicability of which cannot be doubted.<sup>391</sup>

---

390. For example, in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the U.S. Supreme Court stated in dictum: "[T]he United States is a party to a great number of tax treaties that *require* the Federal Government to adopt some form of 'arm's length' analysis in taxing the domestic income of multinational enterprises . . ." *Id.* at 196 (emphasis added).

391. PROF. DR. KLAUS VOGEL ET AL., *KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS* 422-23 (1991); *see also* Thomas, *supra* note 36, at 130-31 (arguing that bilateral treaties impose an obligation to use the arm's length standard and therefore help to establish *opinio juris* under customary international law).

The authors support this opinion in part by reference to the 1977 OECD Commentary on paragraph 1 of article 9, which states that “[n]o re-writing of the accounts . . . is authorized if the transactions . . . have taken place on normal open market commercial terms (on an arm’s length basis).”<sup>392</sup>

Many writers holding a similar view contend that existing treaties prohibit the use of formulary apportionment.<sup>393</sup> Some commentators distinguish between transaction-based methods that take account of transactional profits, which they consider to be consistent with the binding obligation to use the arm’s length standard, and those general profit-based methods that take account of the total combined profits of the related corporations, which they consider to be prohibited.<sup>394</sup> Likewise, certain supporters of formulary apportionment, such as Dale Wickham and Charles Kerester, while apparently conceding that article 9(1) requires the use of an arm’s length standard, argue that this standard “does not require an arm’s length *price*. An arm’s length price is only one means of satisfying an arm’s-length standard.”<sup>395</sup> They argue that profit split methods should be understood as consistent with the binding obligation imposed by treaties to use the arm’s length standard.<sup>396</sup>

In contrast, other commentators have argued that article 9(1) should be read literally as permissive or as merely descriptive, and that article 9(1) imposes no persuasive or binding obligation to use the arm’s length standard. For example, Louis M. Kauder, a former official in the Treasury Department’s Office of International Tax Counsel and the Justice Department’s Tax Division, has noted that “[o]ne implication of the phrase ‘may be taken into account’ (or ‘may adjust’) is that it grants each taxing authority permission to do something (i.e., make a transfer pricing adjustment to the income of an affiliate of an MNE) that otherwise it could not do.”<sup>397</sup> But he argues that no other rule in U.S. tax treaties based on the OECD Models or in national or international law forbidding transfer pricing

---

392. VOGEL *supra* note 391, at 423; 1977 OECD MODEL, *supra* note 134, ¶ 1, at 88.

393. *See, e.g.*, Coffill & Willson, *supra* note 15, at 1116 (“numerous bilateral treaties between the United States and other nations preclude the use of formula apportionment”).

394. *See, e.g.*, Frances M. Horner, *International Cooperation and Understanding: What’s New About the OECD’s Transfer Pricing Guidelines*, 50 U. MIAMI L. REV. 577, 578-79 (1996).

395. Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 348 (July 20, 1992).

396. *See id.*

397. Kauder, *supra* note 37, at 1149.



adjustments exists.<sup>398</sup> Therefore, he concludes, article 9(1) does not represent even an authoritative permission; rather, it “must be explained as descriptive. That is, it simply describes what the tax authority of one of the treaty countries might do in respect of related parties and their intercompany transactions.”<sup>399</sup>

Kauder goes on to suggest that the only function of article 9(1) is to lay the factual basis for a possible correlative adjustment pursuant to article 9(2) of the U.S. treaties (which, in turn, is modeled on article 9(2) of the OECD Models): “[T]he descriptive related-party language of the treaties does not bind either country to any particular method of accomplishing adjustments among related parties, but rather lays the predicate for a possible correlative adjustment that may follow from an initial adjustment.”<sup>400</sup> Kauder concludes that “the related-party articles of the treaty do not prohibit formulary apportionment but rather, at most, provide a mechanism for possible relief from double taxation.”<sup>401</sup>

A number of other commentators state that under the OECD, U.N., and U.S. model treaties, countries are “allowed to” make an adjustment based on arm’s length principles.<sup>402</sup> Thus, they imply that the provision grants an authoritative permission to states parties.

How can we resolve the arguments between those scholars who contend that tax treaties based on the OECD and U.N. Models impose a binding obligation on states parties to use the arm’s length standard and those critics, like Kauder, who maintain that the language in article 9(1) of these treaties is not only permissive, but merely descriptive and without any preemptive effect? Moreover, what of the possible divergence in meaning between the “independent enterprise” (or arm’s length) standard explicitly laid down in the treaties and the “arm’s length method,” understood traditionally as the use of the CUP, resale price or cost plus methods?

In keeping with the normative approach to treaty interpretation sketched earlier, this Article will first turn to the Vienna Convention rules on treaty interpretation as widely-accepted secondary rules that

---

398. *See id.*

399. *Id.*

400. *Id.* at 1150.

401. *Id.* at 1151.

402. *See, e.g.,* PAUL R. MCDANIEL & HUGH J. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 150-51 (4th rev. ed. 1998) (“Most US income tax treaties contain an article which *allows* the US to determine the income of persons subject to its taxing jurisdiction on the basis of an arm’s length principle . . . .”) (emphasis added).

can provide a common interpretation.<sup>403</sup> It is important to note at this juncture, however, that the OECD, U.N., and U.S. Models contain a special provision regarding their interpretation. In particular, article 3(2) of the 1997 OECD Model, which is substantially similar to article 3(2) of the U.N. Model and of the 1996 U.S. Model, provides that

[a]s regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.<sup>404</sup>

Vogel has persuasively argued that article 3(2) does not apply at all where the term in question has an ordinary meaning and is not a technical tax term.<sup>405</sup> Article 3(2) also indicates explicitly that the “context” of the use of a term may require some other definition.

Here, because the word “may” in article 9(1) is not a technical term, it should be concluded that article 3(2) does not apply. Moreover, even if it did apply, the context of the use of the word “may” in article 9(1), in a provision dealing with income allocation, should be understood as requiring resort to internationally accepted rules of interpretation, such as those contained in the Vienna Convention.

*b. The Ordinary Meaning of Article 9(1) in Context and in Light of the Object and Purpose of Double Taxation Treaties.* Article 31 of the Vienna Convention first points to the “ordinary meaning” of the language in question. As noted above, the plain language in article 9(1) seems to be merely permissive. Nevertheless, there are several possible interpretations of the use of the word “may”: (1) as purely descriptive, as Kauder contends; (2) as granting an authoritative permission imposing binding obligations on other states to respect (in some unspecified way) an initial adjustment based on the arm’s length

---

403. On application of the Vienna Convention to the interpretation of tax treaties and the principle of common interpretation, see generally Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 INT’L TAX & BUS. LAW. 1, 33-39 (1986).

404. 1997 OECD MODEL, *supra* note 171, art 3(2). Compare *id.* with U.N. MODEL, *supra* note 149, art. 3(2), and 1996 U.S. Model, *supra* note 180, art. 3(2).

405. On the inapplicability of article 3(2), and more generally on the problem of “qualification,” where “a treaty term requires the interpretation of a term that is not a legal term in the law of the contracting states,” see Vogel, *supra* note 403, at 61, 68. Vogel contends that article 3(2) does not apply if the term in the treaty “has a meaning only outside of the tax law.” *Id.* at 71.

standard; (3) as imposing a persuasive obligation on an initiating state to give the arm's length standard great weight in making an initial adjustment; or (4) as laying down a binding obligation to use the arm's length standard in making such an initial adjustment. Which of these possible interpretations should be adopted?

The Vienna Convention provides that a treaty provision's ordinary meaning must be ascertained in light of the "context" of the provision and the treaty's "object and purpose."<sup>406</sup> Here, the primary purpose of double taxation conventions is to prevent double taxation. Thus, an interpretation of article 9(1) as merely descriptive, while plausible based on the language alone, is not persuasive in view of this purpose because it would not reduce the risk of double taxation. Additionally, such commentators as Kauder rely on the existence of paragraph 2 of article 9, which requires correlative adjustments, to argue that paragraph 2 does the real "work" of article 9 and that paragraph 1 is merely prefatory. Such a view of paragraph 1's role does not appear to give sufficient weight to the historical evolution of article 9 of the 1977 OECD Model and later OECD Models, and to the fact that the 1963 OECD Model and all previous League of Nations-era models incorporated *only* the equivalent of paragraph 1 of article 9.

On the other hand, the other three possible interpretations of article 9(1) might reduce the risk of double taxation. For example, as discussed below, even an authoritative permission to use the arm's length standard in making an initial adjustment might require other states to respect the initial allocation by making correlative adjustments based on the arm's length standard.

The language of article 9(1) does provide some support for an authoritative permission. In particular, it implies that a state party has the right to make an adjustment based on the arm's length standard, and, if it does so, that the other party has an obligation to respect that adjustment (presumably by making a correlative adjustment). It is certainly true, as Kauder has pointed out, that there is no other prohibition in the text of the treaties or preexisting prohibition under customary international law<sup>407</sup> against the reallocation of income among related taxpayers that article 9(1) relaxes. But even in the absence of such prohibitions, as established in Part III, authoritative permissions serve the function of imposing

---

406. See Vienna Convention, *supra* note 347, art. 31(1).

407. See *infra* Part V.

binding obligations on other parties to allow and respect the permitted action. Indeed, in the context of a binding treaty whose main object and purpose is to prevent double taxation, the “ordinary meaning” of an authoritative permission is to establish such correlative obligations.

Article 31 of the Vienna Convention also permits the meaning of a treaty provision to be established by subsequent agreement or state practice indicative of agreement on its meaning.<sup>408</sup> It is not possible here to carry out a survey of the history of all bilateral tax treaties and subsequent agreements between their parties, or even a survey limited to U.S. treaties. Nevertheless, as we saw in Part I, the Treasury Department, in its public statements, has implied that, under article 9 of U.S. tax treaties, the United States has some form of obligation (whether persuasive or binding) to apply the arm’s length standard and not abandon it in favor of a system of formulary apportionment.

*c. Supplementary Means of Interpretation.* This analysis of the text of article 9(1) of the U.N., OECD, and U.S. Models in light of its context and the object and purpose of preventing double taxation, together with the scant evidence of subsequent state practice, leaves doubt as to whether article 9(1) grants an authoritative permission or imposes persuasive or binding obligations on an initiating state to use the arm’s length standard. In a case of such ambiguity, article 32 of the Vienna Convention allows consideration of supplementary evidence, which, along with the *travaux* relating to any particular treaty, can be considered to include the OECD and U.N. Models, the official OECD and U.N. Commentaries,<sup>409</sup> the U.S. Models, and the Treasury Department’s official explanations of the U.S. Models. Indeed, the OECD and U.N. Commentaries explicitly indicate that they were intended to aid in treaty interpretation.<sup>410</sup>

---

408. See Vienna Convention, *supra* note 347, art. 31(3).

409. See John F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model—II*, 1984 BRIT. TAX REV. 90, 96-101.

410. On the status of the U.N. Group of Experts’ Commentary, the United Nations has stated that “[i]f the negotiating parties decide to use in a treaty wording suggested in the United Nations Model Convention, it is to be presumed that they would also expect to derive assistance in the interpretation of that wording from the relevant commentary.” U.N. MODEL, *supra* note 149, at 11 (emphasis added). The 1997 OECD Commentary similarly states that OECD member countries “should follow these Commentaries . . . when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.” 1997 OECD MODEL, *supra* note 171, ¶ 3, at I-1 (emphasis added).

When we turn to the official Commentary on the 1963 OECD Model, we find no explicit guidance on the meaning of the language in article 9(1). Instead, the Commentary on article 7 of the 1963 OECD Model, which also addressed the allocation rules in article 9, implied that articles 7 and 9 were not meant to depart substantively from the pattern of tax treaties concluded since World War II.<sup>411</sup> In its original report issued in 1960, the Fiscal Committee had affirmed that the allocation rules incorporated in articles 7 and 9 reflected a re-adoption of principles appearing in existing bilateral tax treaties, most of which, it claimed, were “based on the Mexico and London Model Conventions of the League of Nations.”<sup>412</sup>

In this connection, it is illuminating to recall that the 1933 Draft Convention, as well as the 1943 Mexico and 1946 London Models, provided that diverted profits “shall” be entered in the accounts of an enterprise in accordance with the arm’s length standard. Further, the League Fiscal Committee’s Commentary on article 5 of the 1933 Draft Convention stated that “[a]rticle 5 deals with subsidiaries which *will be taxed* as independent enterprises provided no profits or losses are transferred as a result of the relations between the affiliated companies. If such transfers are effected, the administration *will make* the necessary adjustments in the balance-sheets.”<sup>413</sup> The use of such imperative language suggests that the drafters of these conventions intended to impose a binding obligation on states parties to follow the arm’s length standard in making initial adjustments. As indicated in Part III, the drafters may have instituted such a binding obligation in order to establish more firmly a new convention involving use of the arm’s length standard.

In any case, as noted in Part II, states almost invariably (with the primary exception of France’s treaties with the United States) chose not to adopt this imperative language in their actual bilateral treaties, but instead replaced “shall” with “may” in their provisions on allocation of profits between related enterprises. The Fiscal Committee, in its original 1960 report, failed to note this critical discrepancy between the language in the models and actual bilateral

---

411. See 1963 OECD MODEL, *supra* note 104, ¶ 2, at 79 (affirming that it was “thought sufficient to restate” the essential principles already figuring in “a large number of European double taxation Conventions concluded since the war, . . . with some slight amendments and modifications primarily aimed at producing greater clarity”).

412. *Third Report of the Fiscal Committee*, *supra* note 108, at 4581.

413. *1933 Committee Report*, *supra* note 81, at 4247 (emphasis added).

treaties, which it claimed were “based on” the models.<sup>414</sup> In short, the Fiscal Committee did not make clear whether it intended to “readopt” the meaning of the models, which used the imperative “shall,” or whether it intended to refer to the meaning of the parallel allocation provision in actual bilateral treaties, which, like the new proposed OECD model, used the word “may” nearly uniformly.

Because the word “shall” was converted to the apparently permissive “may” in the 1963 OECD Model and in all subsequent models, the question arises as to whether this change was meant to make a clear break with the League of Nations models by changing a binding obligation into an authoritative permission, or instead was intended to maintain at least persuasive authority (or perhaps even binding authority) for the arm’s length standard. The OECD and U.N. Model Commentaries and other sources provide evidence for each of these interpretations, but, as the following analysis establishes, they best support the conclusion that the post-World War II models grant the arm’s length standard strong persuasive authority.

*d. Supplementary Evidence Supporting an Authoritative Permission.* There is evidence in the Commentaries supporting the inference from the ordinary meaning of the text, and the object and purpose of the double taxation conventions, that article 9(1) grants an authoritative permission. For example, the 1963 OECD Commentary affirmed that article 9 provides that tax authorities “*may . . . re-write the accounts of the enterprises if . . . the accounts do not show the true taxable profits arising in that country. It is evidently appropriate that rectification should be sanctioned in such circumstances, and the Article seems to call for very little comment.*”<sup>415</sup> Both the 1977 and 1997 Commentaries employ similar language.<sup>416</sup> The 1995 Transfer Pricing Guidelines indicated that the article “authorizes” a tax administration to re-write accounts.<sup>417</sup> The U.N. Group of Experts’ Commentary on the U.N. Model essentially quoted most of the 1977 OECD Commentary, repeating that the tax authorities “may” re-write accounts.<sup>418</sup>

---

414. See *supra* note 412 and accompanying text.

415. 1963 OECD MODEL, *supra* note 104, at 93 (emphasis added).

416. Compare 1977 OECD MODEL, *supra* note 134, ¶ 1, at 88, with 1997 OECD MODEL, *supra* note 171, ¶ 2, at C(9)-1.

417. See 1995 TRANSFER PRICING GUIDELINES, *supra* note 172, ¶ 2.3, at II-1.

418. See U.N. MODEL, *supra* note 149, at 106.

The 1963 OECD Model, as noted above, appeared to reflect the practice by states of using similar permissive terminology in their bilateral treaties. Indeed, it seems that states intentionally rejected the imperative “shall” in the League models in favor of permissive language in their treaties, implying an unwillingness to accept a binding obligation to use the arm’s length standard. Thus, the consistent use of the term “may” in the OECD and U.N. Models, and in bilateral treaties, along with the use of such terminology as “sanctioned” and “authorizes” in the supplemental OECD sources, lends weight to the interpretation that the treaties grant an authoritative permission to use the arm’s length standard. Such an authoritative permission by itself would not prohibit the use of other methods for determining taxable profits.

*e. Supplementary Evidence Supporting a Binding Obligation.*

At the other extreme, there is one passage in the OECD Commentaries suggesting that article 9(1) may impose a binding obligation to use the arm’s length standard under certain circumstances. In particular, the 1963 Commentary affirmed that “[i]t should perhaps be mentioned that the provisions of the Article apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts . . . is authorised if the transactions . . . have taken place on normal open market commercial terms.”<sup>419</sup> The 1997 Commentary contains very similar language, adding (as did the 1977 Commentary) a clarification that normal open market commercial terms means on an “arm’s length” basis.<sup>420</sup> On its face, this statement suggests that parties have a binding obligation to apply not only an arm’s length standard, but also an arm’s length method based on particular transactions.

*f. Supplementary Evidence Supporting a Persuasive Obligation.*

There are numerous statements in the OECD Commentaries and other OECD documents suggesting the existence of a persuasive obligation of an initiating state to use the arm’s length standard. For example, as noted above, the 1963 Commentary affirmed that the new text was not intended to change the substance of earlier model treaty provisions on allocation, which apparently laid down a binding obligation. It is appropriate to interpret the 1963 and later OECD Models as establishing a persuasive obligation because such an

---

419. 1963 OECD MODEL, *supra* note 104, at 93.

420. *See* 1997 OECD MODEL, *supra* note 171, ¶ 2, at C(9)-1.

obligation is more binding than a mere authoritative permission, which is in keeping with the apparently binding character of the earlier models. At the same time, it gives some respect to the “plain language” of the 1963 and later OECD Models, which employ permissive terminology, because it does not go so far as to impose a binding obligation.

In its 1960 report on the predecessors of Articles 7 and 9 of the 1963 OECD Model, the Fiscal Committee stated:

*The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another . . . . Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles.*<sup>421</sup>

While the Fiscal Committee thus referred to article 9 as containing “directives,” it simultaneously stressed that the article was not intended to establish “precise rules” and that, above all, the article sought to lay down certain “principles.” This type of language suggests that the Committee had in mind a strong persuasive obligation to use the arm’s length standard as opposed to a binding obligation.

Further, the 1963 Commentary indicated that it is “appropriate” that rectification should be “sanctioned” if accounts do not show true taxable profits.<sup>422</sup> The word “sanctioned” could be read as “approved of” or “encouraged,” which in turn could signify that states parties *ought to* make such a rectification based on the general arm’s length standard. Given the reference to “open market commercial terms” that follows, the implication is that parties ought to make an adjustment based on the arm’s length method in particular. The 1997 Commentary contains similar language (replacing “rectification” with “adjustment”).<sup>423</sup>

The 1997 Commentary also added a provision on thin capitalization, which states in part that the Committee on Fiscal Affairs considers that “the application of rules designed to deal with thin capitalisation *should normally* not have the effect of *increasing the taxable profits of the relevant domestic enterprise to more than the*

---

421. *Third Report of the Fiscal Committee, supra* note 108, at 4597-98 (emphasis added).

422. *See* 1963 OECD MODEL, *supra* note 104, at 93.

423. *See* 1997 OECD MODEL, *supra* note 171, ¶ 2, at C(9)-1.



*arm's length profit*, and that this *principle should* be followed in applying existing tax treaties.”<sup>424</sup> This language implies that, at least normally, states are under an obligation not to allocate more than arm's length profits to an enterprise in cases of thin capitalization. The insertion of the qualifier “normally” suggests that this obligation is persuasive, not binding, because certain first-order reasons for not adjusting profits to an arm's length amount are not entirely excluded and may still override reasons for using the arm's length standard. The reference to such a “principle” that “should” be followed in applying article 9 also conveys the sense of a persuasive obligation.

Another new provision in the 1997 Commentary on article 9(1) notes that a

number of countries interpret the article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level . . . . However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments . . . and under mutual agreement procedures.<sup>425</sup>

The first sentence quoted above suggests that many countries take the position that article 9(1) does not limit their right to adopt national laws permitting use of an allocation method that is inconsistent with the arm's length standard, but only imposes an obligation to apply an arm's length “principle” when dealing with treaty partners under mutual agreement procedures.<sup>426</sup>

In the following sentences quoted above, the Committee on Fiscal Affairs appears to imply, on the one hand, that states are obligated to conform their national laws to the principles of article 9(1). On the other hand, the Committee suggests that article 9(1) expresses “principles” rather than binding rules. And the Committee contemplates cases in which adjustments may not accord with these principles. It states that these cases can be worked out through negotiations under the mutual agreement procedure. Together, these observations imply a view on the part of the Committee that article

---

424. *Id.* ¶ 3(c), at C(9)-2 (emphasis added).

425. *Id.* ¶ 4, at C(9)-2-3 (emphasis added).

426. See in this connection *Double Taxation Conventions and the Use of Base Companies*, in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES ¶ 30, at 68 (1987).

9(1) imposes only a persuasive obligation to use the arm's length standard.

Moreover, in its 1979 OECD Report on transfer pricing, the OECD stated:

It is generally acknowledged that, in taxing the profits of an enterprise which engages in transactions with associated enterprises outside the jurisdiction of the relevant taxing authority, the profits *should* be calculated on the assumption that *the prices charged in these transactions are arm's length prices*. This is the underlying assumption in Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital (1977) on transactions between associated enterprises.<sup>427</sup>

The conclusion that the OECD interpreted article 9(1) as imposing a persuasive and not a binding obligation is also supported by its affirmation in the 1979 OECD Report that, in seeking to arrive at an arm's length price,

*some regard to the total profits of the relevant MNE may . . . be helpful, as a check on the assessment of the arm's length price or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.*<sup>428</sup>

The OECD appears, therefore, to leave the door open for the coordinated use of formulary methods, so long as they are intended to assist in arriving at an arm's length price, or in cases where "other methods give rise to serious difficulties."<sup>429</sup> The report seems to suggest that what is most important is that the two countries use a "common approach."<sup>430</sup> This position is consistent with the OECD Models' allowance, in article 7, of the use of formulary apportionment as a fallback method in determining the income allocable to permanent establishments.<sup>431</sup>

In 1995, the OECD Council adopted a revised recommendation that the prices of transactions between associated enterprises "*should . . . for tax purposes be in conformity with those which would be charged between independent enterprises . . . as provided [in article*

---

427. 1979 OECD REPORT, *supra* note 136, ¶ 3, at 8 (emphasis added).

428. *Id.* ¶ 14, at 15 (emphasis added).

429. *Id.*

430. *Id.*

431. *See, e.g.,* 1997 OECD MODEL, *supra* note 171, art. 7.

9(1)].”<sup>432</sup> In the 1995 Transfer Pricing Guidelines, the OECD defined the “arm’s length principle” as the “international standard that OECD Member countries have agreed *should* be used for determining transfer prices for tax purposes.”<sup>433</sup> The Guidelines asserted that a “tax administration in an OECD Member country . . . could not raise an assessment based on a taxable income calculated as a fixed percentage of turnover and *simply ignore* the arm’s length principle.”<sup>434</sup>

All of the above statements by the OECD in the 1979 OECD Report and the 1995 Transfer Pricing Guidelines imply that the OECD views article 9(1) of the OECD Models as imposing a persuasive obligation, rather than a binding obligation or mere authoritative permission, to use not only an arm’s length standard but also a transaction-based arm’s length method. To the extent that they represent the common views of OECD members on how the Models ought to be interpreted, the 1979 OECD Report and the 1995 Transfer Pricing Guidelines may at least constitute “supplementary means” of interpreting the OECD Models within the meaning of article 32 of the Vienna Convention. Moreover, for this reason, the 1995 OECD Report and the 1995 Transfer Pricing Guidelines may also constitute evidence of subsequent agreement or state practice demonstrating a consensual interpretation of treaty terms within the meaning of article 31 of the Vienna Convention.<sup>435</sup>

The U.N. Group of Experts, like the OECD, apparently also believed that the arm’s length standard should have only persuasive authority. For example, at its 1977 meeting (before the U.N. Model was drafted), the Group reiterated “that the allocation methods already devised or to be devised were to be construed *not as binding rules* but merely as providing the basic framework for an informed approach by tax authorities to the problems presented to them in the allocation of profits of taxpayers within their jurisdiction.”<sup>436</sup> The Commentary of the Group of Experts on the U.N. Model similarly suggests that the drafters viewed the language in article 9(1) of the model as imposing a persuasive obligation, which necessarily included

---

432. Revised Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/Final], *reprinted in* 1995 TRANSFER PRICING GUIDELINES, *supra* note 172, at A-1, A-2 (emphasis added).

433. 1995 TRANSFER PRICING GUIDELINES, *supra* note 172, at G-1 (emphasis added).

434. *Id.* ¶ 4.13, at IV-5 (emphasis added).

435. *See* Vienna Convention, *supra* note 347, art. 31(3).

436. SEVENTH REPORT, *supra* note 145, at 28.

an authoritative permission, to use the arm's length standard and in particular the arm's length method. The Commentary to article 25 stated that "*transactions* between related entities *should* be governed by the standard of '*arm's length dealing*'; as a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard, the taxable profits *may* be redetermined."<sup>437</sup>

Turning to the U.S. Models, the inclusion in the 1981 U.S. Model of paragraph 3 of article 9 implies that the United States regarded article 9(1) as imposing a persuasive or binding obligation that circumscribed the taxing discretion of the United States. To recall, paragraph 3 provided that "[*t*]he provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between [related] persons . . . ."<sup>438</sup> There would be no need for this reservation of discretion to apply section 482 principles if the United States considered article 9(1) to be merely descriptive or merely an authoritative permission and thus devoid of any preemptive effect.

The 1996 U.S. Model deleted paragraph 3 from article 9. The Technical Explanation indicated that the Treasury Department removed the paragraph because its language "had proven to be confusing."<sup>439</sup> The Treasury Department noted that the "1981 Model language does not grant authority not otherwise present. Regardless of whether a particular convention includes a version of paragraph 3, the Contracting States preserve their rights to apply internal law provisions relating to adjustments between related parties."<sup>440</sup> The Treasury Department emphasized that such adjustments

are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, *as long as they accord with the general principles of paragraph 1, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length.*<sup>441</sup>

The statement that under paragraph 1 the United States is obligated to make sure that its adjustments at least "accord with the general principles" of the arm's length standard suggests that the

---

437. U.N. MODEL, *supra* note 149, at 234 (emphasis added).

438. 1981 U.S. Model, *supra* note 142, art. 9(3).

439. 1996 Technical Explanation, *supra* note 179.

440. *Id.*

441. *Id.* (emphasis added).

Treasury Department views the obligation as persuasive rather than binding. Its explanation of the removal of paragraph 3 implies that it continues to regard paragraph 1 as limiting U.S. discretion in how it makes an initial adjustment allocating income among related enterprises. Under the U.S. treaty interpretation principle that places special emphasis on legislative history (including U.S. legislative history), it is appropriate to give significant weight to the Technical Explanation.

*g. The Case for the Strong Persuasive Authority of the Arm's Length Standard and the Moderate Persuasive Authority of the Arm's Length Method.* As the above analysis demonstrates, there is considerable evidence that the OECD, U.N., and U.S. Models were intended to lay down persuasive obligations on the part of the parties to apply a general arm's length standard as well as a transaction-based arm's length method. If so, why did the drafters insist on using permissive language? One possible explanation, suggested in Part III, is that when the OECD and U.N. Models were drafted, there was already sufficient agreement on the arm's length standard as a convention that there was no need to continue explicitly to impose it as a binding obligation under the treaties, or even to use language clearly indicating that it should have persuasive authority. Recognition of the standard as a persuasive obligation, even through the use of permissive language, would be sufficient to maintain it as a convention. The same is true of the arm's length method as a particular method for implementing a broad arm's length standard.

It appears, therefore, that the best interpretation of article 9(1) in relation to initial adjustments (potential obligations (1) and (2)) is that it was intended to impose a strong persuasive obligation on initiating states to use the arm's length standard. That is, states parties have a *binding legal obligation* to attempt in good faith to use the arm's length standard and to give it *great weight* (but not necessarily decisive weight) in deciding how to allocate income to foreign or domestic corporations. Accordingly, states parties must significantly discount the weight of the existing first-order policy reasons they perceive against using the standard in making initial adjustments and increase the weight they assign to reasons favoring use of the standard.<sup>442</sup>

---

442. See Figures 4 and 5.

But does the transaction-based arm's length method in particular enjoy a similarly strong persuasive authority? At this point it may be recalled that the 1997 OECD Commentary prohibits the adjustment of the income of a corporation where particular transactions have taken place on arm's length terms.<sup>443</sup> This provision indicates endorsement of the arm's length method. It suggests that even the arm's length method ought to enjoy persuasive authority. But because the arm's length method is not explicitly prescribed in the text of the treaty, states are obligated to accord it less weight than they must accord to the umbrella arm's length standard.

In short, the arm's length method is best regarded as having moderate persuasive authority under the treaties. Thus, the treaties do not necessarily compel the use of the traditional arm's length method to the extent that other methods of determining a corporation's true profits, including empirical methods like the comparable profits method and profit split method, produce results consistent with the general arm's length standard and to the extent there are strong policy reasons for using these methods that overcome the weight accorded to the arm's length method. It appears that such methods may be consistent so long as they are primarily transactional in focus.

It may be asked how the OECD Commentary's prohibition referred to above is consistent with granting the arm's length method only moderate persuasive authority rather than binding authority. On closer examination, this prohibition, which appears in a non-binding commentary, does not indicate that use of the arm's length method is a binding obligation. This is because the prohibition arises *only* if the accounts already reflect arm's length terms. It does not apply in any other case. This narrow prohibition is fully consistent with the existence of a persuasive obligation to use the arm's length method in making initial adjustments. That is, where related corporations have actually used arm's length prices, states parties should be precluded from adjusting profits; to do otherwise would directly violate the obligation to give significant weight to the arm's length method.

Regarding the obligation of the United States to use the arm's length standard in allocating income to U.S. corporations (potential obligation (1)), it is important to observe that, unlike its League of Nations, OECD, or U.N. counterparts, the 1996 U.S. Model included

---

443. See 1997 OECD MODEL, *supra* note 171, ¶ 2, at C(9)-1.

a paragraph 4 in article 1 (whose predecessor is article 1(3) in the 1981 U.S. Model) providing in general that notwithstanding other provisions of the convention, “a Contracting State may tax its residents . . . as if the Convention had not come into effect.”<sup>444</sup> Under paragraph 5 of article 1 of the 1996 U.S. Model (paragraph 4 in the 1981 U.S. Model), however, the provisions of paragraph 4 are not to affect “the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises) . . . and [Article] 25 (Mutual Agreement Procedure) . . . .”<sup>445</sup>

The Treasury Department’s Technical Explanation of the 1996 U.S. Model states that paragraph 4 “contains the traditional savings clause found in all U.S. treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary.”<sup>446</sup> In particular, these paragraphs permit the United States to tax corporations incorporated in the United States that are considered under the model convention to be U.S. residents<sup>447</sup> without regard to the provisions of article 9 other than paragraph 2, relating to correlative adjustments. Louis Kauder thus concludes that article 1(3) of the 1981 U.S. Model (article 1(4) of the 1996 U.S. Model) eliminates any obligation the United States might otherwise have undertaken pursuant to article 9(1) to use the arm’s length standard in determining the taxable profits of a U.S. corporation.<sup>448</sup>

This conclusion must be considered carefully because, although article 1(4) of the 1996 Model purports to override all other treaty provisions, it must still be interpreted in light of the treaty’s overall object and purpose: avoiding double taxation. Economic double taxation could easily result if the United States used formulary apportionment in making an initial adjustment to the income of a U.S. corporation, while a treaty partner used the arm’s length method in making a correlative adjustment to the income of a related foreign corporation. As indicated by the carving out of correlative adjustments under article 9(2) from the scope of the savings clause, in article 1(5), the United States generally intended to avoid economic

---

444. 1996 U.S. Model, *supra* note 180, art. 1(4). A substantially similar provision appeared in the 1981 U.S. Model. *See* 1981 U.S. Model, *supra* note 142, art. 1(3).

445. 1996 U.S. Model, *supra* note 180, art. 1(5)(a).

446. 1996 Technical Explanation, *supra* note 179.

447. *See* 1996 U.S. Model, *supra* note 180, arts. 4(1), 4(3).

448. *See* Kauder, *supra* note 37, at 1149 n.12.

double taxation of U.S. corporations that could result from applying article 1(4) to transfer pricing adjustments. The best interpretation of the impact of article 1(4) on initial adjustments, based both on the treaty's purpose and the Vienna Convention rules of interpretation, is that article 1(4) should not affect the strong persuasive obligation of the United States under article 9(1) to use the arm's length standard and its moderate persuasive obligation to use the arm's length method, even with respect to U.S. corporations. Indeed, recognition of a persuasive obligation simultaneously fulfills the treaty purpose of reducing the risk of double taxation while allowing the United States, in keeping with the reservation of fiscal authority in article 1(4), to adopt formulary apportionment in certain cases where the reasons in favor of it are quite compelling.

*h. Summary of Conclusions About the Permissibility of Various Allocation Methods in Making Initial Adjustments.* It follows from the preceding analysis that states, including the United States, may employ empirical allocation methods, but these methods should generally be aimed at producing profits that are comparable to those that would result from the use of the traditional arm's length method. In special cases, sufficiently weighty first-order policy reasons may justify the use of profit-based and other empirical methods that depart significantly from the traditional arm's length method. Even if these empirical methods do not accord with the arm's length method, they may still be consistent with the treaties' umbrella arm's length standard, which enjoys greater persuasive authority than the arm's length method. But classic formulary apportionment ought to be viewed as violating this umbrella arm's length standard. Throughout the League of Nations' discussions, these two methods were seen as relatively bright-line alternatives. Thus, the application of classic formulary apportionment, while not absolutely prohibited, would be justified only in very rare cases and in the face of extremely compelling first-order policy reasons sufficient to override the significant weight that must be given to the arm's length standard.

At the level of U.S. legislation, under article 9(1) of U.S. tax treaties patterned after the OECD Models Congress is obligated to ensure that the U.S. tax code and Treasury Department regulations give great weight to the arm's length method in the determination of initial adjustments and, to the extent they permit the use of empirical methods, that in most cases such methods may be used only as a means of approximating an arm's length result. If there are sufficiently compelling reasons for not adopting the arm's length



standard in particular situations, Congress may require the use of classic formulary apportionment. But if it does so, Congress must also ensure that where related corporations use transfer prices that can independently be determined to be arm's length, the tax code and regulations permit the corporations to "elect out" of the prescribed formulary apportionment method and to use such arm's length prices in determining their tax liabilities, in keeping with the OECD Commentary on article 9(1).

Even if the arm's length standard has strong persuasive authority under U.S. tax treaties, it may have no preemptive effect at all under the "last in time" rule in the face of a later congressional statute requiring the use of formulary apportionment and explicitly overriding existing tax treaties. But Congress itself considers that it must show "due regard" for tax treaty obligations, and the courts will attempt to construe congressional legislation consistently with treaty obligations.<sup>449</sup> Thus, if current treaties remain in force and are not renegotiated, under existing U.S. law Congress is obligated to give the arm's length standard great weight in designing any new legislation.

2. *The Existence and Character of an Obligation to Make Correlative Adjustments.* A second problem, alongside initial adjustments, involves the existence and character of an obligation to make correlative adjustments under article 9(1) or 9(2) of the OECD and U.N. Models (potential obligation (3) mentioned earlier). First, article 9(1) might be read as requiring a non-initiating state to attempt in good faith to make a correlative adjustment to the taxable profits of an associated enterprise in order to take account of the initiating state's use of the arm's length standard. The grant of what is at a minimum an authoritative permission in the model treaties implies that other states have some form of obligation to respect the first state's application of the arm's length standard. It would seem to require that the system used by the other state not be likely, in combination with the initiating state's use of the arm's length standard, to lead to economic double taxation, which is the primary evil that the treaty as a whole seeks to avoid.

Indeed, many states have taken the position that even in treaties that contain only paragraph 1 of article 9 and omit paragraph 2, there is a basic obligation to respect another state's use of the arm's length standard, and to engage in negotiations under the competent

---

449. See *supra* text accompanying notes 363-69.

authority procedure with the goal of arriving at some form of correlative adjustment.<sup>450</sup> These views were endorsed by the OECD in its 1997 Commentary, which states that

the mere fact that Contracting States inserted in the convention the text of Article 9, as limited to the text of paragraph 1—which usually only confirms broadly similar rules existing in domestic laws—indicates that the intention was to have economic double taxation covered by the Convention. As a result, most Member countries consider that economic double taxation resulting from adjustments made to profits by reason of transfer pricing is not in accordance with—at least—the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25.<sup>451</sup>

Article 9(2) provides that where, pursuant to the independent enterprise standard set forth in article 9(1), a state, in calculating the taxable profits of an enterprise located within its jurisdiction, includes profits on which an enterprise located in the other state has already been taxed, then “that other State *shall* make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.”<sup>452</sup> As indicated by the imperative “shall,” the ordinary meaning of this article is that so long as the initial adjustment by the initiating state was based on the arm’s length standard, the other state has a binding obligation to make a correlative adjustment.

With respect to state practice, it appears that states parties to actual bilateral treaties are generally willing to make correlative adjustments and recognize an obligation to do so where they conclude that the initial adjustment is based on the arm’s length standard. For example, the U.S. Treasury Department’s Technical Explanation of the 1996 U.S. Model confirms that the United States recognizes such an obligation. It notes that, under paragraph 2 of article 9,

[w]hen a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, and the other Contracting State agrees that the adjustment was appropriate to reflect arm’s-length conditions, that other Contracting State is

---

450. See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES: THREE TAXATION ISSUES ¶ 75, at 28-29 (1984) [hereinafter 1984 OECD REPORT]. Other states, however, believe that article 9(1) imposes no such obligation. See *id.* ¶ 76, at 29.

451. 1997 OECD MODEL, *supra* note 171, ¶ 10, at C(25)-3.

452. *Id.* art. 9(2) (emphasis added).

*obligated* to make a correlative adjustment (sometimes referred to as a ‘corresponding adjustment’) to the tax liability of the related person in that other Contracting State.<sup>453</sup>

The Technical Explanation further confirms that, even in the case of a U.S. corporation otherwise subject to the savings clause of article 1(4) of the 1996 Model, if a foreign treaty partner initiates an arm’s length adjustment to the income of a foreign related entity, the United States is still obligated, under article 9(2), to make an appropriate adjustment to the profits of the related U.S. corporation.<sup>454</sup>

What light does the legislative history of the OECD and U.N. Models shed on the character of the obligation under article 9(2)? The Committee on Fiscal Affairs stated in its 1977 Commentary on article 9(2) that

an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm’s length.<sup>455</sup>

This statement affirms that the second state has some discretion in determining whether the initial adjustment is proper, and that the method the first state should use is a transaction-based arm’s length method. The 1995 Transfer Pricing Guidelines emphasized that the “non-mandatory nature of corresponding adjustments . . . is important to maintaining the fiscal sovereignty of each OECD Member country.”<sup>456</sup> The Commentary of the U.N. Group of Experts contained language on correlative adjustments similar to the language in the 1977 OECD Commentary.<sup>457</sup>

The obligation to make correlative adjustments is intimately linked with the potential existence of an obligation to engage in the competent authority process under article 25 of the OECD Model. In this connection, the 1977 OECD Commentary stated that “the competent authority is under an *obligation to consider* whether the objection [of a taxpayer] is justified and, if it appears to be justified to take action on it in one of the two forms provided for in paragraph 2.”<sup>458</sup> It affirmed that if

---

453. 1996 Technical Explanation, *supra* note 179 (emphasis added).

454. *See id.*

455. 1977 OECD MODEL, *supra* note 134, ¶ 3, at 88.

456. 1995 TRANSFER PRICING GUIDELINES, *supra* note 172, ¶ 4.35, at IV-12.

457. *See* U.N. MODEL, *supra* note 149, at 237.

458. 1977 OECD MODEL, *supra* note 134, ¶ 19, at 178 (emphasis added). Paragraph 2 of article 25 of the 1977 OECD Model provides that the competent authority “shall endeavour, if

it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, *indeed it will be its duty*—as clearly appears by the terms of paragraph 2—to set in motion the mutual agreement procedure proper.<sup>459</sup>

The Commentary then addressed the issue of whether the approach to the other state constitutes merely a duty to negotiate or instead a duty to reach an agreement. It concluded that “the competent authorities are under a duty merely to use their best endeavours and not to achieve a result.”<sup>460</sup> The Commentary admitted that this situation “is not yet entirely satisfactory from the taxpayer’s viewpoint” because it means that “double taxation is still possible.”<sup>461</sup>

The Commentary of the U.N. Group of Experts provided similarly that “[a]t a minimum, the treaty requires consultation and the obligation to endeavour to find a solution to economic double taxation.”<sup>462</sup> But it asserted that the treaty did not require actual agreement.<sup>463</sup> It noted that “some countries would consider the formal adoption of such [a] standard as a step possessing significant juridical consequences and hence would not be disposed to adopt such a requirement.”<sup>464</sup>

Accordingly, treaty partners are obligated to determine in good faith whether the adjustment by an initiating state conforms to a general arm’s length standard and is consistent with the results of a transaction-based arm’s length method. If they conclude that these tests are met, the treaty partners have a binding obligation to make an appropriate correlative adjustment, also based on the arm’s length standard and the arm’s length method. Thus, the obligation is a conditional form of binding obligation. Further, states have a binding obligation to negotiate the making of such an adjustment in good faith, but do not have an obligation to reach an agreement that avoids

---

the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.” *Id.* art. 25(2).

459. *Id.* ¶ 21, at 179 (emphasis added).

460. *Id.* ¶ 25, at 179.

461. *Id.* ¶ 42, at 182. These provisions in the 1977 Commentary were essentially reproduced in the 1997 Commentary. See 1997 OECD MODEL, *supra* note 171, ¶¶ 20, 22, at C(25)-7, ¶ 26, at C(25)-9, ¶ 45, at C(25)-16-17.

462. U.N. MODEL, *supra* note 149, at 240.

463. See *id.* at 240-41.

464. *Id.* at 241.

economic double taxation in fact. The obligation actually to reach an agreement that avoids double taxation can therefore be viewed as a strong persuasive obligation.

It should be noted here that the article 9(2) obligation to make a correlative adjustment if, and only if, the initial adjustment complies with the arm's length standard reinforces the earlier conclusion that article 9(1) establishes strong persuasive authority for the standard. Article 9(2) clearly indicates that initiating states should, as a general rule, use the arm's length standard, because in doing so they will facilitate correlative adjustments under article 9(2) and thereby help achieve the primary purpose of the treaty: the avoidance of economic double taxation.

3. *Understanding Why the Arm's Length Standard Should Be Regarded as Having Persuasive Authority under Tax Treaties.* What reasons merit the conclusions in this Part that the arm's length standard has strong persuasive authority under bilateral tax treaties? First, we have seen that this conclusion follows from an application of traditional secondary rules regarding the preemptive effect and interpretation of treaties, which are supported in turn by the moral principles of fidelity to promises and the fulfillment of legitimate expectations of other states, and ultimately by recognition of common membership in a community of states.

At the same time, the persuasive authority of the arm's length standard (and, to a lesser extent, of the arm's length method) is strengthened because the stated rationale for the models and the bilateral conventions is the goal of reducing or eliminating double economic taxation, which requires coordination among the actions of fiscal authorities. Realization of this goal is facilitated by recognizing a strong persuasive obligation to use the arm's length standard.

Nevertheless, if coordination is the goal, why do the treaties impose persuasive and not binding obligations? One reason appears to be that the treaties emphasize the desirability of preserving the autonomy of state decision making to the extent possible and of allowing states to follow different policies so long as doing so does not significantly undermine the primary goal of preventing double taxation. Thus, the treaties attempt to facilitate coordination by imposing persuasive obligations, but do not mandate coordination by making the obligations binding. Indeed, we have seen that the treaties mandate neither application of a particular allocation method

nor the making of correlative adjustments in all cases, which would be necessary to eliminate double taxation completely.

This is consistent with the conclusion in Part III that the allocation provisions of tax treaties have been adopted in response to states' perception that they face a dilemma of common aversions. They do not see themselves as caught in a dilemma of common interests, such as a prisoners' dilemma. So there is less need to impose a binding obligation, and certainly no need to require coercion or sanctions. What is required instead, at a minimum, is a convention ensuring that a coordination equilibrium will be reached. Of course, a convention need not have any authority at all, because it is usually self-enforcing. But for reasons articulated by such theorists as Edna Ullmann-Margalit and Joseph Raz, it can be helpful to make a convention in some way "obligatory" as a further safeguard to ensure it will be followed.

Conferring strong persuasive authority on the arm's length standard thus serves a convention-reaffirming and signaling function. States thereby assure treaty partners that they will in good faith attempt to use the arm's length standard and prevent the worst outcome for each treaty partner—the use of inconsistent allocation methods likely to result in double taxation. Granting moderate persuasive authority to the arm's length method, and strong persuasive authority to the obligation to reach agreements on income allocation that avoid double taxation, promotes attainment of the same goals. Thus, it is possible to understand why, empirically, states have conferred persuasive authority on both the arm's length standard and the arm's length method.

More significantly, however, there are good normative justifications for doing so. As established in Part III, the imposition of persuasive obligations can be quite useful in helping to reinforce conventions that solve non-pure coordination problems or coordination dilemmas in which there is a risk that some states may not perceive (or continue to perceive, even if they initially do) the existence of a coordination problem. Income allocation poses the latter type of risk, as evidenced by the many competing allocation methods utilized by states during the League of Nations era.

In addition, income allocation appears to be a non-pure coordination problem, as indicated in Part III, because some states may prefer common use of the arm's length standard while others may prefer formulary apportionment. The structure of article 9 evidently is intended to promote the equilibrium outcome sought by

states in the arm's length standard camp. In effect, it requires that "if one state uses the arm's length standard, then the other state must respect that and make an appropriate correlative adjustment, also based on the arm's length standard."<sup>465</sup> But Article 9 does not absolutely preclude the use by two states parties of empirical methods, or even classic formulary apportionment, as established by the preceding analysis, especially if the two parties can adopt an alternative "common approach" (constituting a different equilibrium outcome) that would reduce the risk of double taxation.<sup>466</sup>

The legitimacy of the treaty rules conferring strong persuasive authority on the arm's length standard is also enhanced by virtue of the agreement of numerous fiscal experts serving on League of Nations, OECD, and U.N. committees. These experts concur that the arm's length standard is workable and effective and merits application as the international allocation norm. As established by such theorists as Joseph Raz, often states can better achieve their goals (here, the avoidance of double taxation) by relying on the advice of experts, especially in such a technical area as income allocation.<sup>467</sup>

Treaties incorporating the equivalent of article 9 of the OECD and U.N. Models represent mutual promises to give great weight to the arm's length standard in income allocation. The moral principle of fidelity to promises thus directly supports the persuasive authority of the standard. Recognizing the persuasive authority of the arm's length standard also helps fulfill the legitimate expectations of treaty partners. As argued above, there would be no point to the inclusion of article 9 in the treaties if it did not establish some degree of obligation to use the arm's length standard.

Finally, recognition of the persuasive authority of the arm's length standard is supported by the consent of states, because the parties to tax treaties have themselves recognized that a coordination problem exists and that it is desirable to impose a persuasive obligation on themselves, and on their treaty partners, to use the arm's length standard as a means of solving this problem. By accepting a persuasive obligation they reassure treaty partners that they will not have a "change of heart" and later reject the arm's length standard. Further, recognition of the strong persuasive

---

465. 1997 OECD MODEL, *supra* note 171, art. 9(2).

466. *See supra* text accompanying note 428.

467. *See supra* text accompanying notes 308-09.

authority of the standard continues to allow states some residual decision-making autonomy on allocation issues.

An additional question remains, however. Do states that have not entered into treaties granting persuasive authority to the arm's length standard have absolute discretion in matters relating to income allocation? Or are they in some way obligated to use the standard under customary international law?

## V. THE AUTHORITY OF THE ARM'S LENGTH STANDARD UNDER CUSTOMARY INTERNATIONAL LAW

### A. The Normative Authority of Customary International Law

This Part turns to an analysis of the authority of the arm's length standard under customary international law as a means of exploring certain larger theoretical and normative issues concerning the authority of customary international law and the means for determining when a norm has become a norm of customary international law. The question at issue is whether *all states*, including the United States, are in some way bound to apply the arm's length standard under customary law, whether or not they have entered into particular treaties imposing persuasive obligations to use the arm's length standard and arm's length method.

This section initially examines the normative authority of customary international law under traditional secondary rules of international law and U.S. law and under normative theories of international law. It goes on to suggest a new normative theory for determining when norms ought to be regarded as having attained the status of customary international law. Section B then applies this normative theory to shed light on the customary law status of the arm's length standard, and concludes that the standard has not yet achieved this status.

1. *The Authority of Customary International Law under Secondary Rules of International Law and U.S. Law.* Legal theorists have long recognized that under national legal systems, as well as international law, customary practices can come to be regarded as authoritative norms.<sup>468</sup> The Statute of the International Court of Justice provides in this connection that the Court may apply "international custom, as evidence of a general practice accepted as

---

468. See, e.g., Hart, *supra* note 193, at 107.



law.”<sup>469</sup> A norm may achieve the status of customary international law and impose obligations on all states if it satisfies certain traditional criteria. These criteria themselves have the status of customary law and can be viewed as secondary rules for determining the content of primary rules of customary international law.<sup>470</sup> According to these criteria, a norm rises to the level of customary international law if: (1) the norm involves a uniform and consistent practice among states, or at least a large majority of them; and (2) most states regard themselves as under a legal obligation to engage in the practice (a requirement often referred to as *opinio juris*).<sup>471</sup> Once most states recognize a practice’s obligatory character, the practice can thus bind all states, including those that have not explicitly consented to the practice (unless they qualify as “persistent objectors” to the practice).<sup>472</sup>

The precise meaning of *opinio juris* has been much debated among courts and legal theorists, as explored in more detail below. In the 1969 *North Sea Continental Shelf Cases*,<sup>473</sup> the International Court of Justice explained the requirement as follows:

Not only must the acts concerned [constituting state practice] amount to a settled practice, but they must also be such, or be carried out in such a way, as to be *evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it*. The need for such a belief, i.e., the existence of a subjective element, is implicit in the very notion of the *opinio juris sive necessitatis*. The States concerned must therefore feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the acts is not in itself enough. There are many international acts, e.g., in the field of ceremonial and protocol, which are performed almost invariably, but which are motivated only by considerations of courtesy, convenience or tradition, and not by any sense of legal duty.<sup>474</sup>

There are a variety of traditional sources of evidence of uniform and consistent practice as well as of *opinio juris*, including diplomatic statements and correspondence, domestic legislation, and judicial

---

469. STATUTE OF THE INTERNATIONAL COURT OF JUSTICE art. 38(1)(b) (1945).

470. On custom as a secondary rule, see ANTHONY A. D’AMATO, *THE CONCEPT OF CUSTOM IN INTERNATIONAL LAW* 41-44 (1971).

471. See generally J.L. BRIERLY, *THE LAW OF NATIONS* 59-62 (6th ed. 1963) (describing the circumstances in which custom becomes a source of international law). On traditional views of the requirements for customary law, see also D’AMATO, *supra* note 470, at 47-72.

472. See generally BROWNLIE, *supra* note 354, at 512-15.

473. (F.R.G. v. Den., F.R.G. v. Neth.), 1969 I.C.J. 3 (Feb. 20).

474. *Id.* at 44 (emphasis added).

decisions.<sup>475</sup> Importantly, treaties can often evidence both state practice<sup>476</sup> and *opinio juris*.

Treaties can provide evidence of *opinio juris* in at least two ways. First, a treaty provision can codify a norm that has already been accepted as legally binding customary law.<sup>477</sup> Second, because of the widespread acceptance of treaty norms, states (including non-parties) may come to regard these norms as binding on all states as part of customary international law.<sup>478</sup> In the *North Sea Continental Shelf Cases*, for example, the International Court of Justice stated that the contention of Denmark and the Netherlands involved treating article 6 of the Geneva Convention of 1958 on the Continental Shelf<sup>479</sup>

as a norm-creating provision which has constituted the foundation of, or has generated a rule which, while only conventional or contractual in its origin, has since passed into the general *corpus* of international law, and is now accepted as such by the *opinio juris*, so as to have become binding even for countries which have never, and do not, become parties to the Convention. *There is no doubt that this process is a perfectly possible one and does from time to time occur*: it constitutes indeed one of the recognized methods by which new rules of customary international law may be formed. *At the same time this result is not lightly to be regarded as having been attained.*<sup>480</sup>

In this connection, the American Law Institute's Restatement (Third) of the Foreign Relations Law of the United States takes the following position:

Some multilateral agreements may come to be law for non-parties that do not actively dissent. That may be the effect where a multilateral agreement is designed for adherence by states

---

475. See generally BRIERLY, *supra* note 471, at 59-62; BROWNLIE, *supra* note 354, at 5-6.

476. Anthony D'Amato emphasizes that agreeing to be bound by a treaty is a custom-creating act like any other: "When a state makes a commitment to act under a treaty, the commitment, rather than the subsequent act, is significant in terms of customary law." D'AMATO, *supra* note 470, at 90.

477. See, e.g., article 43 of the Vienna Convention, which provides that the termination of a treaty or the withdrawal of a party does not "impair the duty of any State to fulfil any obligation embodied in the treaty to which it would be subject under international law independently of the treaty." Vienna Convention, *supra* note 347, art. 43.

478. The potential for treaties to create customary norms is recognized in the Vienna Convention. Article 38 provides: "Nothing in articles 34 and 37 precludes a rule set forth in a treaty from becoming binding upon a third State as a customary rule of international law, recognized as such." *Id.* art. 38. For a more detailed analysis of how treaty norms may become customary norms, see Anthony D'Amato, *Treaty-Based Rules of Custom*, in INTERNATIONAL LAW ANTHOLOGY 94-101 (Anthony D'Amato ed., 1994); D'AMATO, *supra* note 470, at 103-66.

479. Convention on the Continental Shelf, Apr. 29, 1958, 15 U.S.T. 471, 499 U.N.T.S. 311.

480. *North Sea Continental Shelf Cases* (F.R.G. v. Den., F.R.G. v. Neth.), 1969 I.C.J. 3, 41 (Feb. 20) (emphasis added).

generally, is widely accepted, and is not rejected by a significant number of important states. A wide network of similar bilateral arrangements on a subject may constitute practice and also result in customary law.<sup>481</sup>

What degree of preemptive effect do established secondary rules of international and U.S. law claim for customary international law? Under traditional rules of international law, customary norms generally have binding authority. Customary norms that are considered peremptory norms, or *jus cogens*, even have preemptive effect with respect to contrary treaty norms.<sup>482</sup>

The U.S. Supreme Court has ruled that under U.S. law customary international legal norms have the same preemptive effect as federal common law; that is, they constitute laws of the United States.<sup>483</sup> Customary international law, like treaties, cannot contravene the U.S. Constitution.<sup>484</sup> And while federal legislation is to be interpreted consistently with customary norms where possible,<sup>485</sup> a “last in time” rule appears to prevail.<sup>486</sup>

2. *Normative Theories Regarding the Authority of Customary International Law.* This subsection examines various normative theories that interpret the *opinio juris* requirement and that posit reasons for according customary international law preemptive effect.

First, regarding normative theories that interpret the *opinio juris* requirement, legal scholar Anthony D’Amato, in his influential 1971 book on customary international law, contended that the concept of *opinio juris* amounts to a “qualitative” requirement for custom (alongside the “quantitative” requirement of state practice) that involves the *articulation* of a legal rule before or concurrently with state action consistent (or inconsistent) with the articulated rule.<sup>487</sup> Such articulation “gives a state notice that its action or decision will have legal implications.”<sup>488</sup> In particular, for articulation of a legal rule to occur, there “must be a characterization of ‘legality’;” this permits “states to distinguish legal actions from social habit, courtesy,

---

481. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102 cmt. i (1986) [hereinafter RESTATEMENT].

482. See Vienna Convention, *supra* note 347, art. 53.

483. See *The Paquete Habana*, 175 U.S. 677, 700 (1900).

484. See HENKIN, *supra* note 358, at 237.

485. See *MacLeod v. United States*, 229 U.S. 416, 434 (1913).

486. See HENKIN, *supra* note 358, at 241.

487. See D’AMATO, *supra* note 470, at 74-87.

488. *Id.* at 75.

comity, moral requirements, political expediency, plain 'usage,' or any other norm."<sup>489</sup> D'Amato maintains that "[t]reaties do this better than any other practice of states. Any generalizable provision in a treaty is a statement of a rule of law. As such it meets all the requirements of articulation specified previously."<sup>490</sup>

Some scholars have taken the position that the "necessary subjective element does not consist of any feeling or any conviction on the part of the acting states, but simply of an express, or most often presumed, acceptance of the practice as law by all interested states."<sup>491</sup> Others, like Arthur M. Weisburd, have argued that "the *opinio juris* requirement means that a state must believe that if it breaches a rule the states toward which it owes the duty may inquire into its conduct and that it will be obliged to make those states whole, in some fashion, for its breach."<sup>492</sup>

While the existence of a process by which treaty norms can evolve into norms of customary international law is generally accepted, the precise mechanism by which this process works is rather mysterious and the subject of much academic speculation. It is worthwhile to examine theories about this process because of their relevance in determining whether the extensive network of bilateral treaties following the OECD or U.N. Models has given rise to a customary norm imposing at least a persuasive obligation on all states to use the arm's length standard and the arm's length method.

A number of scholars have taken the position that because treaties are analogous to contracts that bind only the parties, they can generate new customary norms only to the extent that non-parties accept the norms in the treaty.<sup>493</sup> These scholars accordingly stress that multilateral treaties may engender new norms of customary law so long as this condition of acceptance by non-parties is satisfied.<sup>494</sup>

Some legal experts have argued that while customary norms may more easily be generated by multilateral treaties, a network of bilateral treaties among a similar number of states may likewise

---

489. *Id.* at 75-76.

490. D'Amato, *supra* note 478, at 101.

491. KAROL WOLFKE, CUSTOM IN PRESENT INTERNATIONAL LAW 51 (2d rev. ed. 1993).

492. Arthur M. Weisburd, *Customary International Law: The Problem of Treaties*, 21 VAND. J. TRANSNAT'L L. 1, 10 (1988).

493. *See, e.g.*, Richard Baxter, *Treaties and Custom*, 1970-I RECUEIL DES COURS 25.

494. *See, e.g., id.* at 57-74; *see also* R.R. Baxter, *Multilateral Treaties as Evidence of Customary International Law*, 41 BRIT. Y.B. INT'L L. 275 (1968).

create customary international law. For example, D'Amato has affirmed that

if we look at the matter mathematically, a multilateral convention among ten states is the equivalent of forty-five similarly worded bilateral treaties among the same ten states. Surely there can be no legal difference between the exact same treaty language contained in a single instrument signed by ten states, and forty-five bilateral treaties, all of which contain the exact same language. To be sure, multilateral treaties are more likely than bilateral treaties to contain generalizable provisions that are capable of being subsumed into customary law (witness the recent proliferation of multilateral human-rights conventions.) But there can be no theoretical difference between a multilateral and a bilateral treaty in terms of their effect upon customary law.<sup>495</sup>

Legal scholar Chantal Thomas, in an article contending that the arm's length standard has achieved the status of customary international law, has similarly maintained that "a series of bilateral treaties establishing the same rule, if extensive enough, can also provide important evidence of customary international law."<sup>496</sup>

Other writers have disputed the argument that bilateral treaties may establish customary law as easily as multilateral treaties. For example, Malcolm N. Shaw, while acknowledging that "a series of bilateral treaties containing a similar rule may be evidence of the existence of that rule in customary law," has emphasized that "this proposition needs to be approached with some caution in view of the fact that bilateral treaties by their very nature often reflect discrete circumstances."<sup>497</sup>

Under traditional customary law principles, in order for the *opinio juris* requirement to be satisfied the norm need not be enforceable or enforced. Some scholars, however, argue that for a norm to be considered "obligatory" some social sanction must usually be triggered by its violation. Thus, the highly regarded international legal scholar J.L. Brierly affirmed that for a norm to constitute customary international law "[t]here must be present a feeling that, if the usage is departed from, some form of sanction will probably, or at any rate ought to, fall on the transgressor."<sup>498</sup> Similarly, Thomas argues that for a norm to qualify as a customary international legal

---

495. D'Amato, *supra* note 478, at 99.

496. Thomas, *supra* note 36, at 122.

497. MALCOLM N. SHAW, *INTERNATIONAL LAW* 77 (4th ed. 1997). Shaw further points out that "great care has to be taken in inferring the existence of a rule of customary international law from a range of bilateral treaties." *Id.* at 581.

498. BRIERLY, *supra* note 471, at 59.

norm “a high probability of ‘punitive action’—which may include a wide range of negative responses—must attach to its violation by any nation.”<sup>499</sup> This requirement, she believes, when added to the traditional requirement that states acknowledge that they have some obligation to observe the norm, helps to establish when a norm truly has the force of law and to “distinguish customary international law from other rules.”<sup>500</sup>

The conventional understanding of *opinio juris*, as reflected in the opinion of the International Court of Justice in the *North Sea Continental Shelf Cases*, can give rise to a paradox. According to this understanding, in order for a particular common practice to be considered legally binding, states must *already* perceive themselves to be under a legal obligation to follow it. Legal philosopher John Finnis contends that this understanding of *opinio juris* is paradoxical “for it proposes that a customary norm can come into existence (i.e., become authoritative) only by virtue of the necessarily erroneous belief that it is already in existence (i.e., authoritative).”<sup>501</sup>

Finnis proposes a solution to this paradox. He argues that at the root of *opinio juris* are two related practical judgments.<sup>502</sup> The first is that in some domain of human affairs “it would be appropriate to have *some* determinate, common, and stable pattern of conduct and, correspondingly, an authoritative rule requiring that pattern of conduct” and that “to have this is more desirable than leaving conduct in this domain to the discretion of individual states.”<sup>503</sup> The second is that “*this* particular pattern of conduct . . . is appropriate, or would be *if* generally adopted and acquiesced in, for adoption as an authoritative common rule of conduct.”<sup>504</sup> Finnis maintains that when

the contents of a multilateral treaty, or the resolutions of an international body representative of states, are spoken of as sources or evidence of custom, what is really (or, at any rate, justifiably) being said is that the treaty or resolutions are evidence not of an opinion about what the law already is, but of *opinio juris* in the limited sense expressed in these two judgements . . . . They affirm that something is desirable (*a*) in general, (*b*) in particular.<sup>505</sup>

499. Thomas, *supra* note 36, at 114.

500. *Id.* at 119.

501. Finnis, *supra* note 193, at 180. Other writers have also identified this paradox. See, e.g., D'AMATO, *supra* note 470, at 8, 13.

502. See Finnis, *supra* note 193, at 181.

503. *Id.*

504. *Id.*

505. *Id.* at 181-82.

A key element of Finnis' explanation of the formation of customary international law is a practical premise, or framework custom, holding that

the emergence and recognition of customary rules (by treating a certain degree of concurrence or acquiescence in a practice and a corresponding *opinio juris* as sufficient to create such a norm and to entitle that norm to recognition even by states not party to the practice or the *opinio juris*) is a desirable or appropriate method of solving interaction or co-ordination problems in the international community . . . . Both the framework custom and the particular customs which become authoritative within its framework derive their authoritativeness directly from the fact that, if treated as authoritative, they enable states to solve their co-ordination problems—a fact that has normative significance because the common good requires that these co-ordination problems be solved.<sup>506</sup>

What reasons are advanced for giving customary international law preemptive effect under various normative theories? Some legal philosophers have argued that the consistent state practice requirement ensures that states are abiding by a customary rule out of their own free consent. Under these theories, consent then becomes a reason supporting the authority of customary international law.<sup>507</sup> Other theorists, such as D'Amato, have pointed out that by its very character customary international law binds even those states that do not consent to the rule, unless they qualify as “persistent objectors.”<sup>508</sup>

Some theorists argue that custom may be viewed as “the way in which states, through their behavior, identify one equilibrium point among several possible, just as a treaty does. If other states follow suit, then the point of equilibrium has been reached and a customary norm emerges.”<sup>509</sup> These theorists further contend that a norm must be considered binding if the existing states that follow the norm as a solution to a coordination dilemma “wish to channel the behavior of newcomers . . . . *Opinio juris* emerges, therefore, when the original participants in a spontaneous regularity of behavior start treating that behavior as legally required in order to secure the adherence of new

---

506. *Id.* at 184-85.

507. One such consent theorist is Karol Wolfke, who maintains that the consent of a particular state is the basis of the binding authority of customary rules over that state, even if the state has manifested its consent indirectly, such as simply by participating in the international society of states. *See* WOLFKE, *supra* note 491, at 160-68.

508. *See, e.g.,* D'AMATO, *supra* note 470, at 187-99.

509. TESÓN, *supra* note 315, at 86 (describing this view).

states and governments.”<sup>510</sup> According to these theorists, customary law is not likely to emerge where the initial situation is a prisoners’ dilemma because of the rational incentive of governments to defect.<sup>511</sup> Instead, “[b]inding customary law is the result of an initial Coordination matrix that later mutates into a PD matrix by the arrival of new states or governments. The *emergence* of custom requires a Coordination matrix; the *endurance* of custom requires that the participants find a solution to a PD matrix.”<sup>512</sup>

Other normative theories advocate moral reasons for giving customary international law preemptive effect. For example, Fernando R. Tesón argues that “international customary law cannot be simply inferred from state practice. To say that X is a customary rule is to condemn, for moral reasons, self-interested deviation.”<sup>513</sup> According to Tesón, the self-interest that may lead states to adopt a customary practice in order to solve a coordination problem “does not and cannot generate obligation.”<sup>514</sup> Legal philosopher Finnis also acknowledges that “there are direct ‘moral’ arguments of justice for recognizing customs as authoritative (for example, arguments against unfairly defeating reasonable expectations or squandering resources and structures erected on the basis of the expectations).”<sup>515</sup> However, he maintains that

the general authoritativeness of custom depends upon the fact that custom-formation has been *adopted* in the international community as an appropriate method of rule-creation. For, given this fact, recognition of the authoritativeness of particular customs affords all states an opportunity of furthering the common good of the international community by solving interaction and co-ordination problems otherwise insoluble. And this opportunity is the root of all legal authority, whether it be the authority of rulers or (as here) of rules.<sup>516</sup>

3. *Toward a Normative Theory Regarding the Authority of Customary International Law.* This subsection outlines the rudiments of a normative theory regarding the authority of customary international law. The first principle under this theory is that states should respect traditional secondary rules for identifying customary

---

510. *Id.* at 86-87 (describing this view).

511. *See id.* at 88 (describing this view).

512. *Id.* (emphasis in original).

513. *Id.* at 90.

514. *Id.* at 89.

515. Finnis, *supra* note 193, at 184-85.

516. *Id.* at 185.



international law and for giving it preemptive effect. These rules are supported by a number of reasons, including membership in a community, as argued by Finnis.<sup>517</sup> Moreover, recognition of the existence of a community of states implies that each state ought to abide by morally justifiable norms accepted as authoritative by a large majority of state members of that community (or that such a majority believes ought to be accepted as authoritative). Doing so helps to fulfill legitimate expectations of other members of the community.

At the same time, traditional secondary rules, by focusing on state practice as well as the views of states about the desirability of instituting an authoritative norm, give significant voice to states in the creation of customary international law, thus respecting the fundamental principle of state autonomy. Because, for these reasons, customary norms can (and should) bind even states that have not voluntarily consented to them or promised to obey them (unless the states are persistent objectors), the moral principle of fidelity to promises should not prominently figure as a reason for accepting the authority of customary international law. Moreover, it is difficult to infer “consent” or a “promise” merely from practice. But, as Finnis notes, the principle that a state’s conduct may give rise to reasonable expectations about its continued conduct on the part of other states supports the traditional secondary rules.<sup>518</sup>

It may prove useful to elaborate a particular interpretative approach to the traditional secondary rule requirements of consistent state practice and *opinio juris*. First, the consistent state practice requirement is essential to ensure that a customary international law norm is not simply a norm that states regard as desirable in the distant future to implement as a legal rule; rather, it is a desirable norm to which states actually conform. The requirement of conformity prevents the transformation of every norm regarded as desirable into an immediately binding rule.

Second, in light of the conceptual analysis in Part III, it becomes clear that the *opinio juris* requirement is designed to justify the recognition of the *legal authority*—as opposed to the mere *persuasiveness*—of a consistent practice by virtue of the empirical acceptance of the practice’s *authority* by a large number of states. Under this conception, the *opinio juris* requirement is supported by the need to prove that states are acting out of acceptance of the

---

517. *See id.*

518. *See id.* at 184-85.

*authority* of the norm, rather than purely out of “comity,” tradition, or other first-order reasons.

Finnis’ account of *opinio juris* is an insightful analysis into the *opinio juris* requirement. But in view of the conceptual and normative framework laid out in earlier Parts, his analysis warrants clarification in several respects.

First, two of the practical judgments that he identifies as the core of the concept of *opinio juris* (relating to a perception among states that an authoritative rule would be desirable) require the caveat that such a rule is desirable *now or in the near future*. States may agree that many rules would be desirable to implement in the long term, and their practices may even coincide with the action required by these norms. However, such a vague sense of long-term “desirability” does not provide the immediate sense of desirability (and ultimately obligation) required to conclude that a norm should *already and now* be considered a customary legal norm.

Second, as emphasized above, states must view as desirable the immediate imposition of an *authoritative* rule that requires a particular practice—that is, a rule that preempts independent state decision making about the matter concerned. States must be convinced that the practice in question ought to have binding or at least persuasive authority, and not merely persuasive weight.

This second requirement is consistent with the normative ideal, expressed in Part III, of exercising caution in recognizing the existence of persuasive or binding obligations among states confronting only a coordination problem. Such problems can often be solved by self-enforcing conventions. Nevertheless, as established in Part III, there can be good reasons for imposing obligations (especially persuasive ones) to reinforce a convention. The above interpretation of *opinio juris* posits that imposition of such obligations is warranted only where a majority of states themselves believe that doing so is helpful to prop up and solidify a convention.

Third, states must be convinced that the practice ought to be binding as a *legal* norm and not, for example, merely as a moral norm. Otherwise, the norm could legitimately be described as being a “customary norm” but not a “customary legal norm.”

Fourth, states must believe that it is desirable, now or in the near future, to apply this authoritative rule to the conduct of *all* states, whether or not they have specifically consented to the application of the rule (unless they have, through clear and recurring protests, established their status as “persistent objectors”). Accordingly,

where treaties are used as evidence of practical judgments among states relating to the desirability of establishing an authoritative rule, those treaties must demonstrate that states have already formed or are forming the judgment that it is now desirable to institute an authoritative legal rule binding on all states.<sup>519</sup> Some treaties, such as multilateral treaties with potentially universal membership, will provide the best evidence of such a judgment.

But treaties that were never intended to be ratified by as many states as possible—especially bilateral treaties—will necessarily provide weaker support for the existence of a judgment among states that a particular rule ought to be applied to all states even in the absence of explicit treaty obligations. Indeed, the prevalence of a system of bilateral treaties, unaccompanied by a multilateral treaty of potentially universal membership, may indicate a popular judgment that, in the absence of voluntarily accepted treaty obligations, states should not be bound by rules contained in those treaties.<sup>520</sup> The mere abundance of treaties incorporating a particular norm “does nothing to prove a rule of customary international law” if those treaties do not evidence a belief that the norm should be binding on all states apart from the treaties.<sup>521</sup>

Of course, a judgment that there should now be a universal authoritative rule may also be evidenced by bilateral treaties, but only if those bilateral treaties point to a practical judgment that all states ought to be bound by the rule. For example, in the 1955 *Nottebohm Case*,<sup>522</sup> the International Court of Justice held that there existed a customary state practice under which states refrained from “exercising [diplomatic] protection in favour of a naturalized person when the latter has in fact, by his prolonged absence, severed his links with what is no longer for him anything but his nominal country.”<sup>523</sup> This practice manifested “the view of these States that, in order to be

---

519. D’Amato’s concept of “generalizable” norms may correspond with what this Article has described as norms that most states believe are desirable to implement immediately as authoritative legal rules binding on all states even in the absence of voluntarily incurred treaty obligations. On “generalizable” norms, see D’Amato, *supra* note 478, at 95; D’AMATO, *supra* note 470, at 105-7.

520. In the words of legal scholar Richard Baxter, “the very existence of the [bilateral] treaties may indicate that the parties had assumed duties to which they would not have been subject in the absence of agreement.” Baxter, *supra* note 493, at 81. See also WOLFKE, *supra* note 491, at 71; MARK E. VILLIGER, CUSTOMARY INTERNATIONAL LAW AND TREATIES 196-97 (1985).

521. Baxter, *supra* note 493, at 84.

522. (*Liech. v. Guat.*), 1955 I.C.J. 4 (Apr. 6).

523. *Id.* at 22.

capable of being invoked against another State, nationality must correspond with the factual situation.”<sup>524</sup> In this connection, the Court noted:

A similar view is manifested in the relevant provisions of the bilateral nationality treaties concluded between the United States of America and other States since 1868, such as those sometimes referred to as the Bancroft Treaties, and in the Pan-American Convention, signed at Rio de Janeiro on August 13th, 1906, on the status of naturalized citizens who resume residence in their country of origin.<sup>525</sup>

Without explaining its precise reasoning, the Court apparently took the bilateral Bancroft Treaties (which had since been terminated) as evidence of a sense among states that a factual “nexus” test should be applied to limit states’ free right to naturalize and thereby exercise diplomatic protection on behalf of other individuals.<sup>526</sup> In his dissent, Judge Read reached the opposite conclusion—that the treaties evidenced the existence of a common belief that states generally have full freedom to decide their own tests for naturalization:

The fact that it was considered necessary to conclude the series of bilateral conventions [the Bancroft Treaties] and to establish the multilateral Convention referred to above [the Pan-American Convention] indicates that the countries concerned were not content to rely on the possible existence of a rule of positive international law qualifying the right of protection.<sup>527</sup>

It should be emphasized that, in assessing the views of states about the desirability of a legal rule, the judgment of *all* states should count, including both parties and non-parties to a particular treaty. This follows from the general requirement that there be a consensus among states generally on *opinio juris*. In this connection, the views of the parties alone may help establish a customary norm if a multilateral treaty attracts sufficient ratifications such that its members constitute a majority of states, and the treaty’s structure and content support an inference that the parties to the treaty judge it desirable that there should now be established a legal rule binding on all states, including non-parties. But this is only because the states parties constitute a preponderance of all states sufficient to produce the requisite quantity of state practice and *opinio juris*. To establish a

---

524. *Id.*

525. *Id.* at 22-23.

526. *See id.*

527. *Id.* at 34, 41 (Read, J., dissenting).

general judgment along these lines in the case of treaties with a smaller membership would clearly require the determination of the views of non-parties as well.

Finally, because the formation of customary international law is contingent on a widely-shared judgment among states that the imposition of a universal authoritative rule is immediately desirable, the likelihood of enforcement or retaliation in the event of a violation is relevant to the identification of customary norms only if states themselves condition their evaluation of the immediate desirability of instituting an authoritative legal rule on the likelihood of its enforcement. In dilemmas of common aversions (as opposed to dilemmas of common interests such as a prisoners' dilemma, where states have an incentive to cheat), states will not usually see the presence of enforcement measures as necessary to legitimate adoption of the rule. Thus, the availability of enforcement action or the likelihood of retaliation should not be a precondition in every case for the recognition of a norm as an authoritative norm of customary international law.

#### B. The Authority of the Arm's Length Standard as a Customary Norm: A Norm without Binding or Persuasive Authority

Few observers have claimed that the arm's length standard is a norm of customary international law; more typically, states and international organizations such as the OECD or the United Nations assert that it is a norm of treaty law.<sup>528</sup> However, as noted in Part I, Chantal Thomas has put forward a sophisticated argument that all states are now bound to apply the arm's length standard under customary international law.<sup>529</sup> Thomas bases this claim on two assertions. First, she observes that the actual practice of states is to apply the arm's length standard, as evidenced by the model treaties, over a thousand bilateral treaties, and the widespread and uniform administrative practice of applying the standard. Second, she argues that the *opinio juris* requirement is met because, as demonstrated by the extensive network of bilateral tax treaties, states perceive themselves as legally obligated to apply the standard.<sup>530</sup> Thus, with respect to *opinio juris*, Thomas contends that

the sheer abundance of bilateral agreements that faithfully implements the separate accounting principles of the OECD and

---

528. See discussion *supra* Parts I, IV.

529. See Thomas, *supra* note 36.

530. See *id.* at 129-31.

United Nations model treaties provide strong evidence of . . . a sense of obligation . . . . This vast network of bilateral treaties militates strongly in favor of a conclusion that separate accounting is a general rule of international law. Thus, there would appear to be a very persuasive general acknowledgment of a *binding obligation* to practice the separate accounting method.<sup>531</sup>

As noted earlier, Thomas has also put forward the view that a customary legal norm must likely be enforced or provoke retaliation if it is violated. She argues that threats of European retaliation in connection with the *Barclays Bank* case meet this test and help to confirm the status of the arm's length standard as a customary norm.<sup>532</sup> Furthermore, Thomas maintains that the United States cannot use the persistent objector exception to exempt itself from a customary norm requiring the use of the arm's length standard.<sup>533</sup> This is because the "United States federal government has acted on numerous occasions to evince a belief that the separate accounting method represents a binding legal standard."<sup>534</sup>

In light of the normative theory outlined above, should the arm's length standard be regarded as a norm of customary international law? If so, what degree of preemptive effect should it have as a customary norm?

First of all, the arm's length standard does appear to meet the test of a uniform and consistent practice, particularly where state practice is understood as including the practice of agreeing to the arm's length standard in treaties.<sup>535</sup> The widespread acceptance of the standard in over a thousand bilateral treaties is truly remarkable. Certainly this proliferation of treaties recognizing the norm makes it, initially, a strong contender for the status of customary international law. Further, there is significant evidence, as we saw in Part II, that in practice states do attempt to apply the standard—and the arm's length method in particular—and only resort to empirical methods or classic formulary apportionment as fallback methods.

Nevertheless, it is not at all clear that the arm's length standard satisfies the *opinio juris* requirement as interpreted by the revised version of Finnis' analysis advocated above. The question is whether states believe that it is desirable (not at some distant time, but now) to have a general universally binding legal rule requiring the use of

---

531. *Id.* at 130-31 (emphasis added).

532. *See id.* at 131-32.

533. *See id.* at 133.

534. *Id.*

535. *See* D'AMATO, *supra* note 470, at 90.

the arm's length standard even in the absence of a bilateral treaty imposing some form of obligation to use the standard. The evidence strongly suggests that they do not.

Most importantly, states, including members of the United Nations and the OECD, have persistently rejected the idea of adopting in the near future a general multilateral and potentially universal tax treaty that would address allocation issues and include the arm's length standard. Instead, the trend has been for international organizations like the League of Nations, the OECD, and the United Nations, and for states generally, to regard such a multilateral treaty as politically unlikely and as undesirable.

For example, during the League of Nations years, states vacillated over the ultimate desirability of producing a multilateral convention, but in any case showed themselves unprepared to accept such an immediate and generalizable obligation. To recall, in 1927, a League committee recommended a bilateral model convention, believing that it would be "practically impossible" to draft an acceptable multilateral convention, although also expressing the view that it might at some point in the future become possible to do so after a "certain measure of uniformity" had been achieved.<sup>536</sup> Three years later, the League of Nations Fiscal Committee recommended the adoption of a multilateral convention on double taxation, contending that "it would materially encourage the movement to reduce double taxation by uniform law—a method which in important respects is obviously superior to the method of reducing double taxation through the instrumentality of bilateral conventions."<sup>537</sup> It made a similar recommendation in 1933.<sup>538</sup> In 1935, after only a few states indicated their willingness to become parties to a multilateral convention, the Fiscal Committee concluded that "progress is more likely to be achieved by means of bilateral agreements" and that "[g]overnments consider . . . that bilateral agreements are likely to prove more appropriate."<sup>539</sup>

Twenty-three years later, in 1958, the Fiscal Committee of the OEEC attempted to revive the goal of achieving a multilateral convention, recommending the eventual replacement of bilateral conventions with a multilateral convention.<sup>540</sup> In its 1963 report, after

---

536. See *1927 Report on Double Taxation*, *supra* note 47, at 4122.

537. *1930 Committee Report*, *supra* note 57, at 4210.

538. See *1933 Committee Report*, *supra* note 81, at 4242.

539. *1935 Committee Report*, *supra* note 88, at 4251-52.

540. See *1958 Report of the Fiscal Committee*, *supra* note 106, at 4460-61.

noting that the European Economic Community as well as the European Free Trade Association had both endorsed the desirability of a multilateral European convention, the Fiscal Committee of the OECD indicated that it also believed that the conclusion of a multilateral convention among all OECD member countries “would have definite advantages.” However, the Committee emphasized the importance of first improving the existing 1963 Model “in order to permit its use in even greater numbers of bilateral Conventions between Member countries and to facilitate the subsequent conclusion of a multilateral Convention among all Member countries.”<sup>541</sup>

By 1977, when the OECD Committee on Fiscal Affairs issued the second revised OECD Model, the Committee stated that the “elaboration and conclusion of a multilateral double taxation convention . . . would meet with great difficulties.”<sup>542</sup> The Committee did note, however, that “[i]t might . . . be possible for certain groups of Member countries to study the possibility of concluding such a convention among themselves on the basis of the Model Convention, subject to certain adaptations they may consider necessary to suit their particular purposes.”<sup>543</sup> Indeed, at the suggestion of the Committee, the OECD Council adopted a recommendation that “the Governments of Member countries which consider it appropriate examine the feasibility of concluding among themselves multilateral conventions based upon the Model Convention.”<sup>544</sup> Notably, the Council only recommended a study of the feasibility of such agreements. And rather than an OECD-wide multilateral convention, the Council contemplated agreements among relatively small groups of countries. In its 1997 Commentary, the OECD repeated these observations and noted the adoption of two regional conventions: the Nordic Convention on Income and Capital concluded in 1983 with subsequent revisions, and the Convention on Mutual Administrative Assistance in Tax Matters, which was drawn up within the Council of Europe and entered into force in 1995.<sup>545</sup> The OECD concluded:

---

541. 1963 OECD MODEL, *supra* note 104, ¶¶ 60-61, at 29; *see also id.* ¶¶ 52-61, at 26-29.

542. 1977 OECD MODEL, *supra* note 134, ¶ 32, at 15.

543. *Id.*

544. Recommendation of the Council Concerning the Avoidance of Double Taxation (Adopted by the Council on Apr. 11, 1977), Part II, *in* 1977 OECD MODEL, *supra* note 134, app. 1, at 193-94.

545. *See* 1997 OECD MODEL, *supra* note 171, ¶¶ 38-39, at I-12-13.



Despite these two conventions, there are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee therefore considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.<sup>546</sup>

The OECD has also repeatedly affirmed that it is not desirable to establish a general binding obligation on states to agree in all cases on adjustments that would eliminate double taxation.<sup>547</sup> In particular, it has contended that a mandatory arbitration scheme “would involve an unprecedented surrender of fiscal sovereignty,” and that, in practice, most cases were resolved satisfactorily through voluntary negotiations.<sup>548</sup> Nevertheless, the European Union has adopted a multilateral convention requiring arbitration in transfer pricing disputes.<sup>549</sup> In light of the European Union convention’s entry into force and the growing use of arbitration provisions in bilateral treaties, the OECD’s 1995 Transfer Pricing Guidelines indicated that it would be appropriate to analyze again the advisability of a tax arbitration procedure and that the Committee on Fiscal Affairs would undertake a study on arbitration.<sup>550</sup>

From the perspective of the United Nations, the U.N. Group of Experts stated in its report on its seventh session in 1977 that there was a general consensus within the Group that the idea of an international agreement should be considered as premature and too ambitious for the foreseeable future . . . . The Group therefore took the view that a multilateral tax agreement would not seem feasible during the forthcoming decade but, . . . it agreed that it was imperative that those issues be dealt with through an adequate network of bilateral tax treaties.<sup>551</sup>

Similarly, the U.N. report on the U.N. Model affirmed that the creation of a network of bilateral tax treaties based on a common model will be an important step . . . leading to the *eventual conclusion* of a world-wide multilateral tax convention for the avoidance of double taxation . . . . In the meantime, as an intermediate step, groups of countries might consider the possibility of negotiating regional or subregional multilateral tax

---

546. *Id.* ¶ 40, at I-13.

547. *See, e.g.*, 1984 OECD REPORT, *supra* note 450, ¶¶ 41-63, at 20-25.

548. *See id.* ¶¶ 55-56, at 23.

549. *See* Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, 1990 O.J. (L225) 10.

550. *See* 1995 TRANSFER PRICING GUIDELINES, *supra* note 172, ¶ 4.171, at IV-55.

551. SEVENTH REPORT, *supra* note 145, at 61.

conventions . . . .<sup>552</sup>

In 1997, a U.N. Ad Hoc Group of Experts on International Cooperation in Tax Matters considered a proposal to establish binding transfer pricing rules. Most members rejected the proposal, believing that “[e]nshrining a common set of transfer pricing principles in binding rules or regulations could be perceived as a derogation from national sovereignty.”<sup>553</sup> However, the Group expressed the view that in bilateral negotiations countries could consider appropriate arbitration or dispute settlement provisions.<sup>554</sup>

States entering into bilateral tax treaties have thus consistently refused to negotiate, let alone ratify, a potentially universal multilateral treaty. This refusal constitutes compelling evidence that member states do not see the bilateral treaties as reflecting the desirability of recognizing an existing obligation owed to all other states in the absence of treaties. On the contrary, such expressions of hesitation, coupled with the exclusive conclusion of bilateral or regional treaties rather than a universal treaty, seem to indicate that states believe that it is desirable to have a rule allowing them to use whatever allocation system they deem best unless they agree to do otherwise in a treaty.

In fact, it has generally been understood that states have regarded this freedom as a longstanding rule of customary international law. For example, one respected commentator has taken the following position:

[C]ustomary international law does *not forbid double taxation* [citations omitted]. Double taxation, resulting from the interaction of the domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law. If the relevant tax provisions of all the States involved were held to be inapplicable only when and because they give rise to double taxation, a system of loopholes could be created which would be no more acceptable than multiple taxation. Consequently, international law can decrease the incidence of double taxation only through the introduction of rules establishing which of the States involved must withdraw its tax claim. General

---

552. U.N. MODEL, *supra* note 149, at 12 (emphasis added).

553. U.N. DEP'T FOR DEVELOPMENT SUPPORT & MANAGEMENT SERVICES, INTERNATIONAL COOPERATION IN TAX MATTERS: REPORT OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON THE WORK OF ITS SEVENTH MEETING ¶ 47, at 10, U.N. Doc. ST/ESA/250, U.N. Sales No. E.96.XVI.2 (1997).

554. *See id.* ¶ 50, at 12.

international law does not as yet contain such rules. For the most part, only bilateral double tax treaties exist to fulfill this role . . . .<sup>555</sup>

This norm allowing freedom of action, then, appears to be the customary norm. Bilateral treaties are adopted to vary that norm in the bilateral relations of a certain (although a truly impressive) number of individual states.<sup>556</sup>

Even if bilateral tax treaties did evidence a common judgment that use of the arm's length standard should now be an obligation for all states, thus satisfying the *opinio juris* test, the character of this obligation would still need clarification. Would it be merely persuasive, or would it be binding? We have seen that the character of the obligation in bilateral treaties is best viewed as a persuasive obligation, not a binding one. Thus, any customary norm deriving from bilateral treaty obligations would have only persuasive authority and would merely require that states in good faith give great weight to the arm's length standard and the arm's length method in their legislation and administrative practices.

Indeed, precisely because the bilateral treaties only grant persuasive authority to the arm's length standard, the treaties manifest a reluctance by states to recognize the desirability of imposing a general binding obligation to use the standard. That is, the substantive content of article 9 of the OECD and U.N. Models implies that the arm's length standard should not be recognized as a norm of customary international law.

---

555. VOGEL, *supra* note 391, at 4 (emphasis in original); *see also* Martin Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431, 431 (1962) (contending that no "rules of international law exist to limit the extent of any country's tax jurisdiction" or "to require a country to grant relief from international double taxation . . . except to the extent they may be provided by treaty in any particular case"); RESTATEMENT, *supra* note 481, § 413 cmt. a ("states have been reluctant to admit an international obligation to avoid double taxation except on the basis of an agreement and in accordance with its terms"); Jonathan I. Charney, *International Agreements and the Development of Customary International Law*, 61 WASH. L. REV. 971, 980-83 (1986) (endorsing the Restatement's position on the grounds, *inter alia*, that tax treaty obligations "are more closely the result of a quid pro quo arrangement that may not permit their use outside the fabric of the agreement" and are more technical in nature; therefore "it is difficult to merge a generalized principle of this sort into international law without the accompanying detail that must be negotiated individually").

556. It appears that Anthony D'Amato might reach the same conclusion on the ground that the arm's length standard is not a "generalizable" norm. This is suggested by his argument that trade treaties, including GATT, do not contain generalizable norms because states are always free to trade or not to trade with other states. *See* D'AMATO, *supra* note 470, at 105-6. D'Amato might argue that the same freedom exists with regard to the use of income allocation methods.

The issue here is very similar in this respect to the issue in the *North Sea Continental Shelf Cases*. There the International Court of Justice held that article 6 of the 1958 Convention on the Continental Shelf did not give rise to a customary norm because, by its terms, article 6 first only provided that the continental shelf boundary should be determined by agreement, and only if agreement was unavailing were parties potentially obligated to use the equidistance method.<sup>557</sup> In the words of the Court, it was open to doubt that the equidistance method was of a “fundamentally norm-creating character such as could be regarded as forming the basis of a general rule of law,” because in the first place “[a]rticle 6 is so framed as to put second the obligation to make use of the equidistance method, causing it to come after a primary obligation to effect delimitation by agreement.”<sup>558</sup>

In other words, the language of the treaty indicated that states did not view a binding rule *mandating* use of the equidistance method as desirable even under the treaty.<sup>559</sup> For the same reason, states parties certainly did not view it as desirable to institute such a rule as a customary norm binding on all states without regard to the treaty.

In short, even though the network of bilateral tax treaties mentioning the arm’s length standard has become quite extensive, the network consists only of bilateral, individually negotiated agreements that do not reflect a sense among states that, even in the absence of these treaties, they are obligated to apply the arm’s length standard. Thus, the arm’s length standard does not appear to have any legal authority (whether persuasive or binding) under customary international law.

Declining to recognize the arm’s length standard as having persuasive or binding authority under customary international law is consistent with the normative principles articulated earlier. Most

---

557. Article 6, paragraph 2, reads:

Where the same continental shelf is adjacent to the territories of two adjacent States, the boundary of the continental shelf shall be determined by agreement between them. In the absence of agreement, and unless another boundary line is justified by special circumstances, the boundary shall be determined by application of the principle of equidistance from the nearest points of the baselines from which the breadth of the territorial sea of each State is measured.

*North Sea Continental Shelf Cases* (F.R.G. v. Den., F.R.G. v. Neth.), 1969 I.C.J. 3, 24 (Feb. 20) (quoting Convention on the Continental Shelf, Apr. 29, 1958, 499 U.N.T.S. 311, 316).

558. *Id.* at 42.

559. According to the Court, the Convention reflected a belief that “no one single method . . . was likely to prove satisfactory in all circumstances, and that delimitation should, therefore, be carried out by agreement (or by reference to arbitration)” and that it “should be effected on equitable principles.” *Id.* at 35-36.

importantly, it follows from existing secondary rules as just interpreted. Moreover, given states' natural incentives to follow the arm's length standard as an established convention, it is reasonable for them to be reluctant to recognize the arm's length standard as an authoritative norm outside of treaties.

States appear content to persuade one another voluntarily to undertake treaty obligations that in turn establish persuasive obligations on parties to use the arm's length standard. Such treaties, states evidently believe, can help reinforce the arm's length standard by rendering it a persuasive obligation for parties. Presumably because the arm's length standard already enjoys worldwide support as a convention, states are not yet convinced that they all should have such a persuasive obligation even in the absence of consensual treaty commitments.

Of course, the conclusion that the arm's length standard does not currently have authority under customary international law does not imply that, normatively, it should not become a customary norm or be incorporated in a multilateral treaty. Indeed, as strongly suggested by the analysis in Part IV, states *ought* to view the universal recognition of at least a persuasive obligation to use the arm's length standard as immediately desirable because income allocation appears to be a non-pure coordination problem as well as an issue area in which there is a risk that not all states will perceive it, or continue to perceive it, as a coordination problem.

What authority should the arm's length standard have as a customary norm under U.S. domestic law? Under U.S. secondary rules, even if the standard were a norm of customary international law, Congress under the Constitution *could* override it through domestic legislation adopting formulary apportionment, although Congress would have a legal obligation to give it some respect as federal common law. However, because there is no such authoritative rule under customary law, Congress has no obligation to refrain from instituting formulary apportionment by revising existing treaty obligations with the consent of treaty partners.

## VI. CONCLUSION: WHY THE UNITED STATES IS OBLIGATED TO DRIVE ON THE RIGHT

This Article and the patient reader have traversed a long road. Along the way, we have partaken of vistas from the disciplines of legal philosophy, social psychology, international relations theory, game theory and the jurisprudence of international law. By viewing

the problem from these many different perspectives and by focusing on the legal status of the arm's length standard as a case study, the Article has attempted to shed some light on the problem of determining the degree of authority that treaties and customary international law ought to enjoy and what reasons justify giving them such authority.

The Article has suggested that there are a number of compelling reasons for states to refrain from exercising their own independent judgment and instead to comply with international treaty norms as well as norms of customary international law. These reasons include the ability of authoritative international legal norms to help solve dilemmas of collective action, the capacity of legal rules developed by experts to help states better achieve both self-oriented and moral goals, the moral principles of fidelity to promises and of fulfilling legitimate expectations of other states, and finally, the fact that international legal obligations are established by certain secondary rules that, in turn, have been formulated by a community of states of which every state is a member, and that also give significant deference to state autonomy and consent.

The Article has also highlighted the concept of persuasive authority and the ability of international legal norms with persuasive authority to resolve certain coordination problems particularly well, while simultaneously respecting the fundamental autonomy of state decision making. And it has sketched a methodology for ascertaining whether certain practices have risen to the level of customary international law.

This extensive tour has led to a number of conclusions relating to the authority of the arm's length standard. First, under existing treaties the general arm's length standard should be regarded as having strong persuasive legal authority, but not binding legal authority. To have strong persuasive legal authority means that Congress is legally obligated to give the arm's length standard great weight, regardless of the degree of weight it otherwise judges that the standard should be given on the "merits" of the policy arguments reviewed in Part I. In formulating appropriate income allocation legislation, Congress must give significantly reduced weight to those policy arguments against retention of the standard, and significantly enhanced weight to those reasons favoring it.

Because the treaties impose only a persuasive obligation (albeit a strong one) to use the arm's length standard, if there are extremely compelling policy arguments in favor of the limited use of classic

formulary apportionment in certain situations, Congress could lawfully adopt such a legislative provision. Nevertheless, it appears that such a provision would have to be limited to particular situations, such as cases with a high potential for abuse of the arm's length standard or in which other methods consistent with the arm's length standard cannot be made to work.<sup>560</sup> The treaties thus should be interpreted as precluding the wholesale revision of the law to require formulary apportionment in all cases, as has apparently been proposed by Senator Dorgan and other supporters of classic formulary apportionment.

Second, the arm's length standard should be regarded as having, at present, neither persuasive nor binding authority as a norm of customary international law. The United States is thus free to renegotiate tax treaties to permit or require formulary apportionment.

The above analysis has also demonstrated that there are good reasons for recognizing the persuasive authority of the arm's length standard under tax treaties. In particular, the Article has suggested that income allocation is best understood as a non-pure coordination problem as well as an issue area in which there is the potential for some states to fail to perceive it (or continue to perceive it) as a coordination problem. Most states themselves have understood income allocation in this way, which is why they have chosen to promote the arm's length standard as a convention that can help avoid double taxation and promote international economic growth.

Indeed, parties to bilateral treaties have promised one another to give the arm's length standard great weight. They have done so precisely because they wish to guard against the risk that they, or their treaty partners, will in the future change their minds and attempt to shift to a conflicting allocation method, either because such a method is perceived as producing a more favorable equilibrium outcome for the party involved, or because that party ceases to recognize income allocation as a coordination problem at all.

Perhaps most importantly, all states should be viewed as members of a community of states that has established secondary rules regarding the binding force and interpretation of treaties that lead to the conclusion that parties to tax treaties have thus committed

---

560. The question of which situations might merit the application of classic formulary apportionment deserves further study.

themselves to grant strong persuasive authority to the arm's length standard. These secondary rules give significant deference to the voluntary decision of states to recognize income allocation as a coordination problem and to solve it by accepting an obligation to give great weight to the arm's length standard in their allocation laws and practices.

In short, the United States, in numerous bilateral tax treaties, has, like its treaty partners, recognized income allocation as a coordination problem and has agreed to give great weight to a convention of driving on the right-hand side of the highway (that is, of following the arm's length standard). It has agreed to do so to minimize the risk that at some future time it, or its treaty partners, will unilaterally decide to drive on the left-hand side (that is, implement a comprehensive system of classic formulary apportionment), resulting in the potential for a damaging economic collision.

Even if Congress strongly believes, like the drivers referred to in the Introduction, that the view is much better on the left-hand side of the highway, that the United States (and perhaps all countries) would be better off if all countries drove on the left-hand side, and that the United States consequently ought unilaterally to begin driving on the left-hand side to induce treaty partners to do likewise, Congress should refrain from doing so for all the reasons outlined above. The United States' solemn treaty commitments, and ultimately its membership and participation in a community of states, require the use of persuasion, not unilateral action, to effect such a change.

Moreover, Congress should heed the United States' own assessment, evidenced by the treaty obligations it has willingly incurred, of the risks of unilateral action. It may take more work (and time) to negotiate a switch to driving on the left-hand side of the highway, if that is what Congress ultimately decides is preferable, but at least there will be a community of drivers alive to enjoy the view.



## APPENDIX

*Example 1.* Assume that a U.S. manufacturer of high-priced children's dolls owns 100% of the stock of a foreign subsidiary, which sells the dolls outside the United States. The cost of each doll manufactured in the United States is \$25, and the retail sales price in foreign countries is \$50. Under the separate accounting principle, the U.S. parent has an incentive to sell each doll to its foreign subsidiary for as close to \$25 as possible, leaving little taxable profit in the U.S. parent and shifting most of the profit to the foreign subsidiary, where it will be taxed at the foreign country's low tax rate.

*Example 2.* Assuming the same facts as in Example 1, if the comparable uncontrolled price between unrelated corporations manufacturing and selling similar dolls is determined to be \$40, then \$15 of income (\$40 minus \$25) would be allocated to the U.S. parent, and \$10 (\$50 minus \$40) would be allocated to the foreign subsidiary.

*Example 3.* Assuming the same facts as in Example 1, the formulary apportionment method treats both parent and subsidiary as engaging in a single business of manufacturing and selling dolls. Their combined income per doll would be \$25 (\$50 retail selling price less the \$25 cost for the group). Let us assume that a formula takes into account only payroll. If the U.S. parent and foreign subsidiary payrolls are \$600,000 and \$400,000, respectively, then 60% ( $\$600,000/\$1,000,000$ ) of the group's combined income of \$25 per doll (\$15) would be allocated to the U.S. parent. The other 40% of the income per doll (\$10) would be allocated to the foreign subsidiary.

*Example 4.* Assuming the same facts as in Example 1, if the gross profit percentage earned in comparable uncontrolled transactions is 20% of revenue from sales, then the transfer price between the U.S. parent and foreign subsidiary would be the resale price of \$50, less 20% of \$50 (\$10), or \$40.

*Example 5.* Assuming the same facts as in Example 1, if the gross profit markup earned in comparable uncontrolled transactions is 60% of production costs, then the transfer price between the U.S. parent and foreign subsidiary would be determined to be the parent's manufacturing costs of \$25, plus 60% of \$25 (\$15), or \$40.

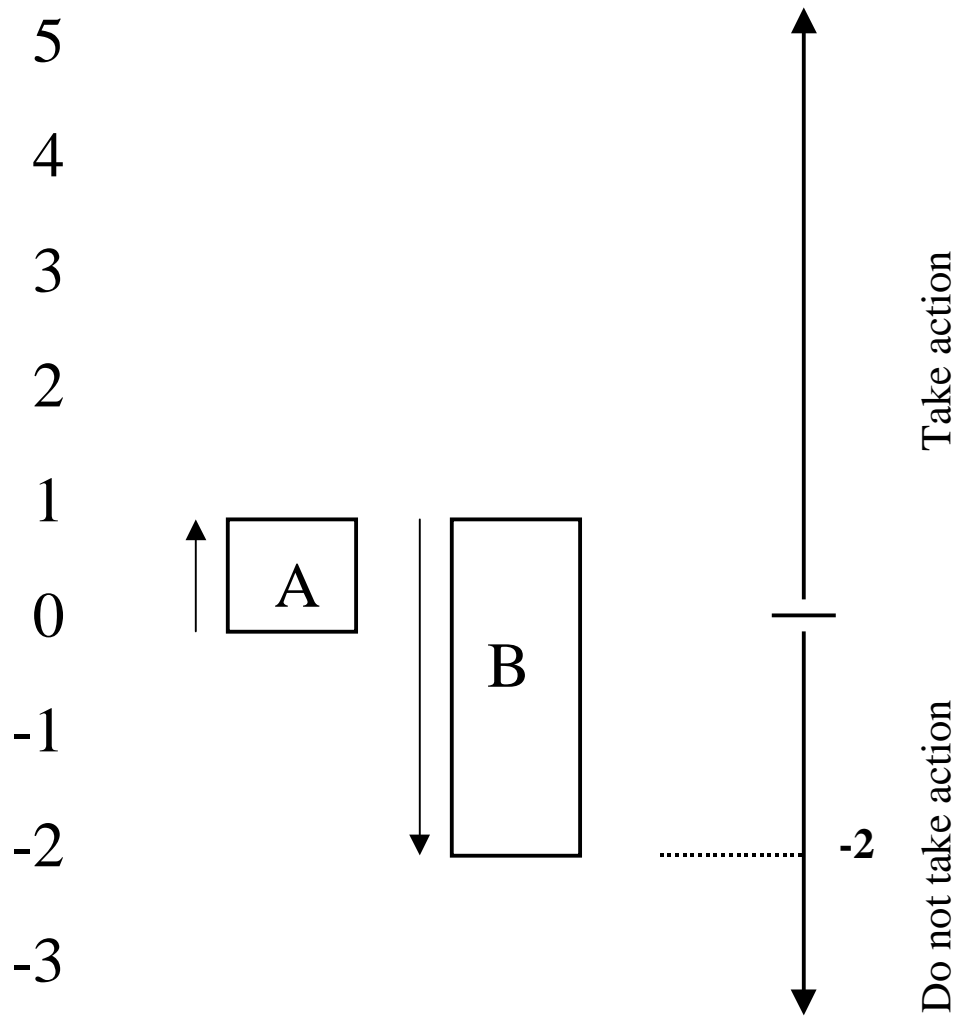
*Example 6.* This example assumes the same facts as in Example 1, and also that the foreign sales subsidiary sells 50,000 dolls per year, generating total sales of \$2,500,000, and reports an operating profit of \$25 per doll (\$1,250,000). If the ratio of operating profit to sales is the most appropriate profit level indicator for the subsidiary and this

ratio ranges from 15% to 25% for comparable uncontrolled taxpayers, then an arm's length range of operating profits for the subsidiary would be \$375,000 (15% x \$2,500,000) to \$625,000 (25% x \$2,500,000). Because the reported operating profit of \$1,250,000 falls outside this range, the IRS would adjust the price the subsidiary pays its U.S. parent so that the operating profit falls within the acceptable range. The IRS would likely aim for the range's midpoint of \$500,000, which would be produced by a transfer price of \$40 per doll.

*Example 7.* Assuming the same facts as in Example 1, under the comparable profit split method, the combined operating profit of \$25 per doll would be split between the U.S. parent and foreign subsidiary based on the ratio used by uncontrolled corporations engaged in similar transactions. If the ratio were determined to be 60% (manufacturer) to 40% (seller), then \$15 of profit per doll would be allocated to the U.S. parent and \$10 of profit per doll would be allocated to the foreign subsidiary (comparable to a transfer price of \$40 per doll).

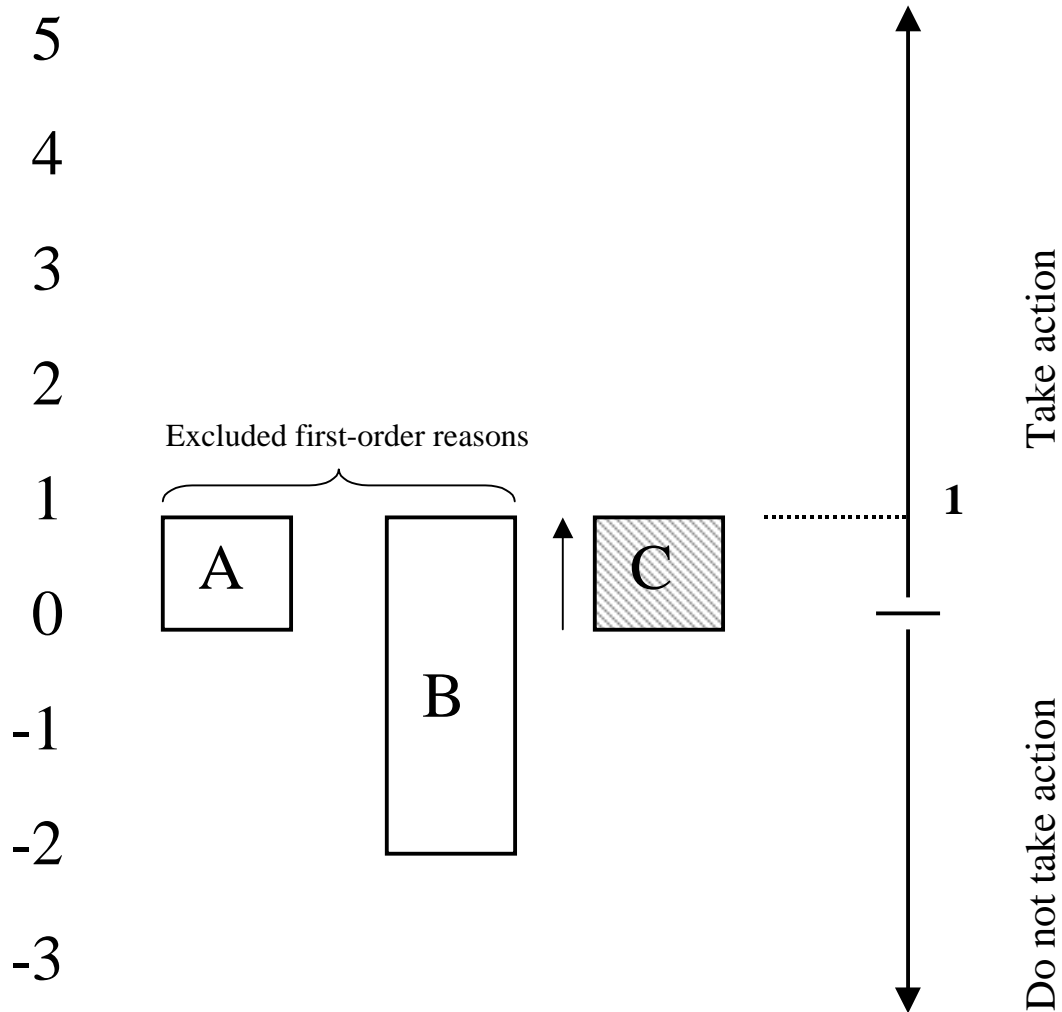
*Example 8.* Assuming the same facts as in Example 1, if the United States established a transfer price of \$40 per doll (producing \$15 of taxable profit to the U.S. parent), and the foreign country determined that the transfer price should be \$30 (resulting in \$20 of taxable profit to the foreign subsidiary), then the total profits taxable by the two countries, \$35 (\$15 + \$20), would exceed the actual combined economic profit of \$25. In effect, the excess of \$10 would represent combined economic profit that is taxed twice.

**Figure 1**  
**A Graphic Interpretation of**  
**Raz's Model of Decision Making**  
**According to the Balance of First-Order Reasons**



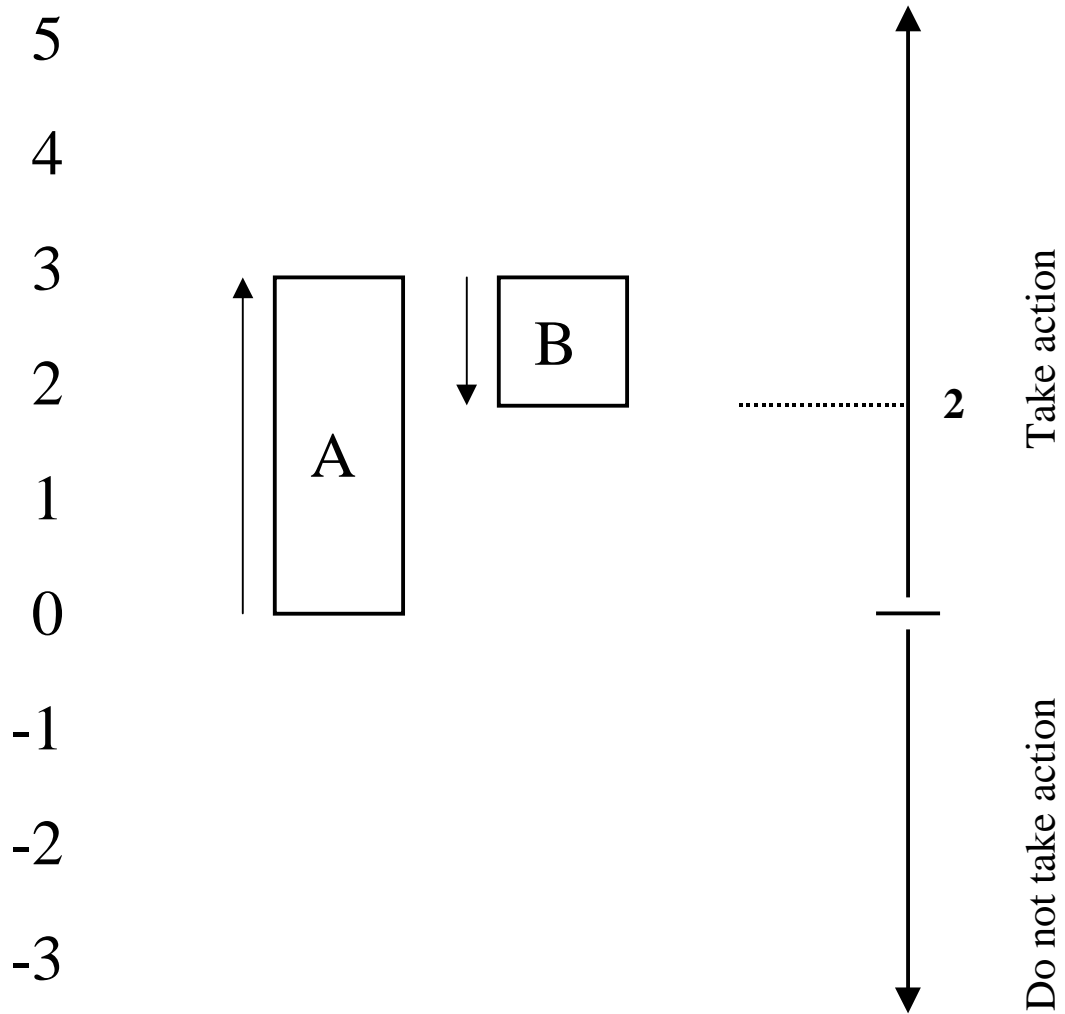
A = Weight of first-order reasons in favor of the action (1)  
B = Weight of first-order reasons against the action (-3)  
Balance of first-order reasons = -2 (Do not take action)

**Figure 2**  
**A Graphic Interpretation of**  
**the Preemptive Effect of an**  
**Authoritative Norm According to Raz**



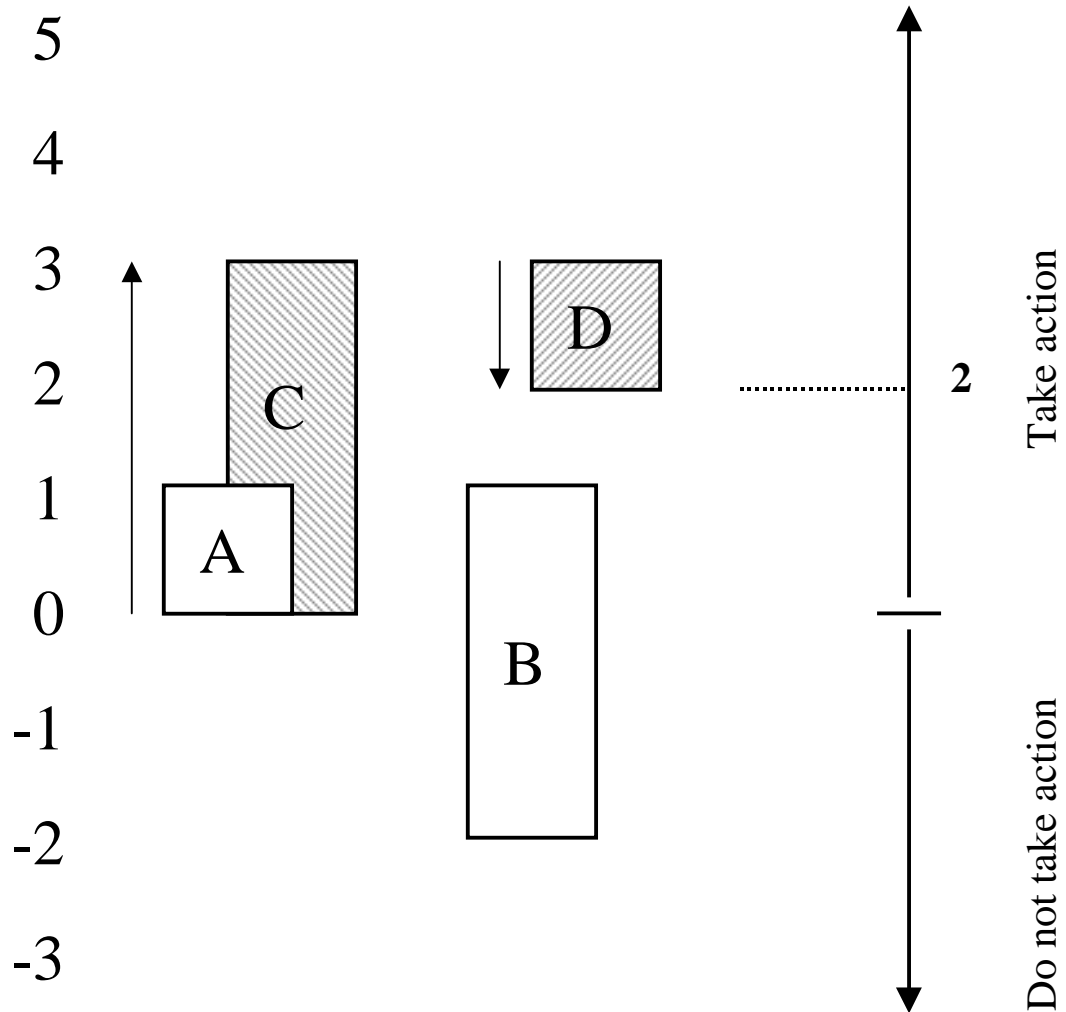
In determining how to act, the actor excludes existing first-order reasons in favor of and against the action and reduces their weights (A and B, respectively) to 0. The norm is treated as an additional first-order reason in favor of the action with a weight, C (1), equal to the weight of the excluded first-order reasons in favor of the action, A (1), less the weight of those reasons that justify treating the norm as an exclusionary reason (a reduction which is disregarded for purposes of this illustration).

**Figure 3**  
**Persuasion**



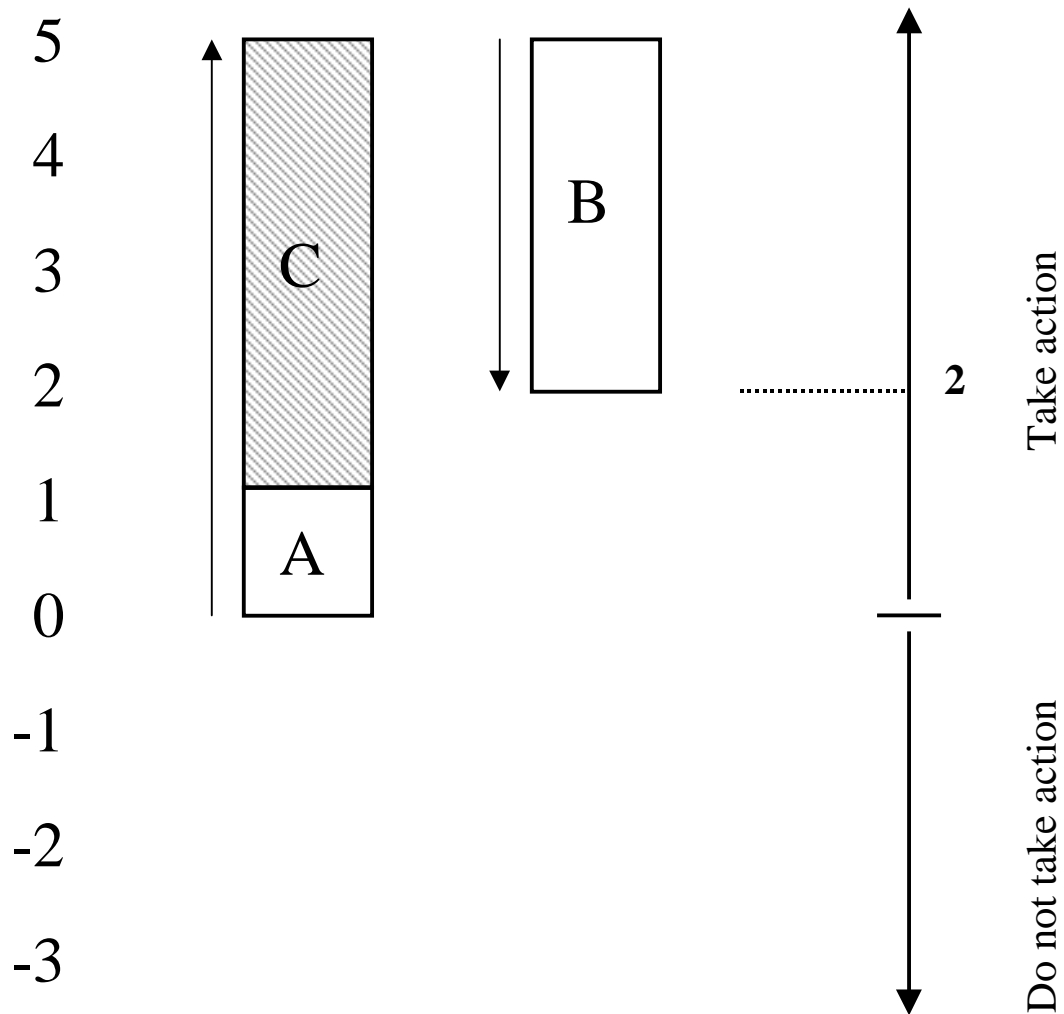
The actor is persuaded to change the weight of first-order reasons in favor of the action (A) from 1 to 3 and the weight of first-order reasons against the action (B) from -3 to -1. The actor's old assessment of A and B (see Figure 1) disappears.

**Figure 4**  
**Persuasive Authority**



The actor's own subjective perception of the weight of first-order reasons in favor of the action, A (1), and first-order reasons against the action, B (-3), remains unchanged. However, in response to a norm with persuasive authority, the actor, in determining how to act, increases the weight of first-order reasons in favor of the action to C (3) and decreases the weight of first-order reasons against the action to D (-1).

**Figure 5**  
**An Alternative Conceptualization of the**  
**Effect of a Norm with Persuasive Authority**



The actor's own subjective perception of the weight of first-order reasons in favor of the action, A (1), and first-order reasons against the action, B (-3), remains unchanged. However, in response to a norm with persuasive authority, the actor, in determining how to act, gives the norm great weight, C (4), as an additional first-order reason in favor of the action.

**Figure 6**  
**A Harmony Game**

		<b>Actor B</b>	
		<b>Cooperate</b> (Dominant Strategy) <b>B1</b>	<b>Defect</b> <b>B2</b>
<b>Actor A</b>	<b>Cooperate</b> (Dominant Strategy) <b>A1</b>	<div style="display: flex; justify-content: space-between;"> <span>4 CC</span> <span>CC 4</span> </div> <p style="text-align: center;"><i>Equilibrium Outcome</i></p>	<div style="display: flex; justify-content: space-between;"> <span>3 CD</span> <span>DC 2</span> </div>
	<b>Defect</b> <b>A2</b>	<div style="display: flex; justify-content: space-between;"> <span>1 DC</span> <span>CD 3</span> </div>	<div style="display: flex; justify-content: space-between;"> <span>2 DD</span> <span>DD 1</span> </div>

For each actor, CC > CD > DD or DC

Adapted from Stein, *supra* note 235, at 118. In this and all subsequent figures, the number in the lower left corner of each cell refers to A's preference in rank order, with 4 as the best outcome and 1 (or 0, in Figures 9 and 10) as the worst. The number in the upper right corner of each cell refers to B's preference, also in rank order. "C" means "cooperate" and "D" means "defect." The pair of letters in the lower left corner of each cell refers to the strategies of A and B, respectively. The pair in the upper right corner of each cell refers to the strategies of B and A, respectively.



**Figure 7**  
**An Assurance (“Stag Hunt”) Game**

		<b>Actor B</b>	
		<b>Cooperate B1</b>	<b>Defect B2</b>
<b>Actor A</b>	<b>Cooperate A1</b>	<div style="display: flex; justify-content: space-between;"> <span>4 CC</span> <span>4 CC</span> </div> <p style="text-align: center;"><i>Equilibrium Outcome</i></p>	<div style="display: flex; justify-content: space-between;"> <span>1 CD</span> <span>3 DC</span> </div>
	<b>Defect A2</b>	<div style="display: flex; justify-content: space-between;"> <span>3 DC</span> <span>1 CD</span> </div>	<div style="display: flex; justify-content: space-between;"> <span>2 DD</span> <span>2 DD</span> </div> <p style="text-align: center;"><i>Equilibrium Outcome</i></p>

For each actor,  $CC > DC > DD > CD$

Adapted from Stein, *supra* note 235, at 119.

**Figure 8**  
**A Prisoners' Dilemma**

		<b>Actor B</b>	
		<b>Cooperate B1</b>	<b>Defect (Dominant Strategy) B2</b>
<b>Actor A</b>	<b>Cooperate A1</b>	CC 3	DC 4
	<b>Defect (Dominant Strategy) A2</b>	CD 1	DD 2  <i>Equilibrium Outcome</i>

For each actor, DC > CC > DD > CD

Adapted from Stein, *supra* note 235, at 122.

**Figure 9**  
**A Pure Coordination Problem**

		<b>Actor B</b>	
		<b>Cooperate B1</b>	<b>Defect B2</b>
<b>Actor A</b>	<b>Cooperate A1</b>	CC 1  <i>Equilibrium Outcome</i>	DC 0  
	<b>Defect A2</b>	CD 0  	DD 1  <i>Equilibrium Outcome</i>

For each actor,  $CC = DD > DC$  or  $CD$

Adapted from Stein, *supra* note 235, at 126.

**Figure 10**  
**A Non-Pure Coordination Problem**

		<b>Actor B</b>	
		<b>Cooperate B1</b>	<b>Defect B2</b>
<b>Actor A</b>	<b>Cooperate A1</b>	CC 1  <i>Equilibrium Outcome</i>	DC 0
	<b>Defect A2</b>	CD 0	DD 2  <i>Equilibrium Outcome</i>
	2 CC	0 CD	
	0 DC	1 DD	

A's preference ordering is  $CC > DD > CD$  or  $DC$   
 B's preference ordering is  $DD > CC > CD$  or  $DC$

Adapted from Stein, *supra* note 235, at 126.