

Title: Chapter 3: The Historical Evolution of Base Erosion and Profit Shifting

Citation: Durst, M. (2018) Chapter 3: The Historical Evolution of Base Erosion and Profit Shifting, Tax Notes International, Volume 90, 4

Official URL: <https://www.taxnotes.com/document-list/contributors-authors/durst-michael-c>

More details/abstract: This is Chapter 3 of the book “Taxing Multinational Business in Lower-Income Countries: A Problem of Economics, Politics and Ethical Norms”. This chapter examines the evolution, over almost a century, of the body of international tax laws that continues to insulate BEPS-style planning arrangements from successful legal challenge in countries around the world.

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Reprinted from *Tax Notes International*, April 16, 2018, p. 449

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forthcoming book *Taxing Multinational Business in Lower-Income Countries: A Problem of Economics, Politics and Ethical Norms*, which *Tax Notes International* is serializing in six installments. The book explores a topic that has been highly controversial in recent years: the use by multinational companies of “base erosion and profit-shifting” tax planning structures to reduce their tax liabilities in countries where they conduct business, including the world’s lower-income developing countries. In this installment, which is Chapter 3, the author explores how the international corporate tax laws evolved over many decades to facilitate base erosion and profit shifting. The most recent installment appeared in *Tax Notes Int’l*, Mar. 19, 2018, p. 1189.

The author would like to thank those colleagues who have generously read and commented on drafts; the author is, of course, solely responsible for any shortcomings that remain. The author also is grateful to the Bill and Melinda Gates Foundation, which funded this book through a grant to the International Centre for Tax and Development. The opinions stated in this book are those of the author, and should not be attributed to any other person or institution.

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Introduction

This chapter examines the evolution, over almost a century, of the body of international tax laws that continues to insulate BEPS-style planning arrangements from successful legal challenge in countries around the world. The chapter focuses on two aspects of current laws: (i) their acceptance of contractual arrangements, among members of commonly controlled multinational groups, that treat low- or zero-tax subsidiaries as conducting income-producing activities that they do not in physical reality perform; and (ii) the failure of current laws — specifically, “transfer pricing” laws, “controlled foreign corporation (CFC)” rules, and laws that seek to limit the payment of interest on loans from related parties — to place effective limits on the amount of profits that multinational companies are permitted to shift to zero- or low-tax affiliates under their contractual arrangements.

The Inherent Formalism of Corporate Tax Law

A starting point in the analysis is to recognize that corporate law, and the corporate income tax laws that represent a component of the broader law of corporations, are both pre-disposed to legal “formalism”: respect for the written terms of contractual arrangements even when they appear to depart from the apparent economic substance of the transactions that the contracts govern. A corporation is itself a legal fiction. The corporation’s existence as a legal entity is based upon the corporate charter, a document which grants shareholders assurance (subject to limited exceptions, as will be discussed presently) that they will not face personal liability for debts arising from business that is conducted in the corporation’s name.

The protection against liability that the corporate charter affords to shareholders often, in

practice, places a premium on the question whether a particular business activity is conducted by the corporation, in its capacity as a legal entity, or instead by the shareholders in their individual capacities. To prevent endless legal controversy over this question, the law long ago developed a strong presumption that if the contracts governing a business activity consistently treat the corporation rather than the shareholders as conducting the activity, that characterization normally will be respected. In light of this presumption, much of corporate legal practice consists of ensuring that the activities of a corporation are clearly documented by contracts in the name of the corporation rather than the shareholders, and that all the i's are dotted and t's crossed in those contracts.

The corporate law places some limits on the extent to which shareholders can shield themselves from liability through contracts specifying that a business is being conducted by the corporation as an entity, rather than its shareholders. Under the doctrine of "piercing the corporate veil," some kinds of behavior by shareholders, like certain kinds of negligence, or the misleading of lenders or customers, can cause shareholders to become directly liable for obligations of a corporation.¹ The law, however, typically permits piercing the corporate veil only in atypical circumstances. Generally, there is a strong presumption that if the applicable contracts identify a corporation rather than its shareholders as performing a business activity, the corporation should be treated as performing the activity for all purposes of the law.

There are countless circumstances in which the law respects a corporation as the performer of business activities, notwithstanding that corporate employees perform little if any physical activity. In particular, it generally is irrelevant whether a corporation performs business activities through its own employees or instead

"outsources" the activity to other persons. For example, an investor might have the idea of manufacturing and distributing a particular kind of kitchen implement. The investor might form a corporation (let's call it "Ladelco") to accomplish these purposes. Ladelco might then contract with a separate company ("Manuco") to (i) purchase the raw materials needed to manufacture the implements, (ii) perform the manufacturing, (iii) advertise the implement through on-line sellers, and (iv) accept orders from and ship products to customers. The contract may provide for Ladelco to compensate Manuco for these services by reimbursing that company for its costs plus a markup of, say, five percent. Any remaining profit is to be remitted to Ladelco, the initiator of the arrangement. (These kinds of "cost-plus" arrangements are quite common in practice.)

The law generally will, for all purposes, respect the various elements of this contractual arrangement, particularly (i) the rights of Manuco to receive its cost-plus compensation, but no more, in return for its services; and (ii) the right of Ladelco to receive all residual profits from the sale of the kitchen utensils. The law has no choice but generally to respect contractual formalities in situations like this and many others, since otherwise the law would have no practical means of sorting out the rights and liabilities of the various parties involved. Commerce would become chaotic. A high degree of formalism in corporate law, therefore, seems as a general matter to be unavoidable.

The corporate law's high level of respect for the terms of contracts extends not only to contracts among unrelated companies like Ladelco and Manuco, but also to arrangements among corporations within the same, commonly owned group. In many instances, a group will desire to conduct several different business operations simultaneously — for example, to operate several different hotels in different locations. The group will place each operation in a separate subsidiary to shield the assets of each from claims arising from other operations. The use of multiple entities within a single group is especially frequent among businesses operating internationally; for many reasons, including the need to comply with different countries' legal and tax requirements, operations in different countries are frequently placed in separate

¹For a discussion of situations in which courts might choose to "pierce the corporate veil" and hold shareholders liable for corporate obligations, see, e.g., Jonathan Macey and Joshua Mitts, "Finding Order in the Morass: The Three Real Justifications for Piercing the Corporate Veil," 100 *Cornell Law Review* 100 (2014). Courts generally are willing to pierce the corporate veil only where special circumstances, like active misrepresentation by shareholders, or failure to maintain the procedural requirements of corporate existence under applicable law, are present.

subsidiaries established under local law. It is in this manner that commonly owned multinational business groups typically are formed.

The parent and the various subsidiaries of multinational groups typically enter into numerous contracts among themselves, under which the different affiliates supply goods, provide services, and lend money to one another. Unless special factors are present to justify piercing the corporate veil, like the misleading of customers or outside lenders,² courts will generally respect the division of responsibilities, and the rights to receive income, that are stated in the contracts into which the different group members have entered.

The corporate law's respect for the terms of contracts made among both unrelated and related companies also extends, I believe inevitably, to countries' corporate income tax laws. That is, for purposes of corporate income taxation, courts generally will respect the division of income among corporations that results from application of the corporations' contractual arrangements with one another. This is not surprising: other than the contracts into which corporations have entered, tax authorities and courts would have no means of determining how much income each corporation should be treated as earning. (As will be discussed at some length below, the situation might be different if the countries of the world were to adopt an alternative means of dividing corporate income for tax purposes among commonly owned companies, perhaps through use of an apportionment formula. This approach, however, while often suggested by commentators, has consistently been rejected by national governments over the course of nearly a century.)

Respect for the terms of contractual arrangements among commonly owned companies is not absolute under countries' corporate tax laws. Tax laws generally contain a

doctrine of "substance over form."³ (In some countries, the substance-over-form doctrine is explicitly included in tax statutes, under the label "general anti-avoidance rule (GAAR).") The doctrine of substance-over-form in the tax law can be seen as somewhat analogous to that of piercing the veil in corporation law, in that both doctrines allow a "safety valve" to permit the overriding of formalistic results in especially compelling circumstances.⁴ Under the substance-over-form doctrine, courts may re-characterize the arrangements described in contracts between companies, if the economic reality of the arrangements plainly departs from their contractual form. Courts typically are willing, however, to apply the substance-over-form doctrine only in especially compelling circumstances, where a taxpayers' contractual arrangements are very plainly contrived for tax-avoidance purposes. To apply the substance-over-form doctrine more readily would risk injecting an untenable degree of unpredictability to the operations of the corporate tax laws.

Thus, courts generally have not applied the doctrine to override the arguable legal fictions on which tax avoidance from BEPS-style planning arrangements depends. Despite the presence of the substance-over-form doctrine, courts often accept the desired tax consequences of the contractual arrangements made among companies, even where strong arguments can be made that the substance of the arrangements differs from its form. The tradition of formalism has long been, and remains, strong within the corporate income tax laws. It was against this background that the practice of BEPS-style tax planning was invented and, over the decades, became increasingly prevalent among the world's multinational companies.

³For a useful overview of the principle of substance-over-form, see, e.g., Brian J. Arnold, "The Role of a General Anti-Avoidance Rule in Protecting the Tax Base of Developing Countries," in Alexander Trepelkov, Harry Tonino and Dominika Halka, eds., *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (2d ed. 2017) at 715-766. For an historical discussion, see David A. Weisbach, "Formalism in the Tax Law," 66 *University of Chicago Law Review* 860 (1999).

⁴The connection between the "corporate veil" doctrine and the problem of BEPS-style tax planning has, however, been noted by others. See the forthcoming essay by Scott Wilkie, "New Rules of Engagement? Corporate Personality and the Allocation of 'International Income' and Taxing Rights," which includes an exploration of the topic and a review of prior literature.

²See generally John H. Matheson, "The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context," 87 *North Carolina Law Review* 1091 (2009).

How the International Corporate Tax Laws Developed

Those areas of tax law that are most central to the history of base erosion and profit shifting around the world — transfer pricing laws, controlled foreign corporation (CFC) rules, and rules governing the extent to which companies can deduct interest paid to other members of their multinational groups — have developed in a long historical arc, beginning early in the Twentieth Century and continuing through the present. The following summarizes important aspects of this history, beginning with the early statement of the principles of international corporate tax law under League of Nations auspices beginning in the 1920s, through the attempt by the United States to adjust its international tax laws to post-World War II economic realities in the U.S. Revenue Act of 1962, and culminating in the “transfer pricing wars” of the early 1990s, which gave rise to the OECD Transfer Pricing Guidelines in roughly the form they have today. Chapter 4 will then describe how the world’s governments are trying to resolve, through the OECD’s BEPS process, problems that have accumulated during this long history.

The Period Between the Two World Wars: Pre-Occupation with ‘Double Taxation’

After the First World War, three factors combined to direct attention among the countries of the world to the task of designing a workable system of international tax laws.⁵ These included (i) the increasing international trade and investment made possible by the ending of the War; (ii) widespread increases in tax rates around the world; and (iii) the emergence of international organizations, notably the League of Nations and,

⁵For important historical discussions of the development of international tax law between the Wars, see Richard S. Collier & Joseph L. Andrus, *Transfer Pricing and the Arm’s Length Principle after BEPS* (Oxford: Oxford University Press, 2017) at 6-49; Mitchell B. Carroll, “Allocation of Business Income: The Draft Convention of the League of Nations,” 34 *Columbia Law Review* 473 (1934); Sol Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Cambridge: Cambridge University Press 1992, as revised by author 2013); Thomas Rixen, “From Double Tax Avoidance to Tax Competition,” 2010 *Review of International Political Economy* 1; and two articles by Brett Wells & Cym Lowell, “Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin,” 65 *Tax Law Review* 535 (2012) and “Income Tax Policy in the 21st Century: Residence vs. Source,” 5 *Columbia Journal of Tax Law* 1 (2013). The historical summary in this book is based largely on these resources.

within the private sector, the International Chamber of Commerce (ICC), an organization of business leaders organized in Paris, in 1919.⁶

The ICC initiated the post-War discussion of international tax laws. In particular, the ICC sought the assistance of the League of Nations in designing a system of laws that would permit companies to avoid “double taxation” under corporate income tax laws when engaging in business spanning national boundaries. The basic concept of double taxation is easy to understand:

Consider a company based in Italy that manufactures automobiles (a “hot” consumer product in the years after World War I) for the U.K. market. The company manufactures the cars in Italy, then sells and ships them to a wholly owned distribution subsidiary established in the United Kingdom, which then sells them to independent car dealerships around the country. Assume that the Italian-based group as a whole, during a particular year, earns total net income of \$100 million from the manufacture of the cars in Italy and their marketing and sale in the United Kingdom. Of this income, how much is properly taxable by Italy and how much by the United Kingdom? In the absence of rules establishing some means of apportionment, the Italian tax authority is likely to argue that the lion’s share of the income is attributable to the excellent design and skillful manufacturing of the cars, which both occurred in Italy. The U.K. tax authority is likely to argue that the lion’s share of the income is attributable to the skillful advertisement, marketing and customer service activities that took place in the United Kingdom. Both Italy and the United Kingdom, therefore, might assert the right to tax a majority of the income from the manufacture and sale of cars, leaving the Italy-based company with an inflated total tax bill.

⁶Collier & Andrus, note 5 above, at 8.

The ICC argued after the First World War that if the threat of double taxation was not to pose a serious impediment to international commerce, some reliable means needed to be found for apportioning income, for tax purposes, among the different countries in which an international business operates. This problem later came to be referred to as the “transfer pricing” problem; and as explained at various points throughout this book, it remains central to the topic of base erosion and profit shifting today. In response, the League of Nations initiated a process of studying the problem of income apportionment and numerous other important problems of international taxation, which extended until the outbreak of the Second World War.⁷

From the start of their review of the transfer pricing problem, those conducting the League’s study had before them two competing policy models, which continue to figure prominently in international tax policy debates: a model of “formulary apportionment” (generally referred to at the time of the League of Nations studies as “fractional” apportionment); and (ii) “separate accounting.” Under formulary apportionment, governments of different countries treat all the members of a multinational group as a single taxable entity, and apportion the group’s combined income among countries according to a formula. Consider, for example, a manufacturing group that sells products through affiliates in three different countries.

⁷ In addition to addressing the problem of methods for apportioning income, the League of Nations’ efforts considered the important problems of (i) how an internationally coordinated system of tax rules might be implemented through a system of income tax treaties among countries (a topic to be addressed in Chapter 4 of this book); and (ii) how the right to tax income of an international business group should be divided between the group’s country of “residence” (i.e., its home country) and the various other countries in which members of the group earn income from conducting business operations (“source” countries).

This book does not seek to address an important problem that figured prominently in the League of Nations discussions and continues to pose serious technical difficulties in tax policymaking and tax administration today: the fact that multinational groups operate in countries around the world through two different kinds of legal entities, separately incorporated subsidiaries and unincorporated branches of parent companies. (For a recent discussion of this problem, see OECD, “Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments” (June 2017).) Questions related to the differing tax treatment of subsidiaries and branches are of substantial practical importance in international tax practice and lawmaking, although trying to discuss this highly technical topic in this book would risk unhelpfully distracting non-specialist readers from the book’s central policy themes.

As a simple kind of formulary apportionment, the governments of the three countries might agree to treat the group as a single taxable entity, and to divide the group’s total income among the countries according to the relative levels of sales to customers by the different affiliates. Thus, for example, if the affiliate in Country A accounts for half the group’s total sales, then half the group’s combined income would be taxable in Country A; if fifteen percent of the sales were made in Country B, fifteen percent of the group’s combined income would be taxable there; and so on.

A feature of formulary apportionment, which has lent controversy to the topic over the decades, is that under a formulary system, large amounts of income could not be attributed to companies within multinational groups that perform few if any observable business activities, as is typically true of the low- and zero-tax subsidiaries that are used in BEPS-style tax planning.

In reviewing the possibility of international formulary apportionment, the League examined three then-existing instances in which jurisdictions were using formulary apportionment for tax purposes: the states of the United States, the cantons of Switzerland, and Austria, Hungary, and Czechoslovakia under a treaty implemented after the First World War.⁸ These three systems employed various kinds of apportionment formulas, in which not only sales but other indicators of corporate activity, like the value of business assets owned or local payroll expenses of different members of the group, were taken into account.

Not only was there precedent for the use of formulary apportionment for the division of taxable income among affiliates, but the ICC itself had suggested a formulary approach in its early communications with the League of Nations.⁹ The League’s experts, however, concluded that a system of international formulary apportionment did not offer practical promise for the prevention of double taxation. The primary objection to formulary apportionment appears to have been (as often is argued today) that different countries

⁸ See Carroll, note 5 above, at 481, 488-489, 491-494.

⁹ See Wells & Lowell (2013), note 5 above, at 14-18.

would adopt and apply differing apportionment formulas, inevitably giving rise to overlapping claims of tax jurisdiction and therefore to double taxation.¹⁰

For these reasons, the League established “separate accounting” as its basic principle for the international division of income for tax purposes.¹¹ Under this principle, there is no attempt to consolidate the accounts of different affiliates within a multinational group. Instead, the separate books and records of each affiliate, which are, of course, a reflection of the results of the contracts under which the affiliate conducts business, are accepted as valid for tax purposes, unless the taxpayer appears to have been departing from normal business principles in dealings with its affiliates, with the result of artificially reducing its taxable income. In other words, the contracts and other business arrangements of each member of a commonly owned group are to be respected for tax purposes, unless the tax authority can show that the member has departed from what has, over the years, become known as the “arm’s-length principle” in its dealings with other members.¹²

The League of Nations discussions addressed the important question of how tax authorities might enforce the separate-accounting approach, with its underlying arm’s-length principle. The League envisioned generally that in those cases where comparable prices can be found for a group’s internal dealings, as where, say, a manufacturing affiliate sells identical products to both related and unrelated parties, the comparable price should be used to determine whether intragroup dealings have been at arm’s-length. The League provided only limited guidance for tax authorities to use in the many situations in which “comparable” prices are not

readily available. The League did, however, indicate that two methods, which already were used by some tax authorities, could be useful.¹³

First, tax authorities could employ a “fractional” approach, under which the income of different affiliates is split between them according to an ad hoc formula (for example, based on relative sales levels and manufacturing costs) devised for the taxpayer. This approach (which as will be seen below survives today in the form of the “profit split” transfer pricing method) was, according to the League’s analysis, sharply distinguishable from a “formulary” approach, under which a single formula would be applied to all taxpayers on a “one size fits all” basis. A second approach accepted by the League, in the absence of useful comparables, was an “empirical” approach, under which tax authorities sought to identify a reasonable profit margin on sales for companies operating within their countries. The “empirical” approach survives today in the form of the “transactional net margin method (TNMM)” of the OECD Transfer Pricing Guidelines, which as will be seen below plays an especially important role in the taxation of businesses operating in lower-income countries.

The arm’s-length principle can be seen as a kind of substance-over-form rule, under which a commonly owned group’s contractual arrangements will be respected for tax purposes unless the arrangements are inconsistent with those that might be found among unrelated entities, dealing with each other in an arm’s-length manner. It was inevitable from the outset that courts would exercise restraint in applying the new arm’s-length standard to re-characterize taxpayers’ contractual arrangements, for the same reason that courts are reluctant to apply the substance-over-form doctrine as a general matter. Excessive eagerness by courts in over-riding companies’ contractual arrangements would inject uncertainty into the international tax laws, and this uncertainty could be a significant obstacle to commerce. Therefore, the League’s approach created an obvious danger that commonly owned groups of companies might be

¹⁰ See Carroll, note 5 above, at 473-476.

¹¹ One particular expert commissioned by the League of Nations, Mitchell B. Carroll of the United States (the author of the article by Carroll cited at various points in this chapter) played an especially influential role in the later stages of the League’s deliberations, in the late 1920s and 1930s. In the 1980s, a prominent commentary strongly criticized Carroll’s analytical work, claiming that it overstated the difficulties of formulary apportionment. Stanley I. Langbein, “The Unitary Method and the Myth of Arm’s Length,” *Tax Notes*, Feb. 17, 1986, at 625, 632-633.

¹² Collier & Andrus, note 5 above at 33, note use of the words “arm’s length” by Mitchell Carroll in the early 1930s.

¹³ See Carroll, note 5 above, at 484-485.

able, without serious risk of successful legal challenge, to engineer their contractual arrangements to steer income artificially to companies that the groups could establish in low-tax countries.¹⁴

Although participants in the League debates recognized the possibility that the arm's-length approach might be used to facilitate international tax avoidance, those steering the League of Nations' efforts were much more concerned with what they saw as their immediate goal of avoiding double taxation, than they were of tax-avoidance practices that might arise in the future.¹⁵ As the main danger perceived was that of over-reaching by tax examiners in different countries, it was quite logical for the League to lean, consciously or not, toward a regulatory regime that tax authorities would find relatively difficult to enforce. Excessive interference by tax authorities with the intended results of taxpayers' transactions would risk subjecting the taxpayers to inconsistent treatment by different countries, resulting in double taxation.

Another important aspect of the League of Nations study, with implications for lower-income countries today, is the role played by a particular model of international business operations, the "mercantilist paradigm" in shaping the League's perceptions concerning what constitutes arm's-length arrangements among affiliates.¹⁶ In the interwar years, a large amount of international commerce consisted of trade in commodities, like mineral and agricultural products, between parent companies headquartered in countries holding overseas colonies, and corporate subsidiaries that had been established in the colonized countries. The League's analyses reflected the idea that in dividing income between the parent and the colonial subsidiary, the natural approach was to apportion to the subsidiary a relatively limited amount of income in return for its activities in growing or extracting physical product, with the

rest of the parent's and subsidiary's combined income treated as attributable to the parent's role in providing investment capital and overall supervision, and therefore taxable to the parent company. The mercantilist model obviously reflected paternalistic assumptions regarding the economic role of colonial dependencies; it also may have reflected a desire by colonial powers to encourage foreign direct investment in their colonies by limiting the taxable income attributable to colonial enterprises.¹⁷

Whatever the League's motivation for propagating the mercantilist model, it has had a lasting effect on the vocabulary and imagery of international tax law. International tax rules continue to rely heavily on a conceptual paradigm under which developing countries typically are envisioned as "source" countries where supposedly uncomplicated ("routine" in the parlance often used by tax practitioners) activities like farming, mining, the performance of services in places like call centers, and basic manufacturing operations take place; and wealthier countries are seen as "residence" countries that provide the capital, as well as the valuable intellectual property, that are used in the operations conducted in the source countries.¹⁸ As will be seen later in this chapter, the persistence of this imagery has helped lend legitimacy to tax planning structures under which subsidiaries of multinational groups operating in lower-income countries tend to be apportioned very low levels of income in return for the "routine" activities they are treated as performing. Moreover, the desire to encourage inbound investment has led many developing countries to tolerate the perpetuation of the model, even though it tends to apportion to those countries relatively limited amounts of taxable income.

¹⁴ See Wells & Lowell (2012), note 5 above, at 561 ff.; Rixen, note 5 above, *passim*.

¹⁵ Wells & Lowell (2012), note 5 above, at 563; Rixen, note 5 above, at 15.

¹⁶ See Wells & Lowell (2013), note 5 above, at 10-13, on which the discussion below is largely based. See also Carroll, note 5 above, at 474-476.

¹⁷ See Peter Duignan & L.H. Gann, eds., *Colonialism in Africa 1870-1960*, vol. 4 (Stanford: Hoover Institution 1975) at 8:

From the very beginning, colonial governments sought to make colonies pay. They encouraged investors, bankers, traders, plantation owners and business groups. Tax systems were drawn up to attract investment.

¹⁸ Thought-provoking analyses of the development of the concepts of "source" and "residence" are provided by Michael J. Graetz & Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 51 *Duke Law Journal* 1021 (1997); and Wells & Lowell (2013), note 5 above.

Emergence of BEPS-Style Tax Planning in the Aftermath of World War II

At the end of the Second World War, foreign direct investment resumed with unprecedented intensity, especially from the United States, the industrial infrastructure of which was undamaged. In the early post-War years, former combatant countries needed foreign capital to rebuild their physical infrastructures. The colonial system also began to dissolve, leading to a desire for cross-border economic development in the former dependencies. Wartime innovations in communications and transportation technologies eased the task of managing multinational businesses on a centralized basis, and increased the speed and reliability which products and services could be delivered internationally. Further, wartime technological developments, for example in antibiotics and other pharmaceuticals, gave rise to global demand for high-value, easily transportable products.

Companies needed to devise corporate legal structures through which to conduct their rapidly expanding international operations. Consider, for example, a U.S.-based pharmaceutical company that wished to expand sales of products to numerous countries on five continents. An initial question facing the group would have been whether to operate, in countries around the world, through separately incorporated local subsidiaries or through unincorporated branches of the U.S. parent company. Even leaving aside tax considerations, several factors would have encouraged the establishment of separately incorporated subsidiaries. Reasons for this would have included a desire to limit cross-liability for claims against the different national operations of the group; in addition, separately incorporated subsidiaries might have been needed to comply with countries' requirements that, say, local citizens serve on companies' boards of directors.

Moreover, a number of business and tax considerations encouraged multinationals to adopt a particular corporate structure that soon became central to BEPS-style tax planning: the use of holding companies in low- or zero-tax countries to own the stock of companies established in the various countries in which the group conducted business. For example, if a U.S.-

based multinational group established subsidiaries in, say, France, the United Kingdom and Spain, it would naturally have arranged for the U.S. parent company not to own the stock of the French, British, and Spanish entities directly, but instead through a holding company established in a low- or zero-tax country like, say, Panama.¹⁹ The group could then accumulate earnings from all three foreign operating entities in the holding company without incurring significant local Panamanian tax, and reinvest the earnings abroad wherever the group desired. There was no need to distribute the foreign earnings all the way up to the group's parent company where they would have become subject to U.S. tax.²⁰ The use of the holding company structure also could simplify the task of accumulating and reinvesting profits under the restrictive national currency-exchange regulations that were common around the world during the post-War era.²¹ Thus, the basic three-tier corporate structure, with a zero- or low-tax holding company in the middle, quickly became standard for multinational companies expanding their international operations after World War II.

Once the model of a zero- or low-tax holding company structure was in place, the technique of shifting income from the operating subsidiaries to the holding company through, for example, intangibles-licensing and lending arrangements, would have been apparent to tax planners. In theory, the amounts shifted from the operating subsidiaries to the low- or zero-tax holding company should have been limited by the arm's-

¹⁹ See generally E.R. Barlow & Ira T. Wender, *Foreign Investment and Taxation* (Cambridge, MA: Harvard Law School International Program in Taxation, 1955) at 168-170. Barlow & Wender mention Panama, Canada, Puerto Rico, Uruguay, and Liechtenstein as countries that hosted international holding companies.

²⁰ In the post-World War II era, the tax laws of countries around the world generally subjected the parent companies of multinational groups to taxation on income from their foreign subsidiaries only when that income was "repatriated" to the parent in the form of dividends. Therefore, the use of separate entities delayed the premature home-country taxation of foreign earnings. In recent decades, most countries in which multinationals tend to be based (including, as of 2018, the United States) have adopted "territorial" systems under which dividends from foreign subsidiaries are exempt from home-country taxation, even when repatriated. Thus, the dynamics of international tax planning have to some extent changed. Multinationals still, though, generally have a number of reasons, apart from any tax-avoidance planning in which they might be involved, to operate in countries through separate legal entities.

²¹ Barlow & Wender, note 19 above, at 168.

length standard. That is, the holding companies should have been permitted to charge only arm's-length royalty amounts under their licensing arrangements with the operating companies, and the holding companies should have extended to the operating companies only economically reasonable amounts of interest-bearing debt. In practice, however, the arm's-length principle appears to have exerted little restraint on the growth of BEPS-style tax planning around the world, and BEPS-style planning grew over the years to become standard practice among multinational groups.

Post-War Legislative Developments in the United States

The United States, which served as the source for much of the world's cross-border investment in the years following World War II, appears to have been the first country to perceive profit shifting by its home-based multinationals as posing a significant public policy issue. At first, in the immediate post-War years, U.S. officials generally took a benign view of the avoidance of tax by U.S. firms from their foreign operations.²² U.S. policy-makers apparently saw foreign direct investment by U.S. firms as a useful adjunct to the Marshall Plan in stimulating economic recovery among war-damaged countries, as well as an aid in competing with the Soviet Union for influence in post-colonial areas.

By the early 1960s, however, important political actors in the United States began to perceive that outbound investment by U.S.-based multinationals had blossomed into too much of a good thing. The ex-combatant countries had largely completed their post-War reconstruction, and some were becoming potent economic competitors of the United States. Also, in an era when national currencies were still backed by a country's gold reserves, outbound investment was contributing to chronically large balance-of-payments deficits, placing pressure on the valuation of the dollar.

In 1961, President John F. Kennedy released a message to Congress urging action to end the deferral of U.S. taxation on income earned by

foreign companies within U.S.-owned multinational groups.²³ This would have made it pointless for U.S.-based multinationals to accumulate foreign income in holding companies, and also generally would have removed the benefit to U.S.-based groups from any explicit exemptions, like tax holidays, offered by a country to investors, since income untaxed by the host country would have become immediately taxable in the United States. The Kennedy proposal contained a carve-out for *explicit* exemptions provided by specified "underdeveloped" countries, on the condition that the exempted income was reinvested in the underdeveloped country. Income exempted from taxation only implicitly, however, through what the Kennedy proposal referred to as "tax haven" planning devices, would be subject to immediate U.S. taxation under all circumstances.²⁴ If enacted, therefore, the Kennedy proposal to eliminate deferral would have ended BEPS-style tax planning by U.S. multinational groups.

Business interests, however, expressed the view that the elimination of deferral would place U.S.-based multinationals at a competitive disadvantage with respect to their non-U.S. competitors, who would remain permitted to avail themselves of tax exemptions offered by countries around the world. Ultimately, the Congress passed and the President signed, in what became the Revenue Act of 1962, legislation that stopped short of the full elimination of deferral, but that attempted to curtail the use of tax planning by U.S.-based multinationals centered on holding companies established in zero- or low-tax countries.

²³ President John F. Kennedy, Special Message to the Congress on Taxation, April 20, 1961.

²⁴ The language used by President Kennedy in describing these avoidance devices makes clear that by 1961, BEPS-style tax avoidance planning had taken on essentially the same form as it displays today. Kennedy said:

The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently more and more enterprises organized abroad by American firms have arranged their corporate structures — aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven — so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.

²² For contemporaneous discussion of this topic, see *id.*, at 77-94.

Congress made two important decisions in the 1962 Act, which ended up having long-term effects on the shape of international tax rules around the world. First, Congress adopted the world's first body of "controlled foreign corporation (CFC)" rules, by which the United States and many other countries have sought, generally without success, to limit their multinational groups' involvement in BEPS-style tax planning. Second, Congress considered, but rejected, a proposal to adopt a system of formulary apportionment for the international division of income earned by related-party groups, instead reaffirming a commitment to the arm's-length approach to transfer pricing which had been developed under the auspices of the League of Nations. The following discussion offers an introduction to both CFC rules and post-War arm's-length transfer pricing rules, as they have developed globally in the more than fifty years that have elapsed since the 1962 U.S. legislation.

Controlled Foreign Corporation (CFC) Rules

The Revenue Act of 1962 generally defined as a "controlled foreign corporation (CFC)" any foreign corporation that was more than 50-percent owned by U.S. corporate or individual shareholders.²⁵ Therefore, the foreign subsidiaries of U.S.-owned multinational groups generally fell within the definition of CFCs. If a CFC was located in a country with a low or zero tax rate, any income received by the CFC, falling within specified categories, would be subject to immediate U.S. taxation as if the income had been repatriated to the United States. The categories of "tainted" income included interest, royalties, and profits from purchases or sales of goods and services to or from related parties — precisely the kinds of income transferred to zero- or low-tax subsidiaries under BEPS-style tax avoidance planning. The 1962 U.S. CFC rules, therefore, if

they had worked as intended, would have removed from U.S.-based multinationals the financial incentive to pull income from foreign subsidiaries into offshore collection points, and presumably would have dramatically reduced U.S. companies' involvement in BEPS-style tax avoidance structures.

From the time of their enactment in 1962, however, the effectiveness of the U.S. CFC rules in discouraging BEPS-style tax planning has been limited. In part, problems have arisen from weaknesses in the verbal structure of the statute. For example, the 1962 legislation defined a CFC as a company that is more than 50 percent owned, by vote or value, by a U.S. parent company or certain other U.S. shareholders. But the "more than 50 percent by vote or value" test proved susceptible of manipulation. For example, there are an infinite number of ways in which voting rights can be spread among different classes of a corporation's stock (with, for example, some shares given voting rights for some purposes rather than others); and it can be very difficult to assign values to particular classes of stock with unique voting or other rights. It soon proved possible to avoid classification as a CFC of some companies that appeared as a practical matter to be controlled by U.S. shareholders.

Similarly, the language defining the kinds of payments that are subject to home-country taxation under CFC rules raises difficulties. For example, "interest" received by a CFC in a low- or zero-tax country generally is subject to home-country taxation under the U.S. CFC rules, but if the CFC also performs some banking services for unrelated customers — something that can easily be arranged among friendly multinationals — its interest income may, under complex rules, qualify as "active financing" income and therefore as exempt from home-country taxation.

As another example, although the U.S. CFC rules generally tax income of a zero- or low-tax CFC from purchasing and reselling property in related-party transactions, the rules do not apply this treatment if the low- or zero-tax company substantially transforms the property through manufacturing processes (that is, the CFC rules provide a "manufacturing exception"). Early in the history of the U.S. CFC rules, U.S. multinationals adopted "contract manufacturing"

²⁵The following discussion in the text seeks to provide only nontechnical and simplified descriptions of the CFC rules of the United States and other countries. More detailed background on CFC rules around the world can be found in the OECD's BEPS report, "Designing Effective Controlled Foreign Corporation Rules" (2015); Office of Tax Policy, United States Treasury, "The Deferral of Income Earned through U.S. Corporations" (2000); and Reuven S. Avi-Yonah & Oz Halabi, "US Subpart F Legislative Proposals: A Comparative Perspective," University of Michigan Law & Economics Working Papers (2012).

arrangements under which CFCs claimed the right to the manufacturing exception by virtue not of their own manufacturing activities, but of manufacturing performed by others under contract. Over time, contract manufacturing arrangements, which U.S. tax authorities generally proved unable legally to curtail, have been used to escape much taxation under the CFC rules.²⁶

Finally, in 1997, an unexpected regulatory incident in the United States delivered the coup de grace to the U.S. CFC rules as meaningful constraints on BEPS-style planning by U.S. multinationals.²⁷ The IRS issued a regulation that apparently was intended to simplify, under U.S. tax rules, the process of qualifying business entities as partnerships or other forms of pass-through entities (like limited liability companies) for tax purposes, thereby providing the entities with tax advantages in certain circumstances. There is no indication that this simplification was intended fundamentally to alter the operation of the CFC rules. The new regulation, however, contained language to the effect that in some circumstances, entities qualifying for pass-through classification would be treated “for all purposes of U.S. taxation” as transparent entities — that is, treated as if they did not exist.

Immediately, U.S. multinationals recognized that they could structure their operating entities in various countries around the world as subsidiaries of low- and zero-tax companies within the group, and then cause the operating subsidiaries to “check the box” so that they would be treated not as separate companies for U.S. tax purposes, but instead as unincorporated branches of the low- or zero-tax companies. This means, as a formal legal matter, that payments of interest, royalties, and other kinds of passive income made by the operating companies to their low- or zero-tax parents weren’t “payments” at all — they were, as a formal matter, non-events — so that the low- or zero-tax company should not be treated as receiving CFC income.

The U.S. IRS and Treasury quickly announced their intention to modify the recently issued regulations to clarify that they could not be applied to defeat operation of the CFC rules. But once the horse of the check-the-box regulations had left the barn, it was politically impossible for the Treasury to retrieve it. Businesses argued that to restore the U.S. CFC rules to health would place U.S.-owned multinationals at a competitive disadvantage with respect to their foreign counterparts. Supporting the business position, Congress made clear that it would legislatively block action to limit the operation of the check-the-box rules in a way that would resuscitate the CFC rules; and indeed in 2006 Congress enacted legislation that effectively confirmed this position. The result is that since 1997, the U.S. CFC rules have been of little effect in limiting the participation of U.S.-based multinationals in BEPS-style tax planning.

Since 1972, dozens of countries have adopted CFC rules that are at least broadly similar to those of the United States.²⁸ Inevitably, however, these CFC rules have been vulnerable to the same kinds of definitional ambiguities that impaired the operation of the U.S. CFC rules, even before the final blow of the check-the-box regulations. It is not clear how successful different countries’ CFC rules have been in curtailing BEPS-style tax planning among multinationals based outside the United States; my experience as a practitioner suggests that the degree of effectiveness has varied substantially among countries. The large volumes of avoidance visible around the world today, however, suggest that overall, CFC rules have operated at a low level of efficacy.

The basic problem with CFC rules, which very likely has prevented them historically from interfering decisively with the growth of BEPS, relates to competition among capital-exporting countries: the countries where multinational groups tend to be based. A country’s CFC rules prevent that country’s own, home-based multinationals from benefiting from BEPS-style tax planning in countries where they conduct business. The multinationals of other countries,

²⁶For an historical discussion, see Stephen R.A. Bates & Derrick A. Kirkwood, “Contract Manufacturing: Is the War Over?” *Tax Notes Int’l*, Apr. 7, 2008, p. 61.

²⁷The history of the check-the-box rules is described in, e.g., David R. Sicular, “The New Look-Through Rule: W(h)ither Subpart F?” *Tax Notes*, Apr. 23, 2007, p. 349.

²⁸The OECD’s 2015 final report on BEPS Action 3, “Designing Effective Controlled Foreign Company Rules,” at page 9, notes that 30 of the countries participating in the BEPS deliberations had CFC rules.

however, that have not enacted CFC rules remain free to engage in the tax planning. Countries therefore tend to be reluctant to enact effective CFC rules, which can be seen as placing their home-based multinational companies at a competitive disadvantage.²⁹

Chapter 4 will give further attention to the topic of CFC rules, in the course of a discussion of the OECD's BEPS recommendations. As will be seen, in its 2015 BEPS reports, the OECD, while noting the possible value of CFC rules in curtailing BEPS-style tax planning, does not offer concrete recommendations for their strengthening. Conceivably, the adoption of effective CFC rules would be made more feasible if all, or at least most, capital-exporting countries were willing to adopt the rules in concert. The BEPS process, though, did not offer concrete suggestions for international coordination of CFC rules, and as an overall matter did not display optimism that the institution of CFC rules would be reinvigorated around the world soon.

As I will discuss further in Chapter 4, however, in its December 2017 tax reform legislation, the United States enacted a new tax on the "global intangible low-tax income (GILTI)" of U.S.-owned corporate groups.³⁰ The GILTI rules are complex; their overall intention is to impose a U.S. tax on much of a U.S. group's foreign income, at a rate of about 10.5 percent, to the extent the group's foreign income was not subject to foreign taxes of at least that rate. The GILTI tax therefore imposes a "minimum tax" on a U.S. group's low-tax foreign income. The GILTI tax serves much the same purpose as a CFC rule. Chapter 4 will consider whether, despite the reserved tone taken toward CFC rules in the BEPS report, U.S. adoption of the GILTI tax might signal a revival of the concept of CFC rules as means of controlling BEPS-style tax planning.

Post-1962 Transfer Pricing Laws

In addition to CFC rules, the U.S. Congress in 1962 focused on the possibility of strengthening the arm's-length approach to transfer pricing. Legislative consideration of transfer pricing rules, in what became the Tax Reform Act of 1962, began in a perhaps surprising manner.³¹ The House of Representatives (the lower house of the U.S. Congress, where revenue-raising legislation must originate) approved a provision under which, in sales of tangible property between related parties, if a comparable price could not be identified, income from the production, purchase and resale of the property generally was to be divided among entities according to a formula based on companies' assets, payroll expenses, and advertising expenses. The formulary method was to apply only to related-party transfers of tangible property, so it is not clear how the method would have applied in connection with avoidance planning involving transfers of rights to intangibles or of services. The formulary method also would not have applied if relevant comparable prices could be found, or if the taxpayer could agree upon a more accurate transfer pricing methodology with the U.S. tax authorities.

Businesses objected strongly to the House proposal, claiming both that the legislation was unacceptably vague, and that applying a single formula to many different factual circumstances would inevitably lead to unfair results. When the House-passed bill was transmitted to the U.S. Senate for its consideration, the Senate eliminated the formulary-apportionment provision from subsequent versions of the legislation. Ultimately, in the 1962 Act, Congress decided against making any change to existing transfer-pricing law, thus in effect retaining the "arm's-length" approach as it had been developed by the League of Nations. Congress, however, directed the U.S. Treasury

²⁹ See generally Michael C. Durst, "Self-Help and Altruism: Protecting Developing Countries' Tax Revenues," in Thomas Pogge & Krishen Mehta, eds., *Global Tax Fairness* (Oxford & NY: Oxford University Press, 2016) at 316.

³⁰ The new GILTI tax is contained in Section 951A of the U.S. Internal Revenue Code.

³¹ The following discussion of the 1962 Revenue Act, and ensuing transfer pricing regulations of 1968, in the United States is based on Michael C. Durst & Robert E. Culbertson, "Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today," *57 Tax Law Review* 37, 48-58 (2003), and the authorities cited therein.

Department to re-examine the question whether additional regulations might be needed to govern transfer pricing. Congress directed the Treasury specifically to consider whether regulations should include “guidelines and formulas for the allocation of income and deductions.”

In 1968, after a substantial delay, the U.S. Treasury issued transfer pricing regulations in response to Congress’s request. The new regulations generally rejected Congress’s 1962 invitation to consider the use of “formulas.” Instead, the 1968 regulations introduced the idea of transfer-pricing guidelines, which the new regulations called “methods”; and it was clear that these methods were to be governed by the arm’s-length principle, with its heavy dependence on information derived from “comparables.”

The 1968 regulations established three basic transfer pricing methods: (1) a “comparable uncontrolled price” method, which was to be used if apparently reliable comparables information for the related-party transaction in question could be located; (2) a “cost-plus” method, to be applied to sales of manufactured products between related parties, under which the arm’s-length nature of pricing was to be evaluated according to whether the manufacturer’s gross markup on costs was similar to the markups obtained in comparable sales involving unrelated parties; and (3) a “resale price” method (sometimes called a “resale minus” method), to be applied to purchaser-resellers of products within a commonly controlled group, under which pricing was to be evaluated according to whether the reseller’s gross profit (i.e., its gross margin) was similar to that observed in comparable sales between unrelated parties. If none of these three methods could be applied, the 1968 regulations permitted the use of “other” methods, which in practice was taken to mean individually crafted profit-split methods like the “fractional” methods of apportionment to which the League of Nations had referred.

In addition to creating the concept of transfer pricing “methods,” the 1968 U.S. regulations also established the precedent of remarkably wordy and complex governmental transfer pricing guidance, built around the expectation that tax authorities would conduct highly detailed factual analyses of the operations and history of each

taxpayer before proposing tax adjustments. It has been my experience that the kinds of extraordinarily detailed factual inquiries for which the U.S. regulations (and, as will be seen, the OECD Transfer Pricing Guidelines later modeled after the U.S. regulations) call sometimes are beyond the practical capacity of even the most skilled government tax examiners, or private-sector tax advisers, to perform comprehensively in the context of real-life tax examinations.³²

The efficacy of the 1968 regulations was soon tested in a series of high-profile court controversies in the United States. Most of these cases involved a particular fact pattern associated with BEPS-style avoidance planning, “outbound migrations of intangibles,” which bedeviled U.S. tax authorities in the 1960s and with which the U.S. Internal Revenue Service continues to struggle, largely unsuccessfully, today.³³ These cases usually have involved the question of whether a U.S.-based multinational has received adequate compensation, typically in the form of royalties, when transferring patent or other intellectual property rights to a low- or zero-tax

³² One prominent commentator in 1968 made the following observation:

The first question that arises after a close reading of the proposed . . . regulations is how much simplicity and reduction of uncertainty will be effected thereby. Their constant references to all facts and circumstances and the numerous valuation complexities created by the various formulas contained therein, bode ill for ease of administration hopes. Moreover, the incredible mass of detail contained in the proposed regulations, coupled with their almost equally consistent retreats to vaguely worded general principles, tend to weaken the cohesive nature of these provisions. The net effect of the regulations seems more likely, on balance, to increase rather than decrease disputes . . . It may well be that the new proposals, despite their general readability, just cannot be effectively applied to concrete situations in practice.

James S. Eustice, “Tax Problems Arising from Transactions Between Affiliated or Controlled Corporations,” 23 *Tax Law Review* 451, 517 (1968).

³³ For summaries of these historical cases, see Reuven S. Avi-Yonah, “The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation,” University of Michigan Working Paper (2007), at section 4. Recent examples include *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009); and *Amazon.com, Inc. v. Commissioner*, 148 T.C. number 18 (2017) (case remains subject to review by U.S. Court of Appeals).

Legislation included in the December 2017 U.S. tax reform act, however, revised some of the rules for valuing outbound transfers of intangibles from the United States; it is possible, therefore, that the “intangibles migration” cases will be of largely historical significance in the future. See H.R. Conf. Rep. No. 466, 115th Cong., 1st Sess. (2017) at 661-662.

affiliate under a BEPS-style tax plan.³⁴ In almost all of these cases, the taxpayers have prevailed against the IRS, typically by submitting to courts extensive analyses by consulting economists, arguing that the royalties received by the U.S. parent company, which might on their face appear to be at below-market, actually are similar to royalties received by companies in “comparable” arm’s-length arrangements. Although outbound transfers of intangibles, of the kind involved in these cases, are unlikely to arise frequently in lower-income countries, the U.S. cases afford general caution regarding the practical limitations of “comparables analysis” as the basis for reasonably administrable transfer pricing rules.

Continuing official frustration with the comparables-based rules resulted in a comprehensive congressional review of U.S. transfer pricing law in connection with what became the Tax Reform Act of 1986.³⁵ Early in the consideration of the 1986 Act, the House Ways & Means committee speculated that the arm’s-length approach to transfer pricing laws might be untenable as a conceptual matter.³⁶ Ultimately, however, Congress in 1986 chose to make only minor adjustments to the existing transfer pricing rules of the Internal Revenue Code, leaving the law’s foundation in the arm’s-length principle

generally unchanged.³⁷ In addition, following the approach it had taken in 1962, Congress in the 1986 Act instructed the Treasury Department to perform a comprehensive study of the problem of transfer pricing, to examine whether the regulations should be changed “in any respect.”

The Treasury issued its report on transfer pricing, usually referred to as the Treasury “White Paper,” in 1988.³⁸ The report did not recommend wholesale replacement of the arm’s-length standard with a formulary approach. The White Paper, however, introduced a novel approach to transfer pricing enforcement that contains some elements of a formulary approach, and which fundamentally changed how tax authorities around the world try to enforce the arm’s-length principle.

The White Paper recommended the creation of a new transfer pricing method, which Treasury labeled the “basic arm’s-length return method,” or “BALRM.” The method appears to have been conceived originally largely as a means of addressing the pricing of outbound transfers of intangibles by U.S. parent companies; although, as will be seen, its use in other contexts has become substantially more important. Under BALRM, the IRS would have examined the level of profitability being earned by the low- or zero-tax affiliate within an intangibles-centered avoidance arrangement. If the level of profit earned by the affiliate seemed higher than reasonable in view of the actual functions performed by the affiliate — which, under the typical BEPS-style avoidance plan, would be minimal — the excess profit would be assumed attributable to the intangible that had been transferred by the U.S. parent and included in the

³⁴For example, a U.S.-based multinational in the pharmaceuticals business might have developed, through research and development in the United States, a valuable patent to a new drug, enjoying large U.S. tax deductions in the process. Then, pursuing the format of an intangibles-centered avoidance plan described in Chapter 2, the U.S. might have licensed the patent to a low- or zero-tax affiliate in return for a royalty of 5 percent of sales; and the affiliate might then have on-licensed the rights to companies operating around the world for a royalty of 10 percent of sales. This arrangement would permit the rapid accumulation of high levels of profit within the low- or zero-tax company. The U.S. tax authorities have typically argued in this kind of situation that the royalty initially paid by the low- or zero-tax company (five percent in this example) is below arm’s-length levels, thereby depriving the United States of adequate taxable income from the arrangement.

³⁵The following discussion, of the U.S. 1986 Reform Act and the ensuing Treasury Department “white paper” on transfer pricing, is based on Durst & Culbertson, note 31 above, at 64-77.

³⁶The Committee said:

A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not “as if” they were unrelated to their foreign subsidiaries.

H.R. Rep. No. 99-426, reprinted in 1986-3 C.B. (vol. 2) 424 (footnote omitted).

³⁷In particular, Congress added the “commensurate with income rule” to Section 482 of the U.S. Internal Revenue Code, which was intended to permit the IRS, in a tax controversy involving the arm’s-length level of a royalty that should be received in return for the outbound transfer of an intangible, to treat as evidence the level of income actually earned by a low- or zero-tax company from the intangible, even though that knowledge would not have been available to the multinational group at the time the transfer was made. At the time, many viewed the new rule as an alarming departure from the arm’s-length approach to transfer pricing. In practice, however, the commensurate with income rule appears to have had little if any effect on the outcome of tax controversies in the more than 30 years since its enactment.

³⁸The White Paper, and the international controversy over transfer pricing laws that followed, are discussed in detail in Durst & Culbertson, note 31 above, at 64-88.

parent's U.S. taxable income. The net effect would be to increase the royalty paid by the low- or zero-tax subsidiary back to the United States.

Even when seen primarily as a means of addressing the longstanding U.S. problem of outbound migrations of intangibles, the proposed BALRM approach of attributing to specified corporations market levels of "routine" income, would have been criticized by many as an excessive departure from the arm's-length paradigm. By the late 1980s, however, the BALRM proposal also had become embroiled in a transfer pricing dispute of a different kind, between the United States and some of its major trading partners, including, notably, Japan.

The root of the controversy was a substantial decline in the value of the U.S. dollar during the second half of the 1980s against a number of world currencies, especially the Japanese yen. This was a period in which Japanese manufacturers of automobiles, and other durable goods like industrial machinery, were making dramatic inroads in the U.S. marketplace. The rapid appreciation of the yen versus the dollar made it very difficult for manufacturers to build cars and other expensive products in Japan, paying for labor and supplies in yen, and to sell the products profitably, for depreciated dollars, in the United States.

Japanese manufacturing groups therefore were experiencing losses, or substandard levels of profitability, from their U.S. operations. The Japanese companies, supported by Japan's National Tax Administration, argued that for tax purposes, the losses or other substandard results should be shared between the Japanese parent company and its distribution subsidiary in the United States. The U.S. IRS, however, argued that the distribution subsidiary was performing a service for its parent company for which it should be compensated, even if for the time being the corporate group's U.S. operations, as a whole, were experiencing losses or unusually low profitability.³⁹

³⁹ See generally Joseph H. Guttentag & Toshio Miyatake, "Transfer Pricing: U.S. and Japanese Views," *Tax Notes Int'l*, Feb. 7, 1994, p. 375; "Tax Experts Say Japan Moving Toward Profit Splits as Key Pricing Method," *Daily Tax Report (BNA)*, June 2, 1994 at D-3; Akira Akamatsu, "Japanese Competent Authority Discusses U.S. APA Procedure," *Tax Notes Int'l*, Apr. 7, 1997, p. 1109.

Japan and other trading partners of the United States feared that the Internal Revenue Service would use the BALRM approach, contrary to international tradition, as a *de facto* minimum tax on the operations of U.S. distribution subsidiaries of foreign-owned manufacturing groups. Moreover, it appeared the United States envisioned applying the new approach on a somewhat mechanical basis, under which economists employed by the IRS would be permitted to estimate reasonable minimum levels of income for foreign-owned U.S. subsidiaries, without the need to conduct factually intensive, case-by-case analyses of potentially relevant "comparables."

Alarmed trading partners convened what turned into a multi-year session of the OECD's tax arm, to try to forge a compromise between the U.S. and foreign positions with respect to net-income benchmarking of subsidiaries. The negotiations in the OECD were, at times, unusually heated for that forum, and the debates are still sometimes referred to laconically as the "great transfer pricing wars" of the early 1990s. The result was the release in 1994 of new U.S. transfer pricing regulations, and the near-simultaneous release of a set of OECD Transfer Pricing Guidelines in 1995.⁴⁰

In response to concerns that the proposed BALRM method would be applied overly mechanically, the new U.S. regulations introduced a new transfer pricing method called the "comparable profits method (CPM)," and the 1995 OECD guidelines introduced an essentially identical method called the "transactional net margin method (TNMM)."⁴¹ Under TNMM, tax authorities are permitted to require that a local subsidiary of a multinational group earn at least a minimum level of income, commensurate with the functions the subsidiary performs and the business risks that it faces. However, the tax authority is required to base its determination of a

⁴⁰ The 1994 U.S. regulations and 1995 OECD Guidelines are described in Durst & Culbertson, note 31 above, at 90-98.

⁴¹ Despite the differing names of the U.S. and OECD methods, in practice the two methods are applied identically. See Robert E. Culbertson, "A Rose by Any Other Name: Smelling the Flowers at the OECD's (Last) Resort," *Tax Notes Int'l*, Aug. 7, 1995, p. 370. This book will use the OECD terminology and call the method "TNMM," as that is the term generally used in countries other than the United States.

minimum permissible level of income only on the basis of a case-by-case factual analysis of the subsidiary, including a search for financial information on companies that are “comparable” to the subsidiary under examination.

Here is how a tax authority is, in theory, supposed to apply TNMM in ensuring, for example, that a local distributor of brand-name farming equipment, established in a lower-income country by a multinational group, earns adequate income from its operations:⁴² First, the local tax authority is to perform a detailed “functional analysis” of the taxpayer (called the “tested party” in the language of TNMM), to obtain an understanding of how its business operates. For example, does the distributor perform only routine functions like the receipt and delivery of products, or does the distributor also perform extensive advertising functions for which additional income might be expected? Then, after having completed the functional analysis, the tax authority is to review commercially available electronic databases of financial information gathered from publicly traded companies, to locate companies that perform functions comparable to those of the tested party but are independent, in the sense of not being parts of commonly controlled business groups. If any reasonably comparable independent distributors of brand-name farming equipment are identified through the database search, their operating profit margins are subjected to statistical analysis. If the actual operating profit margin of the tested party is not below the median of the comparables’ margins by a statistically significant extent, the tested party’s results are accepted as reflecting arm’s-length pricing in its transactions with the other members of its multinational group. If, however, the tested party’s results fall below the median of the comparables’ results to a statistically significant extent, then the tax authority is permitted to adjust the tested party’s income, for tax purposes, up to the median.

The insistence of the OECD Guidelines that tax authorities apply TNMM only based on

⁴² Rules governing the TNMM are contained in Paragraphs 2.64 to 2.113 of the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as revised in 2017 following the OECD’s BEPS studies.

detailed functional analyses of the tested party, and that tax authorities apply the method by reference to data from uncontrolled comparables, reflected the continuing concerns of the trading partners of the United States within the OECD. The thinking at the time was, in my observation, that by placing formidable procedural hurdles in the way of successful application of the TNMM, countries’ tax authorities would be able to apply the new method successfully only in the case of relatively egregious income-stripping by locally operating subsidiaries.

The negotiators at the OECD do not appear to have had BEPS-style avoidance structures prominently in mind when hammering out the details of new transactional net margin method in the early 1990s. Nevertheless, it soon became clear that TNMM was the natural — and as a practical matter, the only — OECD-approved transfer pricing method potentially available for tax authorities, including those in low-income countries, to use in seeking to enforce reasonable minimum levels of incomes for the “stripped risk” distributors, manufacturers and service providers that figure prominently in BEPS-style tax planning arrangements. Indeed, TNMM appears to have become the world’s most commonly applied transfer pricing method.⁴³

Despite the very wide application of TNMM around the world, however, tax administrations, even in the world’s wealthiest countries, have never been able to administer the TNMM effectively. The root of the problem lies in the OECD’s insistence that tax authorities apply the method only by reference to searches for financial data for “uncontrolled comparables.” Typically, tax authorities are simply unable to locate reasonably satisfactory uncontrolled comparables for the kinds of “stripped-risk” distributors, manufacturers, and service providers that multinational groups establish as part of their tax planning structures.

Part of the problem is that uncontrolled, independent businesses never enjoy the high degree of insulation from business risks that intragroup contracts afford to the limited-risk entities that multinational groups establish under BEPS-style plans. Therefore, the uncontrolled

⁴³ See Collier & Andrus, note 5 above, at 111.

companies that tax authorities might identify through searches of financial databases are systematically noncomparable, in economic terms, to the “tested parties” that the tax authorities are trying to examine. In addition, those independent distributors, manufacturers, and service providers that might happen to exist, and to perform functions roughly similar to those of the tested parties in TNMM examinations, are unlikely to sell stock or other securities on public exchanges, so that their financial information typically is not included in available financial databases.

The practical result is that tax authorities typically are not able to identify enough high-quality comparables to apply TNMM persuasively in determining acceptable arm’s-length margins for local distributors, manufacturers, and service providers within multinational groups. Any comparables that might be identified are likely to differ in obvious ways from the stripped-risk entity that is being examined. For example, efforts to locate purported comparables for, say, a local distributor of high-margin, branded food or beverages might result in the identification of a few local wholesale food distributors which handle lower-margin, unbranded products, at volumes significantly lower than those of the large brand-name distributors.

Even with highly imperfect matches of this kind accepted, moreover, searches typically result in very small sample sizes of purported comparables: in my experience, sample sizes of only five or six purported comparables are often used in practice. Tax authorities then attempt, following the OECD Guidelines, to use statistical techniques to determine an “arm’s-length range” of profitability for the taxpayer that is under examination; and if the taxpayer’s actual profitability is within that range, the taxpayer will be considered to have satisfied the arm’s-length pricing standard under the Guidelines.⁴⁴ Basic

⁴⁴ For example, in examining a particular stripped-risk distributor, a tax authority might locate, using commercially available databases, financial information for six at least arguable uncontrolled comparables. Those six comparables might have a medium operating margin of 2.7 percent of sales; and applying some form of statistical technique to the available data, the tax authority might determine an “arm’s length range” of operating margins extending from 1.0 to 4.5 percent. So long as the tested party has earned an operating margin of at least 1.0 percent, therefore, the tested party will be considered, in its operations, to have complied with the arm’s-length standard.

statistical theory, however, makes clear that it is impossible to conduct reliable statistical analyses using very small sample sizes, especially when the data being used are of low quality to begin with.⁴⁵ The result is that the statistical ranges estimated in practice tend to be far too wide to be of real use in tax administration: basically, the range is so wide that even implausibly low margins are found to be within the “arm’s-length range.” In sum, TNMM as used around the world today provides tax administrations with only a very flawed means of attempting to prevent excessive profit-shifting by the kinds of limited-risk distributors, manufacturers, and service providers that are used under BEPS-style tax planning structures.

This book will return to the topic of transfer pricing rules, and in particular the TNMM, in Chapter 4, which analyzes the OECD’s recent BEPS reports. As will be described in Chapter 4, the OECD and other international organizations have recognized the importance of rectifying the problem of insufficient comparables if TNMM is to function effectively in tax administration, especially in developing countries.⁴⁶ Chapter 4 will consider the potential feasibility of improving the operation of the TNMM as a component of policies to enable lower-income country tax administrations to achieve better control over profit-shifting from their jurisdictions.

Profit-Shifting Through Interest Deductions

As described in Chapter 2, a very common kind of BEPS-style tax avoidance structure is based on the lending of money between members of multinational groups. Members of multinational groups routinely establish “financing subsidiaries” in low- or zero-tax countries and fund the financing subsidiaries with large amounts of cash. The financing subsidiaries then extend loans to the group’s

⁴⁵ See generally Durst & Culbertson, note 31 above, at 108-114, which contains a more extended and annotated discussion of the shortcomings of statistical analyses under TNMM. See also Michael C. Durst, “Making Transfer Pricing Work for Developing Countries,” *Tax Notes Int’l*, Dec. 13, 2010, p. 851.

⁴⁶ See especially Platform for Collaboration on Tax (group comprised of OECD, World Bank, IMF, and United Nations), “A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses” (2017).

various operating subsidiaries (which often are risk-limited companies established pursuant to BEPS planning) around the world. The operating subsidiaries pay interest on the loans, which they deduct for tax purposes, thereby reducing their tax bills in the countries where they are located. There is no corresponding tax cost when the interest is received by the low- or zero-tax financing company, so that the overall result is to reduce the multinational group's global tax bill.

Corporate income tax laws around the world typically allow corporations to deduct interest on loans; and claiming a deduction for interest is not in itself evidence of tax avoidance. The problem, however, is that under BEPS-style avoidance plans, risk-limited subsidiaries can incur interest-bearing debt from related lenders, especially low- and zero-tax financing companies, far in excess of the level of debt that is necessary for a company to incur for business reasons.

For illustration, consider the situation of a global multinational group as a whole. The group might find it desirable, for business reasons, to borrow money from banks and other outside lenders to a certain extent: say, to the point at which the group's "debt-to-equity ratio" — that is, its ratio of debt outstanding to the total value of its outstanding stock — is 1.5 to 1 (a typical debt-to-equity ratio for companies in some industries). The group will refrain from borrowing more, because then its debt will become too risky, forcing the group to pay overly high interest rates; also, incurring high levels of debt might subject the group to an excessive risk of bankruptcy if economic conditions change for the worse. Thus, at arm's length, there are natural limits to a multinational group's desire to incur additional debt to outside lenders.

Within a commonly owned multinational group, however, there are no substantial business constraints on the volume of loans made from one group member to another: as a matter of economic reality, since the same parent company owns the lender and the borrower, the loans place no one at genuine economic risk. The tax benefits that can be derived from the loans, nevertheless, can be very large. Not surprisingly, therefore, financing companies under BEPS-style planning structures often lend very large sums to group members operating in countries around the world, causing

those members to be much more heavily indebted than the group as a whole. For example, whereas a group as a whole may have a debt-to-equity ratio of 1.5 to 1, some companies within the group might have ratios of, say, 3 or 4 to 1. This kind of leverage permits massive amounts of tax avoidance through deduction of interest paid to group financing companies in low- or zero-tax countries.

Although, in theory, the arm's-length principle should limit the amount of debt between related parties to levels justified by bona fide business considerations, in practice the OECD's transfer pricing methods, including TNMM, do not impose effective limits on tax-avoidance through related-party lending arrangements. This is largely because the OECD's transfer pricing methods, including TNMM, seek to place a floor on the amount of "operating income" that a subsidiary is treated as earning for tax purposes — and "operating income" in accounting terminology means income *before* the deduction of interest paid by an entity. Therefore, even if a company earns, say, the minimum operating profit margin required by TNMM, the company can reduce its taxable income further by deducting interest paid, even to related parties.⁴⁷ The inability of transfer pricing methods, especially the commonly used TNMM, to meaningfully limit taxpayers' interest expenses represents a serious loophole in the OECD's approach to controlling BEPS-style tax planning.

For many decades, countries around the world have maintained rules, separate from their transfer pricing rules, that attempt to limit deductions for interest paid by a company to related lenders based on whether the company is "thinly capitalized" — that is, whether the corporation has more debt relative to equity than seems reasonable given business needs.⁴⁸ For

⁴⁷ For example, consider a member of a multinational group that distributes products in a particular country, and has sales revenue during the year of \$10 million. Despite the difficulties of applying TNMM, the tax authorities of the country establish successfully that the distributor should earn an operating margin of at least 3 percent, so that the distributor should earn an operating income of at least \$300,000. The distributor nevertheless remains free under the transfer pricing rules to reduce its taxable income below \$300,000, perhaps even to zero, by claiming deductions for interest on loans from related parties.

⁴⁸ These kinds of rules are discussed in the OECD's report on BEPS Action 4, which will be discussed below in Chapter 4.

example, a country's statute might disallow deductions for interest on a company's loans, to the extent the company's debt-to-equity ratio exceeds, say, 3 to 1. This "thin capitalization" approach to the control of interest deductions has never been very effective, however, because (i) the debt-to-equity ratios specified have tended to be generous, allowing for the deduction of interest substantially in excess of most companies' genuine business needs, and (ii) companies have been able to avoid application of the statutes by contributing cash to the taxpayer company, thus increasing the value of its equity and artificially reducing the company's debt-to-equity ratio.

As will be discussed further in Chapter 4, the OECD has recommended in its BEPS reports that countries adopt tighter limitations on corporate interest deductions, generally limiting interest deductions to 30 percent of a company's net income before payment of interest. Because these rules don't depend on a company's debt-to-equity ratio, they can't be avoided by injections of additional cash to the company. As will be discussed in Chapter 4, the OECD has modeled its recommendation on income-based interest limitations that some, mainly relatively wealthy, countries have adopted over about the past ten years.

As will be seen in Chapter 4, however, by the OECD's own analysis, the recommended 30-percent limitation would allow companies to continue to deduct interest on substantially larger loans than companies in most industries need to meet their genuine business needs. Therefore, even if lower-income countries adopt the OECD recommendation, companies in the countries will still be able to accomplish substantial tax avoidance through the payment of interest on loans from low- or zero-tax finance companies. Moreover, because of perceived pressures of tax competition, it is not clear that many, if any, lower-income countries will choose to adopt even the limited controls on interest deductions that the OECD has recommended.

Conclusion: Outlook for Chapter 4

The recent OECD BEPS studies are the consequence of an apparent shift in the global political environment following the 2008 Financial Crisis; this shift generated calls for reforms of international tax laws that would permit their administration and enforcement with greater predictability and effectiveness. The chapter just completed has sought to outline the history of the elements of international tax law that have been most central to the evolution of base erosion and profit shifting over the years, including transfer pricing laws, CFC rules, and rules governing the deductibility of interest paid by companies to other members of their corporate groups. The chapter has argued that all three of these areas of law have developed in ways that limit their effectiveness as means of controlling international tax avoidance. The apparent shortcomings in these areas of law seem to derive, at least in part, to political reluctance among policymakers to impose strong constraints on BEPS-style tax planning.

Chapter 4 will next focus on the OECD's BEPS process, and particularly on the extent to which the BEPS analyses have generated promising proposals for reform in these three central areas of international tax law. To what extent has the BEPS process transcended the political constraints that historically have limited the development of more administrable and enforceable international tax laws? To what extent are the BEPS recommendations likely to generate substantial improvements in the revenue performance of countries around the world, especially those lower-income countries where the potential social benefits from additional corporate tax revenues appears to be greatest? Chapter 5 then will seek to articulate a mix of policy instruments, including measures both from within and outside the scope of the BEPS studies, which might offer practical promise for the enhancement of revenues from the corporate income tax in lower-income countries. ■