"This article first appeared in the Virginia Tax Review in Volume 40, Number 2 (Winter 2021). It should be cited as: Eduardo Baistrocchi, The International Tax Regime and Global Power Shifts, 40 Va. Tax Rev. 219 (2021)."

# THE INTERNATIONAL TAX REGIME AND GLOBAL POWER SHIFTS

*Eduardo Baistrocchi*[*]

*The global economy's center of gravity is shifting. For the first time since the 19th century, emerging and developing countries have been contributing over 50% of the global GDP since the onset of the 21st century. If soft power mirrors but lags behind economic power, then the source for global and political influence will be shifting gradually east, particularly from the U.S. to China. This paper offers the first historical analysis of the impact of global power shifts and innovation at the technological and financial regulatory fronts on the evolution of the international tax regime (ITR) since its emergence in the early 20th century. It shows that the ITR has been evolving along a spiral trajectory correlated to two global power shifts: first, a power shift from the U.K. to the U.S. in the 1930s and then, an emerging power shift from the U.S. to China beginning in the early 21st century. The ITR evolutionary pattern has similarities with other global legal systems, including the Gold Standard (1880-1914), Bretton Woods (1945-1971) and the World Trade Organization (1948-2017). This paper identifies normative implications of the ITR spiral evolution in new problem areas, such as the taxation of global digital commerce. The theoretical framework rests on the dynamics of hegemonic orders and the rule-standard spectrum.*

TABLE OF CONTENTS

I. INTRODUCTION ............ 221

II. THE THEORETICAL FRAMEWORK ............ 224
- A. *The Dynamics of Hegemonic Orders and the Rule-Standard Spectrum* ............ 224
- B. *Rules and Standards as a Spectrum: Its Static Dimension* ..... 226
- C. *The Rule-Standard Spectrum: Its Dynamic Dimension* .......... 229
  - 1. A Rule May Evolve into a Standard ............ 229

[*] Associate Professor of Law, London School of Economics. This article has benefited greatly from the comments by John Avery Jones, Reuven Avi-Yonah, Alejandro Chehtman, Tsilly Dagan, Steven Dean, Martin Hearson, Emer Hunt, Martin Hevia, Pablo Ibañez Colomo, Liliana Lerchundi, Ezequiel Monti, Leandro Passarella, Ian Roxan, Mitchell Kane, David Kershaw, Pasquale Pistone, Eduardo Rivera López, Partho Shome, Andrew Summers, Suranjali Tandon, Emmanuel Voyiakis, participants in the 2019 Global Tax Symposium, Universidad Torcuato Di Tella Law School Faculty Workshop and the London School of Economics Faculty Workshop. It has also benefited from excellent research assistance by Patricio Castells and Aiden Hepworth. Views, errors and omissions remain my own.

2. A Standard May Evolve into a Rule ................................ 231

III. THE SPIRAL EVOLUTION OF INTERNATIONAL TAXATION: THE THREE ERAS ................................ 231

*A. The First Era: A Structural Analysis (1908-1933)* ................ 233

1. The Rise of the First Era (1908-1928) ................................ 234
2. The Decline of the First Era (1928-1932) ................................ 239
3. The Collapse of the First Era (1932-1933) ................................ 240

*B. The Second Era: A Structural Analysis (1933-2015)* ................ 241

1. The Rise of the Second Era (1933-1963) ................................ 242
2. The Decline of the Second Era (1963-2010) ................................ 244

*a. The U.S. Role in Adapting the ALP to Technological Innovation* ................................ 245

*b. China's and India's Role in the Decline of the Second Era* ................................ 248

3. The Collapse of the Second Era (2010-2015) ................................ 248

*C. The Third Era: A Structural Analysis (2015-2019)* ................ 249

1. Rise of the Third Era: 2015 to the Present ................................ 250

IV. THE SPIRAL EVOLUTION: ANALYSIS AND IMPLICATIONS ................ 257

*A. Assessing the Theory against the Empirical Evidence* ................ 257

1. Why the Evolution Has Been Spiral ................................ 258
2. The ALP Evolution: From the Rule End Towards the Standard End of the Spectrum ................................ 260
3. The Spiral Evolution, Global Political Shifts and Innovation ................................ 262
4. The Spiral Evolution, Countries and MNEs ................................ 265

*B. Implications: A Default Rule-Based ITR to Deal with Opportunistic Behavior and Inequality* ................................ 267

V. CONCLUSION ................................ 269

VI. APPENDIX ................................ 272

*A. The First Era: A Stage-by-Stage Analysis (1908-1933)* ......... 272

1. The Rise of the First Era (1908-1928) ................................ 272
2. The Decline of the First Era (1928-1932) ................................ 278
3. The Collapse of the First Era (1932-1933) ................................ 280

*B. The Second Era: A Stage-by-Stage Analysis (1933-2015)* ...... 281

1. The Rise of the Second Era (1933-1963) ................................ 281
2. The Decline of the Second Era (1963-2010) ................................ 288
3. The Collapse of the Second Era (2010-2015) ................................ 314

*C. The Third Era: A Stage-by-Stage Analysis (2015-2019)* ........ 327

1. Rise of the Third Era (2015-2019) ................................ 327

## I. INTRODUCTION

The world has experienced three globalization booms and four busts over the last two centuries. The first boom, the Concert of Europe system, began in 1815 following the defeat of Napoleon and lasted until the beginning of WWI. The second boom, the League of Nations system, ranged from the end of WWI until the Wall Street Crash in 1929. The third boom, the United Nations system, started at the end of WWII and persisted until about 2015 with the emergence of disruptive forces, including the trade war between China and the United States, the shifting locus of economic activity and the fourth industrial revolution.[1] The years before, in-between and after the three globalization booms have been ones of geopolitical conflicts, major wars and anti-globalization backlashes.[2]

One consequence of the globalization booms was the emergence in the late 19th century of a novel strategic problem among countries: how the international income tax base should be allocated to avoid international double taxation given the lack of a higher authority.[3] Since the end of WWI, countries have been involved in a strategic interaction in pursuit of a solution. The international tax regime (ITR) has emerged as a global legal system that aims to work out the double taxation problem.[4] The ITR is based on a legal

---

[1] *See generally* RICHARD DOBBS, JAMES MANYIKA, & JONATHAN WOETZEL, NO ORDINARY DISRUPTION: THE FOUR GLOBAL FORCES BREAKING ALL THE TRENDS (2015).

[2] MICHAEL J. MAZARR, JONATHAN BLAKE, ABIGAIL CASEY, TIM MCDONALD, STEPHANIE PEZARD, & MICHAEL SPIRTAS, RAND CORP., UNDERSTANDING THE EMERGING ERA OF INTERNATIONAL COMPETITION: THEORETICAL AND HISTORICAL PERSPECTIVES 6–11 (2019), www.rand.org/content/dam/rand/pubs/research_reports/RR2700/RR2726/RAND_RR2726.pdf. *See also* Jeffrey G. Williamson, *Winners and Losers over Two Centuries of Globalization*, (Nat'l Bureau of Econ. Rsch., Working Paper No. 9161, 2002), www.nber.org/papers/w9161.

[3] *See* Werner Haslehner, *Tax Treaty Disputes in Germany*, *in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES 290, 299–300 (Eduardo Baistrocchi ed., 2017). Haslehner's analysis includes the beginning of double taxation relief in the German-speaking area of pre-WWI Europe (1869–1912). The oldest of such tax treaties is between Prussia and Saxony in 1869. The words "countries" and "jurisdictions" are used as synonyms in this paper.

[4] The literature on the ITR is broad and deep. Excellent surveys on the ITR include the following: (1) Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L, REV. 1301 (1996); (2) Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J, 1021 (1997); (3) Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 L. & POL'Y INT'L BUS. 145 (1998); (4) John F. Avery Jones, *Are Tax Treaties Necessary*?, 5 TAX L. REV. 1 (1999). (5) Frans Vanistendael, *Impact of European Tax Law on Tax Treaties with Third Countries*, 8 E.C. TAX REV. 163 (1999); (6) H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 137 (2000); (7) Victor Thuronyi, *International Tax Cooperation and a Multilateral Treaty*, 26 BROOK. J. INT'L L. 1641 (2001); (8) Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259 (2003); (9) Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89 (2004); (10) Reuven S. Avi-Yonah, *International Tax as International Law*, 57 TAX L. REV. 483 (2004); (11) Yoshihiro Masui, *International Fiscal Association 2004 Vienna Congress, General Report: Group Taxation*, 89b CAHIER DE DROIT FISC. INT'L 21 (2004); (12) Allison Christians, *Sovereignty, Taxation and Social Contract*, 18 MINN. J. INT'L L. 99 (2009); (13) Ruth Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y.U. L. REV. 1540 (2009); (14) J. Clifton Fleming, Jr., Robert J. Peroni, & Stephen E. Shay, *Worse Than Exemption*, 59 EMORY L.J. 79 (2009); (15) Wolfgang Schön, *International*

technology first suggested in the 1923 Economists' Report to the League of Nations (LN).[5]

The ITR is now encapsulated in the OECD Model Tax Convention on Income and on Capital (OECD Model).[6] The OECD Model is soft law that is the template for over 3,000 bilateral tax treaties linking most countries from all continents.[7] Since the 2015 Base Erosion and Profit Shifting Reports to the OECD and G20 (BEPS Reports), the ITR aims to mitigate not only international double taxation but also international non-taxation problems after public outrage over aggressive corporate tax planning schemes on all continents.[8]

---

*Tax Coordination for a Second-Best World (Part I)*, WORLD TAX J. 67 (Sept. 2009); (16) R. Vann, *Taxing International Business Income: Hard–Boiled Wonderland and the End of the World*, 3 WORLD TAX J. (2010); (17) Neil Brooks & Thaddeus Hwong, *Tax Levels, Structures, and Reforms: Convergence or Persistence*, 11 THEORETICAL INQUIRIES L. 791 (2010); (18) Adolfo Martín Jiménez, *Beneficial Ownership: Current Trends,* WORLD TAX J. 35 (Feb. 2010); (19) Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011); (20) Daniel Shaviro, *The Rising Tax-Electivity of U.S. Corporate Residence*, 64 TAX L. REV. 377 (2011); (21) Jinyan Li*, The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*, 66 BULL. FOR INT'L TAX'N*,* 452 (2012); (22) Hugh J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 TAX NOTES INT'L 1195 (2013); (23) Ian Roxan, *Limits to Globalisation: Some Implications for Taxation, Tax Policy, and the Developing World* (L., Soc'y & Econ., Working Paper No. 3, 2012), https://ssrn.com/abstract=1995633; (24) Edoardo Traversa, *Interest Deductibility and the BEPS Action Plan: Nihil Novi Sub Sole?,* 2013 BRITISH TAX REV. 607 (2013); (25) Yariv Brauner & Pasquale Pistone, *BRICS and the Future of International Tax Coordination*, *in* BRICS AND THE EMERGENCE OF TAX COORDINATION (Yariv Brauner & Pasquale Pistone eds., 2015); (26) Michael P. Devereux & John Vella, *Are We Heading Towards a Corporate Tax System Fit for the 21st Century?*, 35 FISC. STUD. 449 (2014); (27) Michael Lang, *BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties*, 74 TAX NOTES INT'L 655 (2014); (28) TSILLY DAGAN, INTERNATIONAL TAX POLICY: BETWEEN COMPETITION AND COOPERATION (2017); (29) Miranda Stewart, *Redistribution Between Rich and Poor Countries*, 72 BULL. FOR INT'L TAX'N 297 (2018); (30) Philip Baker, *The League of Nations´ Draft Convention for the Allocation of Business Income Between States – A New Starting Point for the Attribution of Profits to Permanent Establishments*, 2018 BRITISH TAX REV. 514 (2018); (31**)** Sol Picciotto, *International Tax, Regulatory Arbitrage and the Growth of Transnational Corporations*, 25 TRANSNAT'L CORPS. 27 (2018); (32) Itai Grinberg, *International Taxation in an Era of Digital Disruption: Analyzing the Current Debate* (Scholarship at Geo. L. Work in Progress 2018), https://ssrn.com/abstract=3275737; (33) SUNITA JOGARAJAN, DOUBLE TAXATION AND THE LEAGUE OF NATIONS (2018); (34) PETER HARRIS, INTERNATIONAL COMMERCIAL TAX (2d ed. 2020).

[5] *See Report on Double Taxation*, League of Nations Doc. E.F.S.73. F.19 (1923), http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default.

The members of the committee were Prof. Bruins (Commercial University, Rotterdam), Prof. Luigi Einaudi (Turin University), Prof. Seligman (Columbia University, New York), Sir Josiah Stamp (London University). *See also* EDWIN R. A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION (1928).

[6] *See* Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention on Income and on Capital: Full Version* (Nov. 21, 2017), https://doi.org/10.1787/g2g972ee-en.

[7] *UN Primer on Double Tax Treaties*, UNITED NATIONS: DEP'T ECON. & SOC. AFFS., https://www.un.org/esa/ffd/capacity-development-tax/primer-dtt.html (last visited Oct. 27, 2020).

[8] Jannick Damgaard, Thomas Elkjaer, & Niels Johannesen, *The Rise of Phantom Investments. Empty Corporate Shells in Tax Havens Undermine Tax Collection in Advanced,*

The ITR is a decentralized network market that has set jurisdictions in competition for capital, residents and tax revenue.[9] The ITR is enforced via a decentralized network of local courts that may have the incentive to interpret and apply the ITR strategically to favor the positions of their own jurisdictions *vis a vis* competing jurisdictions.[10]

The global economy's center of gravity is moving along an east–southward trajectory. The average location of economic activity across geographies worldwide has shifted from a point in the mid–Atlantic (between the U.S. and Europe) in 1980, to a location east of Helsinki and Bucharest in 2008.[11] Developing and emerging countries like China are in fact returning to the role they had for most of history. Before technological innovation gave Britain its industrial lead in the 19th century, today's developing and emerging economies dominated global output. It has been estimated that in the eighteen centuries prior to 1820, they had produced, on average, around 80% of the global total. The consolidation of Europe's Industrial Revolution, however, left behind developing and emerging countries. By the early 20th century, their share in global output had fallen to about 40%.[12] Yet as of the early 21st century, developing and emerging countries have been making a comeback in this area. For example, China's economy was larger than the U.S.'s in 2014.[13] Developing and emerging countries have been able to contribute again to over 50% of the global output, in purchasing power parity terms, as was the usual case before the Industrial Revolution.[14] As Danny Quah argues, "[i]f soft power mirrors but lags behind economic power, then the source for global and political influence will be similarly shifting gradually east."[15]

This paper offers the first historical analysis of the correlation between global power shifts and innovation at the technological and financial regulatory levels on the evolution of the ITR since its emergence in the 1920s. This analysis is relevant because it offers normative lessons that could contribute to solving the new challenges that the ITR is facing in the early 21st century: the increasing difficulties countries are facing in reaching

---

*Emerging Market and Developing Economies*, FIN. & DEV., Sept. 2019, at 11. *See also* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES, *supra* note 3.

[9] Eduardo Baistrocchi, *The International Tax Regime and the BRIC World: Elements for a Theory*, 2013 OXFORD J. LEGAL STUD. 1 (May 10, 2013). *See also* DAGAN, *supra* note 4, at 12–14.

[10] Eduardo Baistrocchi, *The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications*, 2008 BRITISH TAX REV. 352, 354 (2008).

[11] Danny Quah, *The Global Economy's Shifting Centre of Gravity*, 2 GLOB. POL'Y 3, 3 (2011).

[12] *Emerging Economies: Climbing Back*, ECONOMIST (Jan, 19, 2006), https://www.economist.com/finance-and-economics/2006/01/19/climbing-back.

[13] In 2014, the IMF estimates the size of the U.S. economy was USD17.4 trillion and the size of China's economy was USD17.6 trillion. *See* Keith Fray, *China's Leap Forward: Overtaking the US as World's Biggest Economy*, FIN. TIMES (Oct. 8, 2014), https://www.ft.com/content/166230a2-a18c-38f1-bcac-cbbdd495503a

[14] *See* ANGUS MADDISON, THE WORLD ECONOMY, VOLUME 1: A MILLENNIAL PERSPECTIVE 126–27 (2007).

[15] Quah, *supra* note 11, at 3.

consensus on how to deal with emerging issues. Taxation of global digital commerce is a case in point.

This paper is organized into five sections and three appendices. After this introduction, Section II presents a theoretical framework grounded on the dynamics of hegemonic orders and the rule–standard regulatory spectrum ("the spectrum"). The spectrum offers a framework to illuminate the evolving legal architecture of the ITR and its correlation with shifting hegemonic orders. Section III provides a structural, descriptive analysis of the history of the ITR in the light of the dynamics of hegemonic orders and the spectrum. It proposes a rational reconstruction of ITR evolution in the G20 along a spiral trajectory. The ITR spiral evolution has been crystallized in three sequential eras of regulations: from a standard-based legal system to a rule–based regime and then back to a standard-based legal system over a period of 111 years running from 1908 to 2019. The three eras, in turn, are divided into 63 stages representing the rise, decline and fall of the relevant era. The analysis offered in Section III is encapsulated in four figures. Figures 1, 2 and 3 embody graphic representations of each era, while Figure 4 represents the combined centennial ITR spiral evolution. Section IV assesses the spiral evolution theory against empirical evidence and its normative implications. Section V concludes. Appendices A, B and C provide a granular analysis of the three eras, respectively. The appendices complement the structural analysis offered in Section III.

## II. THE THEORETICAL FRAMEWORK

### *A. The Dynamics of Hegemonic Orders and the Rule-Standard Spectrum*

A rule-based international tax system is a global public good, in the same way the rule-based international monetary and trade systems are public goods. International relations scholars have long argued that such systems are only stable under conditions of hegemony, in which a predominant power ensures the supply of these public goods.[16] The gold standard of 1880–1914 marked the peak of an open trading system under British hegemony and the Bretton Woods system of 1945-1971 marked the peak of a fixed exchange rate system under U.S. hegemony. The World Trade Organization (1948-2017) is another example of a rule–based global public good with one peculiarity: it was originally proposed and then blocked by the same country,

---

[16] *See, e.g.*, ROBERT O. KEOHANE, AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY (1984); David A. Lake, *Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?*, 37 INT'L STUD. Q. 459 (1993); Robert W. Cox, *Gramsci, Hegemony and International Relations: An Essay in Method*, *in* GRAMSCI, HISTORICAL MATERIALISM AND INTERNATIONAL RELATIONS (Stephen Gill ed. 1993); 4 CHARLES P. KINDLEBERGER, THE WORLD IN DEPRESSION, 1929–1939 (1986); Robert W. Cox, *Social Forces, States and World Orders: Beyond International Relations Theory*, 10 MILLENNIUM 126 (1981); Stephen D. Krasner, *State Power and the Structure of International Trade*, 28 WORLD POL. 317 (1976). Please note that global hegemon, global power and ruling power are synonyms in this paper.

the U.S., with its "America First" policy on the assumption that the WTO no longer serves U.S. interests.[17]

The hegemon ensures the provision of global public goods that are needed to maintain, for example, an open world trading system, including a stable currency system and a stable international tax regime. A hegemonic regime also needs a purpose, which after WWII has been "embedded liberalism" subsequently replaced by neoliberalism.[18] The hegemon role in the international tax sphere is to provide some underlying purpose and coherence. The hegemon, which is normally the major capital exporter, is really pursuing the interests of the hegemon's capital, and it uses the ideas and a sense of purpose to generate consent for its hegemony. The hegemon has the incentive to pursue the interests of its multinationals and it uses the income allocation norm as a tool through which it persuades other countries to accept a set of rules that makes it harder for them to tax the hegemon's capital.

In this section, I introduce a sequential model to explain the evolution of the ITR. It maintains that the rule–standard spectrum offers a framework to illuminate the evolving legal architecture of the ITR and its correlation with hegemonic orders. International hegemony is defined here as "the mobilization of leadership" by a predominant power in order to create international order. An international order is manifest in the settled regulations and arrangements between jurisdictions that define and guide their interactions.[19]

Definitions of the rule and standard concepts are in order. A jurisdiction can give content to norms *ex-ante* (via rules) or *ex-post* (via standards). Examples of rules and standards can be found in many settings. For instance, a norm that demands "no driving in excess of 55 miles per hour" is a rule, because violations are proscribed *ex-ante* and no judgment is required by the subject of the regulation. The trigger in a rule is mostly empirical, rather than evaluative.[20] Conversely, a norm to "drive carefully" is a standard, because it requires judgment from the subject and precise prohibitions are determined *ex-post* through case law or a functional equivalent.[21]

Rules and standards differ in at least one important dimension: the distribution of power within a legal system. Whereas rules are usually a

---

[17] Martin Wolf, *Martin Wolf on Bretton Woods at 75: Global Co-Operation under Threat*, FIN. TIMES (July 10, 2019), https://www.ft.com/content/e82a1f48-a185-11e9-a282-2df48f366f7d.

[18] John G. Ruggie, *International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order*, 36 INT'L ORG., 379, 393, 414–15 (1982).

[19] G. John Ikenberry & Daniel H. Nexon, *Hegemonic Studies 3.0: The Dynamics of Hegemonic Orders*, 28 SEC. STUD. 395, 411–12 (2019).

[20] Pierre J. Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 382–83 (1985).

[21] The theoretical framework of this article is grounded on the law and economics literature on the rules and standards concepts. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis,* 42 DUKE L.J. 557 (1992). *See also* Isaac Ehrlich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974). On the rule and standard framework in international taxation from a legitimacy perspective, *see* Steven A. Dean, *Neither Rules nor Standards*, 87 NOTRE DAME L. REV. 537 (2013).

creation of the legislative branch of government or a functional equivalent, standards are a decentralized creation of the law through, paradigmatically, the judiciary or a functional equivalent.[22] The standard "drive carefully" is a case in point; it allocates a relatively wide power to courts to provide an *ex-post* meaning to this standard. Conversely, the rule "no driving in excess of 55 miles per hour" keeps the power centralized under the rule setter's control. So the rule conveys a relatively narrow power to the judiciary or a functional equivalent because the trigger in a rule is only empirical.

In sum, under conditions of hegemony, a rule–based ITR normally emerges as a global public good. When this hegemony breaks down due to shocks, the ITR legal architecture drifts towards the standard–based end of the continuum because the hegemon is no longer able to enforce participation in a rule–based system.

It is now time to explore the rules and standards spectrum from a static and dynamic perspective.

### *B. Rules and Standards as a Spectrum: Its Static Dimension*

The rules and standards concepts are opposing ends of a spectrum. Indeed, a pure rule is on one end and a pure standard is at the other end. A number of hybrid regulations are in–between the opposing ends of the continuum.

There is a myriad of patterns of regulations in the rule–standard spectrum. The OECD Model is used here as a case study. An instance of a pure rule is the term "national," in relation to a contracting State. National means "[…] any individual possessing the nationality or citizenship of that Contracting State."[23] So the OECD Model provides an *ex-ante* meaning to the term "national," where just having the, say, French passport implies that the individual should be deemed as a French national within the terminology of the OECD Model (Pattern #1: A Pure Rule).

An example of a pure standard is the principal purpose test (PPT). The PPT is an anti-avoidance regulation to deter tax treaty shopping. The PPT regulation provides the following:

> [...] a benefit under this Convention shall not be granted in respect of an item of income […] if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the *principal purposes of any arrangement* […] that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.[24]

[22] *See* Kaplow, *supra* note 21, at 608–11.

[23] OECD, *supra* note 6, at M-10.

[24] *Id.* at M-80–81 (emphasis added).

The PPT is a pure standard because it lacks an *ex-ante* meaning. This includes the lack of the *ex-ante* meaning of the words *principal purpose of any arrangement*. The meaning of these words can only be provided *ex-post* through case law or a functional equivalent (Pattern #6: A Pure Standard).

Hybrid regulations in–between the pure rule and pure standard opposing ends of the spectrum include the following four patterns. First, the advance pricing agreement (APA) is an example of an *ex-ante* procedural regulation. It provides a procedural framework in which the contracting States may provide an *ex-ante meaning* to the material regulations of the jurisdictions involved before the taxpayer makes the relevant cross–border investment. The APA norm is as follows: "The competent authorities of the Contracting States shall endeavour to resolve [*ex-ante*] by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention."[25] The APA is not a pure rule because contracting states are not obliged to agree on the *ex-ante* meaning of the material set of regulations. So APA is an example of a regulation that is closer to the pure rule end than the pure standard end of the spectrum because APA may provide an *ex-ante* meaning of the pertinent set of norms (Pattern #2: *Ex-ante* Procedural Regulation).

Second, a rule can be embedded in one or more standards. For example, a standard (e.g., "a fixed place of business through which the business of an enterprise is wholly carried on is a permanent establishment") is subject to a rule (e.g., a place of extraction of natural resources).[26] So the OECD Model deems that a place of extraction of natural resources is a fixed place of business for permanent establishment purposes (Pattern #3: A Rule Embedded in One or More Standards).

Third, a standard can be embedded in one or more rules. For example, the rule (undefined terms must be defined by contracting states' domestic laws) is subject to a standard ("unless the context otherwise requires").[27] So, for example, the undefined term "law" in Article 3.2 of the OECD–based tax treaty signed between Chile and United Kingdom shall be defined according to Chilean domestic law, unless the context requires otherwise (Pattern #4: Standards Embedded in One or More Rules).

Fourth, tax arbitration is an example of an *ex-post* procedural regulation. The relevant provision states the following:

> Where, […] a) a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and b) the competent authorities are unable to reach an agreement to resolve that case […], any unresolved issues arising

[25] *Id.* at M-68.
[26] *Id.* at M-19.
[27] *Id.* at M-11.

> from the case shall be submitted to arbitration if the person so requests in writing.[28]

Tax arbitration is an example of a regulation that is closer to the standard end rather than the rule end of the spectrum. This is so because tax arbitration is an *ex-post* procedural regulation: it provides an *ex-post* meaning to the material regulation that is *after* rather than *before* the cross–border investment has been made (Pattern 5: *Ex-Post* Procedural Regulation).

Table 1 crystallizes examples of the rule–standard spectrum along the six different patterns of regulations outlined above.

TABLE 1: THE RULE-STANDARD SPECTRUM

| | **Patterns** | **Examples** |
|---|---|---|
| **#1** | Pure Rule | The term "national" |
| **#2** | *Ex-ante* Procedural Regulation | APAs |
| **#3** | A Rule Embedded in One or More Standards | A Place of Extraction of Natural Resources |
| **#4** | A Standard Embedded in One or More Rules | Tax Treaty Interpretation |
| **#5** | *Ex-post* Procedural Regulation | Tax Arbitration |
| **#6** | Pure Standard | Principal Purpose Test |

Patterns #1, #2 and #3 crystallize a rule–based legal system because they provide an *ex-ante* meaning of the relevant regulatory framework with a decreasing degree of clarity. Pattern 1 (a pure rule) provides the clearest possible *ex-ante* meaning. Conversely, patterns #4, #5 and #6 encapsulate a standard–based legal system because they provide an *ex-post* meaning to the regulatory framework with a decreasing degree of clarity. Pattern #6 (a pure standard) lacks an *ex-ante* meaning; only case law or its functional equivalent can provide an *ex-post* meaning.

In sum, patterns #1 and #6 are on the opposing ends of the spectrum. There are at least four hybrid patterns of regulations in–between the opposing ends: patterns #2 to #5. The hybrid patterns are closer to one or the other end of the spectrum; for example, Pattern #5 (*ex-post* procedural regulation like tax arbitration) is closer to Pattern #6 (pure standard), instead of Pattern #1 (pure rule), because tax arbitration can only provide an *ex-post* meaning to the relevant set of norms. It is now time to explore the rule–standard spectrum from a dynamic rather than static perspective.

### *C. The Rule–Standard Spectrum: Its Dynamic Dimension*

Rules and standards may change over time: a rule can evolve into a standard (and vice versa). This evolution may be triggered, for example, by exogenous forces such as shifts in foreign direct investment (FDI) bilateral flows, case law with public good features and/or technological innovation.

[28] *Id.* at M-68–69.

1. A Rule May Evolve into a Standard

Let us begin with an example of a rule becoming a standard due to shifts in bilateral FDI flows. The U.K. persuaded the Irish Free State (IFS) to accept the exclusive residence jurisdiction rule for solving the double taxation problem in their tax treaty during the interwar period. The Agreement between the British Government and the Government of the Irish Free State in respect of Double Income Tax was signed on 14 April 1926 (the IFS-UK DTC).[29] It provided the following no–source taxation rule:

> […] Any person who proves to the satisfaction of the Revenue Commissioners that for any year he is resident in Great Britain […] and is not resident in the Irish Free State shall be entitled to exemption from Irish Free State income tax for that year in respect of all property situate and all profits or gains arising in the Irish Free State, and to exemption from Irish Free State super-tax for that year […].[30]

So U.K. resident companies were exempt from Irish income taxes (and vice versa). The corporate residence test, in turn, provided the following:

> For the purposes of this Agreement a company, whether incorporated by or under the laws of Great Britain […] or of the Irish Free State or otherwise, shall be deemed to be resident in that country only in which its business is managed and controlled [the 1926 residence test].[31]

The IFS/UK DTC was an asymmetric tax treaty because it is assumed here that virtually all inward FDI into the Irish Free State originated in the U.K. by 1926.[32] Thus, the 1926 residence test is closer to the pure rule end, instead of the pure standard end, for contextual reasons: the asymmetric FDI flows between the IFS and the U.K. The 1926 residence test was a rule–based regulation because it provided an *ex-ante* meaning: all companies doing business in the IFS were U.K. residents in the 1926-27 fiscal year, so they were exempt from the Irish tax.[33]

---

[29] Finance Act 1926 (Act No. 35/1926) (Ir.), http://www.irishstatutebook.ie/eli/1926/act/35/enacted/en/print.

[30] *Id.*, 1st sched., pt. I, § 1(b).

[31] *Id.*, § 4.

[32] Ireland was part of the U.K. until 1922 and the only industry in the IFS was agriculture (as opposed to Northern Ireland, which was relatively industrialized). In 1924, imports into the IFS were vastly from the U.K. and exports from the IFS almost solely went to the U.K. The name IFS disappeared in 1937 with the adoption of a new constitution and the state henceforth became known as the Republic of Ireland. *See* Frank Barry & John Bradley, *FDI and Trade: The Irish Host-Country Experience*, 107 ECON. J., 1798 (1997).

[33] There was no TP regulation in the 1926 IFS/UK DTC. So the rule/standard spectrum analysis is applied here to the closest available regulation dealing with the double taxation problem: the residence test.

Interestingly, the residence test in force in the DTC between the Republic of Ireland and the U.K. in 2017 is similar to the 1926 residence test. The 2017 residence test provides the following:

> Where […] a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated [the 2017 residence test].[34]

Unlike the 1926 scenario, FDI flows between the Republic of Ireland and the U.K. were broadly symmetrical by 2017. For example, the outward FDI flows from the U.K. to Ireland were USD 2,068.7 M; and the Inward FDI flows from Ireland to the U.K. were USD 3,373.9 M.[35] Moreover, FDI from the U.K. to Ireland was just 7.7% of the total FDI to Ireland by 2017.[36]

So the residence test that by 1926 was a rule–based regulation because virtually all inward FDI to Ireland came from the U.K., by 2017 had become standard–based because of a substantial shift in FDI flows between Ireland and the U.K. Hence, the application of the 2017 residence test now requires what is usual in any standard–based regulation: a case–by–case analysis of the place of effective management of the relevant corporation. Unlike what happened in the 1926-1927 fiscal year, the place of corporate residence for Ireland/U.K. DTC purposes could have been either the Republic of Ireland or the U.K. in the fiscal year 2017-2018.

In sum, the test of residence in the Ireland-U.K. tax treaty network is an example of a regulation evolving from the rule end towards the standard end of the spectrum over the course of almost a century (1926-2017). This

---

[34] Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.K.-Ir., Nov. 4, 1998, art. 4, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/822648/Synthesised_text_of_the_Multilateral_Instrument_and_the_1976_Ireland-UK__Double_Taxation_Convention____in_force.pdf.

[35] *See* Org. for Econ. Co-operation & Dev. [OECD], *Benchmark Definition, 4th Edition (BMD4): Foreign Direct Investment: Financial Flows by Partner Country (Edition 2017)*, https://doi.org/10.1787/10707ea6-en (last visited Oct. 17, 2020).

[36] Data on main investing countries in Ireland in 2017 is as follows:

| **Main Investing Countries in Ireland** | **2017 (in %)** |
|---|---|
| United States | 23.8 |
| Offshore Centers | 19.0 |
| The Netherlands | 13.3 |
| Luxembourg | 12.2 |
| Switzerland | 9.9 |
| United Kingdom | 7.7 |

*See Foreign Direct Investment*, AN PHRÍOMH-OIFIG STAIDRIMH: CENT. STAT. OFF. (Nov. 1, 2018), https://www.cso.ie/en/releasesandpublications/er/fdi/foreigndirectinvestmentannual2017/.

evolution is due to contextual forces: a shift in the FDI flows between Ireland and the U.K.

### 2. A Standard May Evolve into a Rule

It is time to offer an example of a regulation evolving from the standard end towards the rule end. The doctrine of good faith performance establishes a standard for contract interpretation in the U.S. The good faith concept is now encapsulated in the Uniform Commercial Code. It is defined as "[…] honesty in fact and the observance of reasonable commercial standards of fair dealing."[37] Over the last century, case law with public good features has enriched the concept of good faith so that it is now possible to infer a number of rules.[38] The judicial test that distinguishes good faith performance from bad faith performance, and the examples identified by case law, is an example. The good faith standard has eventually turned into a constellation of rule–based regulations in certain areas of U.S. contract law as a result of a myriad of judicial decisions applying the good faith concept to a wide range of factual scenarios. Case law with public good features has been mutating the good faith concept's original character from the standard–based regulation end towards the rule–based end in certain areas.

In sum, rules and standards may change over time due to, for example, exogenous forces such as substantial shifts in bilateral FDI flows[39] or case law with public good features.[40] In the next section I will provide an account of the evolution of the ITR and show that it can be explained by the theoretical framework just outlined.

## III. THE SPIRAL EVOLUTION OF INTERNATIONAL TAXATION: THE THREE ERAS

This section offers a structural analysis of the ITR as applied to MNEs. The allocation norm regarding the profits of parent and subsidiary enterprises, and enterprises under common control (associated enterprises), is used here as a proxy because of two reasons. First, the separate entity approach (SEA) concept is at the heart of the OECD Model and its

[37] Steven J. Burton, *Breach of Contract and The Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 376 n.35 (1980) (quoting U.C.C. § 1-201(19) (AM. L. INST. & UNIF. COMM'N 1977)).

[38] Case law is a public good if it allows a representative person to predict the probable outcome of a court's future decision. The predictive function of case law is normally desirable in the rule of law, because it minimizes transactions costs. *See* JAMES M. BUCHANAN, THE LIMITS OF LIBERTY: BETWEEN ANARCHY AND LEVIATHAN 107–09 (1975) (arguing that legal precedent is a form of social capital having public good characteristics). *See also* William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J. L. & ECON. 249, 250 (1976) (arguing that "the body of legal precedents [is] a capital stock that yields a flow of information services.").

[39] *See supra* Section II.A.1.

[40] *See infra* Section III.B.2.

predecessors since the 1920s.[41] Second, the allocation norm, now encapsulated as the arm's length principle (ALP) in Article 9 of the OECD Model, is a fundamental element of the SEA approach because it offers a methodology for quantifying the income attributable to associated enterprises.

Article 9 provides, *inter alia*, the following:

> *Associated enterprises: 1. 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 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 […] (emphasis added).[42]

The logical structure of article 9 of the OECD Model is represented in Table 2:

TABLE 2: STRUCTURE OF ARTICLE 9

| (a) If commercial or financial relations have been entered into between associated enterprises; |
|---|
| (b) and those relations are inconsistent with the ALP; |
| (c) then the tax authority may adjust the relevant transfer price to make it consistent with the ALP. |

Table 2 shows that the ALP is the central test of Article 9 because transfer pricing (TP) adjustment can only be justified if the ALP is not met in a given case. The ALP is based on a fundamental assumption: the availability of a comparable market price (the transfer pricing problem). The DuPont case is an example of a TP dispute.[43]

---

[41] For example, the LN work on the SEA and ALP includes the 1928 Model Draft Convention and the 1933 Carroll Report, respectively. *See infra* Sections III.A, III.B. *See also* 4 MITCHELL B. CARROLL, *Taxation of Foreign and National Enterprises*, *in* METHODS OF ALLOCATING TAXABLE INCOME 9 (1933), http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/cartaxa.xml;collection=;database=;query=;brand=acdp.

[42] OECD, Model Tax Convention on Income and on Capital, Condensed Version 34–35 (2017).

[43] The facts in *DuPont* were particularly favorable to the IRS, the U.S. tax authority, since the taxpayer admitted that it had set transfer prices with its low-tax (Swiss) marketing subsidiary, DISA, with no reference to anything but maximizing DISA's profitability. An internal DuPont memo discovered by the service read as follows:

*A. The First Era: A Structural Analysis (1908-1933)*

This section offers an analysis of the first ITR standard–based era (the first era). It lasted 25 years, running from 1908, with the emergence of the first profit allocation dispute in the world involving Germany and the U.K., and was solved in the light of two pure standards: the separate entity approach and the sham doctrine.[44] The first era ended in 1933 with the publication of the Carroll Report to the League of Nations (LN) suggesting what was then a rule–based legal system for solving the profit allocation problem: the ALP. The first era consists of the 11 stages shown in Figure 1 below.[45]

The first era developed in a turbulent global context that included the collapse of the first globalization (the Concert of Europe system) with the onset of WWI, the emergence and collapse of the second globalization (the LN system) running from 1919 until the Wall Street Crash in 1929.[46]

> It would seem to be desirable to bill the tax haven subsidiary at less than an 'arm's length' price because: (1) the pricing might not be challenged by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer prices; (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an 'arm's length' price and might well be less; thus we would be no worse off than we would have been had we billed at the higher price.

*See E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d 445, 447 n.4 (Ct. Cl. 1979).

[44] *See Gramophone & Typewriter Ltd. v. Stanley* (1908) 2 K.B. 89; *infra* App'x A, stage 1.

[45] Appendix A offers a stage-by-stage analysis of the first era (1908–1933).

[46] *See supra* Section 1.

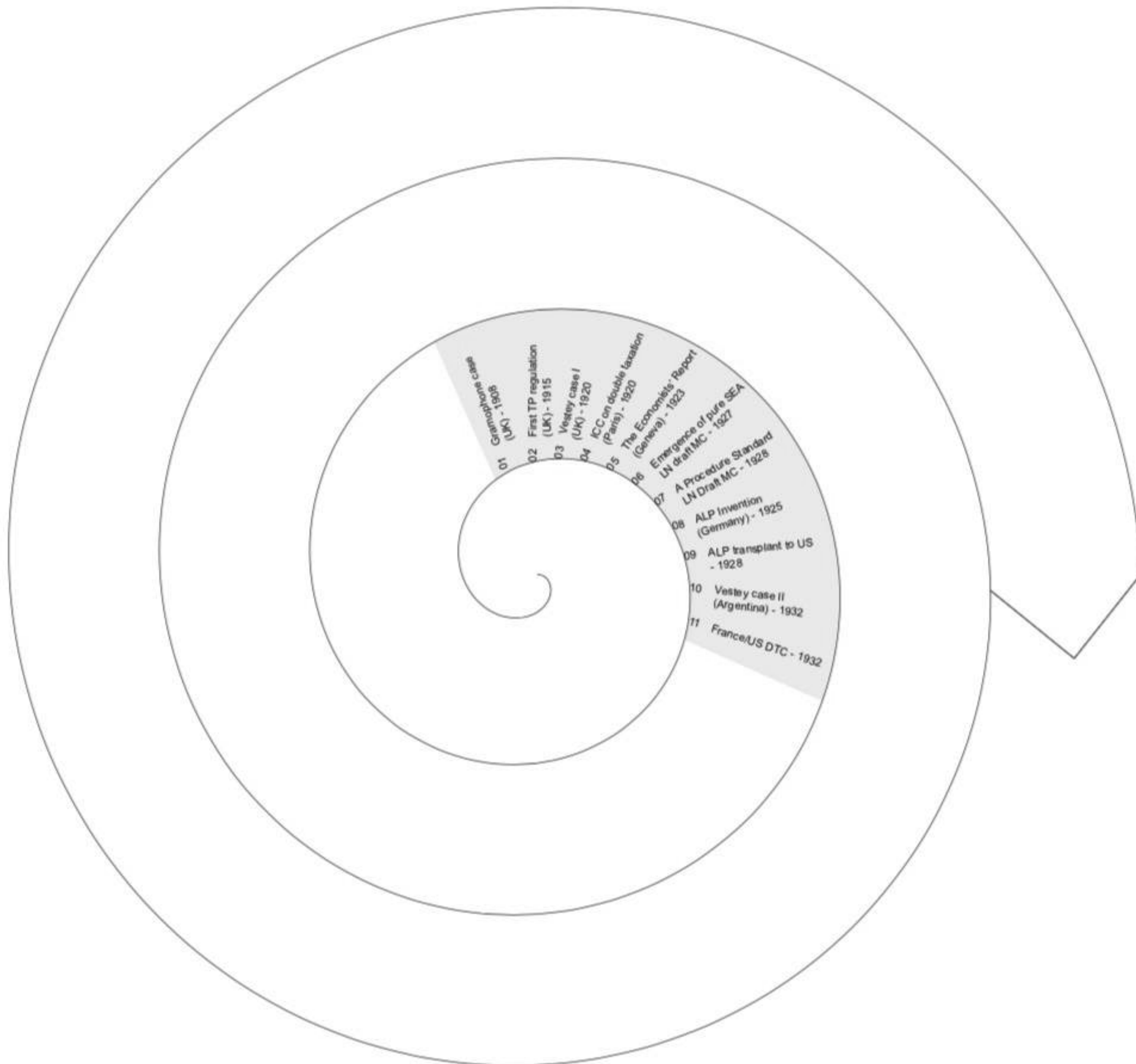


**Figure 1 The Allocation Norm: The First Era 1908-1933**

1. The Rise of the First Era (1908-1928)

MNEs began to face the issue of international double taxation as of WWI. An example of this issue was a combined tax rate of 73.2% faced by U.S. corporate investors doing business in the U.K. by 1919.[47] Immediately after WWI, MNEs and individuals represented in the International Chamber of Commerce (ICC) demanded that the LN should do something to eliminate

[47] JOGARAJAN, *supra* note 4, at 93 n.24.

the "evils" of double taxation.[48] The ICC meeting in Paris adopted a resolution in 1920 urging:

> […] prompt agreement between the Government of the Allied countries in order to prevent individuals or companies from being compelled to pay a tax on the same income in more than one country, taking into consideration the country to which such individual or company belongs has a right to claim the difference between the tax paid and the home tax.[49]

The ICC managed to place the issue of international double taxation high on the LN agenda.[50] In 1923, a committee of four economists submitted a report to the LN suggesting a range of policy options for solving the double taxation problem. The report set out the basic principles underlying international tax jurisdiction for the first time. It pointed out that an income tax based on ability to pay does not answer the question as to whose ability to pay is to be considered in each taxing jurisdiction. To answer this question, the report developed the "doctrine of economic allegiance," which underlies modern discussions of jurisdiction to tax.[51] Fundamentally, the report endorsed two bases for economic allegiance, which justify a country's levying of taxes: where income is produced (the source jurisdiction) and where it is consumed or saved (the residence jurisdiction).[52]

The 1923 report then addressed the issue of double taxation regarding the source and residence jurisdictions by analyzing which one has the prior claim to tax income deriving from one jurisdiction by a resident of the other and which one has the obligation to prevent double taxation by giving up its claim. On practical grounds, the source jurisdiction should have the prior right because it can generally impose its taxes on income deriving from within it first.[53] However, the 1923 report recommended that in future negotiations between tax jurisdictions, income items should be classified according to whether the primary economic activity giving rise to the income takes place in the source country or in the residence country and that the prior right to tax the income should be divided accordingly between them.[54]

---

[48] MITCHELL B. CARROLL, GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER 29 (1978); *see infra* App'x A, stage 4.

[49] JOHN G. HERNDON, RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 20 (1932).

[50] *See* Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement 1921–1945*, 59 HARV. L. REV. 73, 73 (1945).

[51] Avi-Yonah *supra* note 4, at 1355.

[52] *Report on Double Taxation*, *supra* note 5, at 4027–29 (identifying four bases for economic allegiance: where wealth is produced, where it is finally located, where rights over it can be enforced and where it is consumed or otherwise disposed of; the first and fourth bases [source and residence, respectively] were identified as the most important).

[53] *Id.* at 4044; *see also infra* App'x A, stage 5.

[54] *Report on Double Taxation*, *supra* note 5, at 4055 (discussing four methods of avoiding double taxation: (1) taxation based entirely on source (with residual residence–based taxation); (2) taxation based entirely on residence; (3) formulary allocation; and (4) taxation

The LN held technical meetings in Geneva in 1925, 1927 and 1928 to transform the 1923 Economists' Report proposal into draft model conventions. In 1927, the LN first introduced the single entity approach (SEA) or orphan theory for the international taxation of MNEs in its Draft of a Bilateral Convention for the Prevention of Double Taxation in 1927.[55]

According to the SEA, each unit of an MNE, like a subsidiary, should in principle be deemed to be a single (orphan) entity and income should be allocated to it according to accounting standards (separate accounting principle).

Interestingly, the 1927 version of the SEA and SAP did not include the ALP (pure SEA). The 1927 LN pure SEA aimed at dealing with the TP problem between, *inter alia*, subsidiaries of the same corporate group. Article 5 provided the following:

> […] In the **absence of accounts** showing [the] 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**.[56]

Article 5 shows that the 1927 allocation norm was implemented by applying the separate entity approach based only on the accounts of the entities. The ALP did not exist in the 1927 version of Article 5. Moreover, Article 5 included an *ex-post* procedural regulation, as defined in section 2.1 above, as default to solve income allocation disputes. Indeed, the need for negotiations between the contracting states was the default provision if proper accounts were not available ("the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment").[57]

The pure SEA did not deter tax planning schemes based on TP, as shown in the first intercontinental TP dispute in the world. The dispute involved the Vestey Brothers Group (Vestey Group), the then largest UK MNE in the

based on source or residence, depending on the type of income. The report rejected the first option, considered the second as an ideal unlikely to be realized and opted for the fourth, possibly modified by the third, as the most practical option.); *see also infra* App'x A, stage 5.

[55] Several scholars distinguish the terms "orphan approach" from the "family approach" in TP literature. The orphan approach refers to the separate entity and arm's length principles (*see infra* App'x B, stage 12) that predicate that the different units of an MNE should be deemed as separate entities (orphans) if intrafirm transactions are consistent with comparables (i.e., the ALP). Conversely, the family approach denotes a view according to which MNEs should be considered as single taxpayers (a family) and the tax base should be allocated to the relevant jurisdictions on the basis of elements different from comparables. The location–specific concept is closer to the family approach than the orphan approach). *See*, for example, J. Li & S. Ji, *Location–Specific Advantages: A Rising Disruptive Factor in Transfer Pricing*, 71 BULL. INT'L TAX'N 5, 259 (2017) (using the term "orphan" to describe the OECD approach to the ALP and the term "identical twins" to discuss how the comparability approach is applied).

[56] *Report Presented by the Comm. of Technical Experts on Double Tax'n and Tax Evasion*, League of Nations Doc. C.216.M.85 1927 II, at 15 (1927) [hereinafter *LN Draft Model*] (emphasis added).

[57] *See infra* App'x A, stage 6.

global food industry, with operations in 50 countries.[58] The Vestey Group had decided to move its ultimate holding company from London to Buenos Aires in 1915 to create a favorable tax position and, in turn, remain competitive against its U.S. rivals.[59]

The strategic decision by the Vestey Group to move its holding company to Buenos Aires, based on what appeared to be largely tax considerations, triggered, *inter alia*, a debate in the Royal Commission on Income Tax in 1920 (*Vestey* case I).

The controlling shareholder, Sir William Vestey, in his presentation before the Royal Commission on Income Tax, exposed the fundamental problem of the allocation of the profits of associated enterprises, stating as follows:

> In a business of this nature you can't say how much is made in one country and how much is made in another. You kill an animal and the product of that animal is sold in fifty different countries. You cannot say how much is made in England and how much abroad.[60]

Probably as a consequence of the *Vestey* case I, the LN's 1927 reference to accounts as the primary source for solving the TP problem was deleted in 1928.[61] Indeed, the LN suggested a standard–based regulation to the TP problem in 1928 that was an *ex-post* procedural regulation only: a case–by–case negotiation between the competent authorities. Article 5 of the LN Draft Model (1928) reads as follows:

> […] Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. **The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment** […].[62]

The 1927/28 LN Draft Models represent a high point in the rise of the first era. Indeed, the drafts introduced a standard–based legal system based on a constellation of *ex-post* procedural regulations for income allocation purposes: the SEA backed up by *ex-post*, case–by–case negotiations between contracting states.

An analysis of the strategic interaction between the U.K. and the LN during the first era is relevant here given the then global soft power of the

---

[58] *See infra* App'x A, stage 3.

[59] *See* Evidence of Sir William Vestey, given 31 July 1919 to the Royal Commission on the Income Tax, para. 9501 (1920), www.kessler.co.uk/wp-content/uploads/2013/07/Vestey_Royal_Commission_evidence_and_ensuing_debate.pdf (transcribing questioning of Sir William Vestey: [Question] "*Can you leave all your profits for an indefinite period, say, in Argentina, for all time, to escape taxation either in America or in this country [the United Kingdom]?*" [Response by Sir William Vestey] *"Why not?"*).

[60] *Id.*, para. 9160.

[61] *See infra* App'x A, stage 7.

[62] *LN Draft Model*, *supra* note 56, at 2 (emphasis added).

British Empire. International double taxation was not an issue for the U.K. before WWI. Tax rates everywhere had increased substantially during WWI and were set to stay at a much higher level than before the war. As Sir Josiah Stamp, a prominent British economist, said in 1921:

> [double] taxation is now rapidly developing from a merely unpleasant incident into a dominating feature of daily life, and those features which hitherto have been of little interest, because they have been too small to matter, now become of great importance […].[63]

The LN appointed Sir Josiah Stamp as one of the four economists to study the problem of double taxation internationally and present before it in 1923.[64] Interestingly, Stamp suggested a rule for solving the double taxation problem outside the British Empire. Indeed, Stamp maintained that the best available method for solving the double taxation problem was exclusive residence jurisdiction, i.e., no source taxation.[65]

Likely because of self-interest internationally, the U.K argued strongly before the LN against any source taxation on cross–border income. The argument was that being a capital exporting country, if the U.K. had to give credit for foreign source tax it would lose more tax by giving credit than it would have collected as a source country from non-residents.[66]

The LN held technical meetings in Geneva to transform the 1923 Economists' Report proposal into draft model conventions. Sir Josiah Stamp and Sir Percy Thompson, on one side, and Professor Thomas Adams and Mitchell Carroll, on the other, represented the opposing views of the U.K. and the U.S., respectively, on how to mitigate the international double taxation problem.[67]

Sir Percy Thomson, the tax official representing the U.K. in these crucial meetings, maintained the U.K. pure rule approach for solving the double taxation problem that Sir Josiah Stamp had already suggested in 1923: no source taxation. However, the LN rejected the U.K. approach as most European countries taxed cross–border income on a source basis and the U.S., represented by Professor Adams, was in favor of source taxation and the foreign tax credit system.

---

[63] SIR JOSIAH STAMP, THE FUNDAMENTAL PRINCIPLES OF TAXATION IN THE LIGHT OF MODERN DEVELOPMENTS 1–2 (London, MacMillan and Co. 1921).

[64] John F. Avery Jones, *Sir Josiah Stamp and Double Income Tax, in* 6 STUDIES IN THE HISTORY OF TAX LAW 7 (John Tiley ed., 2013).

[65] The British Empire (BE) dealt with the problem of international double taxation within the Empire as follows. From the introduction of Addington's income in 1802 until 1916, the deduction system was the only relief available. From 1916 to 1920, a limited foreign tax credit (FTC) was introduced for the BE only on a temporary basis. The FTC became permanent in 1920 in the BE and remained in force until 1945, when the UK concluded its first comprehensive tax treaty with the US, extending the FTC system beyond the BE for the first time. JOGARAJAN, *supra* note 4, at 178, 180.

[66] Avery Jones, *supra* note 64, at 11.

[67] *See* JOGARAJAN, *supra* note 4, at 170, 173, 177, 178.

The U.K. failed to persuade any country, except the Irish Free State (IFS), to use the exclusive residence jurisdiction rule for solving the double taxation problem.[68] Indeed, the no–source taxation rule was only introduced in the tax treaty signed by the IFS and the U.K. in 1926.[69]

The U.K. failure was correlated with the then ongoing global power shift from the U.K. to the U.S. in the 1930s. Hence, the U.K. attempt to introduce a rule–based regulation did not distort the standard–based character of the first era (1908-1933) because the U.K. proposal was not accepted by the LN.

2. The Decline of the First Era (1928-1932)

The *Vestey* case I that emerged in the U.K. in 1920 had intercontinental ramifications. The *Vestey* case II arose in Argentina in 1932.[70] It showed the fundamental problems inherent in a standard–based legal system grounded on a regulation based on the 1927 LN pure SEA when dealing with TP abuses. This scheme created double non-taxation opportunities in Argentina and the U.K.

The facts of the Vestey case II case are as follows. La Anglo was the name of the U.K. Vestey Group Argentine subsidiary:

> [Certain Argentine] *companies avoid paying* [Argentine] *income taxes on the grounds that they are manufacturing agencies that transfer their products at cost to their overseas holding companies. This includes La Anglo Company* [a subsidiary of the Vestey Group, whose holding company moved back to the U.K. after WWI]. *The meatpacker La Anglo pretends to be a manufacturing company* [in Argentina] *working at cost for a third entity based overseas* [in Switzerland]. *In fact, that manufacturing company does not exist and the profits are hidden. In Argentina, La Anglo maintains that its profits are taxed in England, and in England, Lord Vestey* [La Anglo's controlling shareholder] *claims that those profits are taxed in Argentina. Thus,* [La Anglo] *avoids paying income taxes in either country*.[71]

The Vestey I and Vestey II cases in the U.K. and Argentina, respectively, show the problem of aggressive corporate tax planning by MNEs during the first era. These tax planning techniques were facilitated by the standard–

[68] Avery Jones, *supra* note 64. "The agreement with the Irish Free State of 1926 (to which legislative effect was given by FA 1926, Sch 2, para 8) charged tax in the residence state only, which may have been due to the superior bargaining power of the UK. The UK never managed to achieve this result with any other country." *Id* at 11 n.56.

[69] *See supra* Section III.A.1. *See also* John F. Avery Jones, *The History of the United Kingdom's First Comprehensive Double Taxation Agreement*, *in* 3 STUDIES IN THE HISTORY OF TAX LAW 241–92 (John Tiley ed., 2009).

[70] *See infra* App'x A, stage 10.

[71] *Diario de Sesiones de la Cámara de Senadores de la Nación*, Período Ordinario, 1, 201 and 250 (1935)).

based regulatory ecosystem: the separate entity approach based on the separate accounting principle. This explains the LN's concern with tax evasion and the need to search for a rule–based legal system in the transfer pricing arena.

3. The Collapse of the First Era (1932–1933)

The first tax treaty in the world incorporating the ALP was signed between France and the U.S. in 1932.[72] This provision was designed to resolve a dispute between the two countries that arose due to an accusation by the French tax authorities that U.S. parent companies had systematically overcharged French subsidiaries, causing artificial income shifting to the U.S.[73] The relevant article provided the following:

> 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.
> The same principle applies mutatis mutandis, in the event that profits are diverted from an American enterprise to a French enterprise.[74]

Carroll described the original intent of this tax treaty provision encapsulating the ALP as follows:

> As the French were apprehensive about their ability to recapture any profit diverted from the French subsidiary to the American parent corporation, we agreed to incorporate in the treaty for bilateral application the well-known section 45 (now section 482 of the US Internal Revenue Code), which authorized the tax authorities to relocate income as if transactions had been effected on an arm's length basis.[75]

---

[72] *See infra* App'x A, stage 11.

[73] CARROLL, *supra* note 48, at 29.

[74] Convention and Protocol Between the United States of America and France, Fr.-U.S., April 27, 1932, *reprinted in* 2 U.S. Dep't of State, Pub. 3011, Foreign Relations of the United States Diplomatic Papers 1932, at 270 (1947), https://history.state.gov/historicaldocuments/frus1932v02/d187.

[75] *See* CARROLL, *supra* note 48, at 40.

The collapse of the first standard–based era shows two distinctive features of the allocation norm. First, France and the U.S. played key roles in the invention and first design of regulations that are predecessors of what is now article 9 of the OECD Model. For example, article IV of the France–U.S. Tax Treaty (1932) is a direct predecessor of article 9(1) of the OECD Model, given the similar wording of both provisions. Second, the France–U.S. Tax Treaty (1932) signals the fall of the first standard–based era of the allocation norm and the emergence of a second rule–based era grounded on the ALP.

### *B. The Second Era: A Structural Analysis (1933-2015)*

The second rule–based era (the second era) lasted 82 years. It began in 1933 with the publication of the LN Carroll Report, which shows the nascent influence of the U.S. in global tax policy making. The second rule–based era ended in 2015 with the publication of the OECD/G20 BEPS Reports in the context of an emerging power shift from the West to Asian countries, particularly China and India.

The second era began in a turbulent global context, including WWII. It then experienced consistent geopolitical stability and economic growth under the third globalization boom (the UN system) until 2015.[76] The second era consisted of 43 stages as shown in Figure 2 below.[77]

---

[76] *See supra* Section III.A.

[77] *See infra* App'x B (offering a stage–by–stage analysis of the second era (1933-2015)).

Figure 2 The Allocation Norm: The Second Era 1933-2015

1. The Rise of the Second Era (1933-1963)

The US was never a member of the LN. However, the LN appointed Mitchell B. Carroll, a prominent U.S. lawyer, to write a report on the problem of income allocation and to propose a solution that could be applied worldwide. This appointment, sponsored by Professor Adams from Yale University, suggests the rising influence of the U.S. in international tax policy since the 1930s.

The Carroll Report proposed using the SEA *and* the ALP as the allocation norm for addressing TP issues between associated enterprises.[78] The Carroll Report recommended the ALP as the best available allocation norm to solve what Carroll considered the central issue of profit allocation, namely the problem of profit shifting based on TP abuse as seen in cases like Vestey I in the U.K.[79] and Vestey II in Argentina.[80] The Carroll Report stated the following:

> [A]s the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates **all problems of allocation**, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities [the SEA]; and if 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 [the ALP].[81]

This paragraph shows that the Carroll Report assumed that the ALP would be a rule–based legal system, as defined in section II.A. above, based on the understanding that comparable transactions would always be available. Indeed, the report stated that the ALP obviated *all* problems of allocation. So presumably the ALP was largely a self-enforcing regulation by 1933.[82] As Thomas Rixen argues, the ALP was perceived as a solution capable of de-politicizing the income allocation problem.[83] The ALP was then incorporated into article 5 of the LN Draft Model (1933).[84]

In 1963, the ALP was subsequently crystallized as article 9 of the OECD Draft Model. The Commentary on Article 9 of the OECD Draft Model (1963) is one paragraph long, also suggesting the largely self-enforcing character of the ALP by 1963.[85] It states:

> This Article [9] deals with associated enterprises (parent and subsidiary companies and companies under common control) and provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the

---

[78] *See infra* App'x B, stage 12.

[79] *See supra* Section III.A.1.

[80] *See supra* Section III.A.2.

[81] CARROLL, *supra* note 41, at 177 (emphasis added).

[82] *See infra* Section IV.B.

[83] SOL PICCIOTTO, INTERNATIONAL BUSINESS TAXATION 172 (1992)*; see also* Thomas Rixen, *From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance*, 18 REV. INT'L POL. ECON. 197, 212 (2011).

[84] *See infra* App'x B, stage 12.

[85] *See infra* App'x B, stage 18.

> enterprises if 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. 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.[86]

In sum, the ALP was largely a rule–based regulation during its first 30 years: from 1933 to 1963. Indeed, both the 1933 Carroll Report to the League of Nations and the 1963 OECD Model commentary to Article 9 assumed that the ALP had an *ex-ante* meaning.[87]

2. The Decline of the Second Era (1963-2010)

The decline of the second era (the decline era) lasted for almost half a century (47 years), from 1963 to 2010. It kicked off with the first major technological innovation shock to the ALP: the emergence of the international trade of intangibles. The 1963 U.S. case of *Nestle* is a telling example. The decline era lasted until a point in time in which MNEs presumably had substantial influence on the evolution of the OECD Model: the unjustified recommendation to limit the anti-avoidance role of the ALP as crystallized in the 2010 version of the OECD Guidelines.

The context of the decline era was grounded on the third globalization boom, based on the Bretton Woods rule–based framework, which fostered geopolitical stability and global growth during most of this period.[88] China joined the ITR in 1983 when it signed its first tax treaty with Japan, granting further global influence to the OECD Model.[89] The end of the decline era correlated with the Great Recession emerging during the late 2000s and early 2010s, and public outrage over corporate tax planning.[90]

The U.S. managed to adapt the ALP principle to technological innovation via U.S. case law and regulations. These U.S. adaptations were swiftly transplanted to the OECD model and from the OECD model to the

[86] Org. for Econ. Co-operation & Dev. [OECD], *Draft Double Taxation Convention on Income and Capital*, OECD Doc. No. C(63)87, at 93 (1963), https://www.oecd-ilibrary.org/taxation/draft-double-taxation-convention-on-income-and-capital_9789264073241-en. (emphasis added).

[87] *See infra* Section IV.B.

[88] Wolf, *supra* note 17.

[89] Toshio Miyatake, *Transfer Pricing Disputes in Japan*, *in* RESOLVING TRANSFER PRICING DISPUTES: A GLOBAL ANALYSIS (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[90] *See infra* App'x B, stage 49.

rest of the world.[91] China never openly challenged the U.S.'s leading role in international tax policy during the decline of the second era.

*The Nestle Company, Inc. v. Commissioner*, decided in the U.S. in 1963, is the world's first TP dispute regarding intangibles for which no comparable was available.[92] *Nestle* involved the payment of royalties in return for patents and the valuation of those patents. The Tax Court analyzed the royalty rate for a valuable intangible, including a renegotiation of the rate to reflect profitability.[93]

The *Nestle* case, decided in the very same year in which the OECD introduced the OECD Draft Convention, signals the beginning of the decline of the ALP (i.e., as a self-enforcing rule). Indeed, intangibles emerged from 1963 onwards as the Achilles' heel of the ALP because of the increasing unavailability of comparables.

The *Nestle* decision created the commensurate–with–income (CWI) standard, which would become a crucial valuation method for intangibles worldwide.[94] Indeed, the CWI standard was first transplanted from the *Nestle* case to the 1986 U.S. tax reform and the regulations of IRC article 482,[95] and then from U.S. domestic law to the 1995,[96] 2009,[97] 2010[98] and 2017[99] OECD TPG versions.

*a. The U.S. Role in Adapting the ALP to Technological Innovation*

The OECD published its Transfer Pricing Report in 1979. In it, the OECD acknowledged for the first time that the application of the ALP is often complex and difficult, and the report represented an attempt to deal with these issues.[100] It endorsed the ALP as the main allocation norm regarding the profits of associated enterprises. The report also embedded a number of standards (particularly three TP methods) to the ALP rule because "the need now is to develop practical means of applying one [common approach]." The three TP methods are: (i) the comparable uncontrolled price method; (ii) the

---

91 *See infra* Section IV.A.3.

92 Nestle Company, Inc. v. Commissioner, 22 T.C.M. (CCH) 46 (1963).

93 *See infra* App'x B, stage 19.

94 *Id.* The phrase "commensurate–with–income" derives from *Nestle*, 22 T.C.M. (CCH), in which the U.S. Tax Court sanctioned a taxpayer's post-agreement increase in royalties paid by an affiliate for a very profitable intangible license. The opinion states that, "[s]o long as the amount of the royalty paid was commensurate with the value of the benefits received and was reasonable, we would not be inclined to, nor do we think we would be justified to, conclude that the increased royalty was something other than what it purported to be." *Nestle*, 22 T.C.M. (CCH). *See also* I.R.S. Notice 88-123, 1988-2 C.B. 458 [hereinafter *U.S. White Paper*].

95 *See infra* App'x B, stage 27.

96 *See infra* App'x B, stage 35.

97 *See infra* App'x B, stage 43.

98 *See infra* App'x B, stage 45.

99 *See infra* App'x B, stage 56.

100 *See infra* App'x B, stage 23.

resale price method; and (iii) the cost–plus method.[101] The three methods were transplanted from U.S. domestic law.[102]

Interestingly, the OECD Transfer Pricing Report (1979) emphasized the dual purpose of the ALP. First, it served as a mechanism to protect taxpayers from economic double taxation ("enabling the double taxation of the enterprises involved to be prevented").[103] Second, it aimed to protect the corporate tax base from base erosion and profit shifting caused by TP abuse ("with the objective [...] of enabling the interest of the national authorities involved to be protected").[104] Finally, the 1979 report claimed for the first time the global scope of this soft law when it refers to developed and developing countries.

In 1986, the Reagan administration was concerned with the unsatisfactory application of the ALP regarding the TP of intangible property, given the increasing shortage of comparables. The Tax Reform Act of 1986 amended section 482 of the IRC by providing that any income from a transfer or license of intangible property must be commensurate with the income attributable to the intangible.[105] The CWI standard would be implemented by introducing amendments to the IRC section 482 regulations.[106]

The language contained in legislative history for the 1986 U.S. Congress advocated the abandonment of the ALP.[107] Thus, the 1986 tax reform triggered strategic interactions between the U.S. and the OECD to adapt the ALP to technological innovation. This interaction ran from the 1986 tax reform in the U.S. to the publication of the 1995 OECD TPG, which replaced the 1979 *OECD Transfer Pricing Report*.

It is noteworthy that the 1979 and 1995 OECD TP reports were structured very similarly to the IRC section 482 regulations of 1968 and 1994, respectively, addressing the same issues and reaching the same conclusions in most instances. The convergence of the OECD reports and the IRC section 482 regulations is not a coincidence. Rather, it is the consequence of long–standing U.S. tax policy to export section 482

---

[101] *See infra* App'x B, stage 23.

[102] *See* Reuven Avi Yonah, *Transfer Pricing Disputes in the United States*, *in* RESOLVING TRANSFER PRICING DISPUTES: A GLOBAL ANALYSIS, *supra* note 89.

[103] Org. for Econ. Co-operation & Dev. [OECD], Transfer Pricing and Multinational Enterprises, ¶ 6 at 10 (1979) https://doi.org/10.1787/9789264167773-en. See infra App'x B, stage 23.

[104] *Id.*

[105] *See infra* App'x B, stage 35; *U.S. White Paper, supra* note 94, at 458.

[106] Org. for Econ. Co-Operation & Dev. [OECD] Comm. on Fiscal Affs., *Intercompany Transfer Pricing Regulations Under U.S. Section 482 Temporary and Proposed Regulations*, OCDE/GD(93)131 (1993).

[107] Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation* (Univ. Mich. L. Sch., Pub. L. & Legal Theory Working Paper No. 92, John M. Olin Ctr. L. & Econ. Working Paper No. 07-17, 2007), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1074&context=law_econ_archive.

regulations to OECD countries and beyond, via the OECD model, with a view to creating international consensus on the application of the ALP.[108]

The OECD accepted the new U.S. approach to intangibles (the CWI standard) as a valuation method compatible with the ALP.[109] The OECD decided to consider the introduction of the CWI standard in the revision of the *1979 OECD Transfer Pricing Report*, which would subsequently be implemented in the 1995 OECD TPG.

Interestingly, the OECD Task Force "also recommended that the [U.S.] Temporary Regulations not to be finalized before [the OECD] completes the review of the OECD 1979 Report."[110] Nonetheless, the U.S. decided not to follow the OECD recommendation on the timing of this reform and the final U.S. Regulations were issued before the publication of the 1995 OECD TPG.

The most relevant novelty of the final U.S. Regulations is the introduction of the CWI concept and the elevation of profit split to a status equivalent to all other methods in order to reach an arm's length result.[111] These innovations aimed at adapting the ALP to intangibles by means of standard–based *ex-post* procedural regulations. This dynamic suggests that the U.S. remained strong enough throughout the second era in the OECD world and beyond to lead in driving the evolution of the ALP, as encapsulated in article 9 of the OECD Model, in pursuit of dealing with technological innovations.

The central innovation of the 1995 version of the OECD Guidelines was twofold. First, the creation of two additional TP methods: the profit split method and the transactional net margin method; and second, a section on procedural fairness in TP disputes. These two innovations were the product of the increasing difficulties of applying the ALP, particularly when no comparables are available, and the consequent expansion in the volume of TP disputes.[112]

In 2000, the OECD openly acknowledged substantial difficulties in applying article 9 of the OECD Model. Indeed, the deeply rooted OECD phrasing, according to which "[Article 9(1)] seems to call for very little comment," which was introduced in 1963 and repeated in 1977 and 1992, was replaced in 2000 by the Committee's telling words above regarding the "considerable time and effort" it had spent on examining various issues surrounding article 9 of the OECD Model and its application.[113]

---

[108] *See* JENS WITTENDORFF, TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE IN INTERNATIONAL TAX LAW 38 (2010) (quoting Stanley S. Surrey, *Secretary Surrey Reports on Developments in Treasury's Foreign Tax Position*, 24 J. TAX'N 54 (1966)) ("The United States believes that the OECD Fiscal Committee is the proper body to undertake the task of establishing the allocation standards to guide countries in reaching accommodations with each other […].").

[109] *See infra* App'x B, stage 33.

[110] *Id.*

[111] *See infra* App'x B, stage 34.

[112] *See infra* App'x B, stage 35.

[113] *See infra* App'x B, stage 38.

*b. China's and India's Role in the Decline of the Second Era*

There is no evidence in the UN Model, first launched in 1980, of any attempt from the emerging and developing world to create a legal technology incompatible with the OECD Model. The BRICS countries played a minor role in the drafting of the UN Model (1980). For instance, neither China nor Russia took part in its drafting as they had yet to join the global economy.

In sum, the creeping addition of at least five standards to the ALP effectively transformed this principle into a standard–based regulation over a period of almost half of a century. Indeed, the Transfer Pricing Report (1979) recommended embedding three standards into the ALP rule to deal with problems in its application: (i) the comparable uncontrolled price method; (ii) the resale price method; and (iii) the cost-plus method.[114] The transactional net margin method and the transactional profit split method were additional standards suggested in the 1995 OECD TPG (the five TP methods).[115] Moreover, the OECD focused on offering an increasing number of *ex-post* procedural regulations such as MAPs and arbitration. This dynamic shows the decline of the second era. The ALP evolved towards the pure standard end of the regulatory spectrum; that is, from being a regulation close to Pattern #1 (pure rule) in the early 1930s to becoming a regulation close to Pattern #4 (a number of standards embedded into a rule) since the leading case *Nestle* in 1963.

3. The Collapse of the Second Era (2010-2015)

The collapse of the second era, in turn, can be inferred from at least three consecutive events. The first such event was the publication of the 2010 OECD TPG (2010), which substantially narrowed the anti-avoidance role of the ALP without offering a justification. It stated the following:

> Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.[116]

The second event was the rise of public outrage over aggressive corporate tax planning schemes in the wake of the 2008 global financial crisis, as in the Starbucks and Apple revelations in the U.K. and Ireland, respectively.[117] This mirrored the public outrage that ensued after data leaks

---

[114] *See infra* App'x B, stage 23.

[115] *See infra* App'x B, stages 34, 35.

[116] *Infra* App'x B, stage 45.

[117] *See generally infra* App'x B, stage 49.

surfaced revealing the secret offshore holdings of high–net–worth individuals and multinational taxpayers.[118]

Finally, the third event was the publication in 2013 of the UN Practical Manual on Transfer Pricing for Developing Countries (UN Transfer Pricing Manual),[119] in which the BRICS countries suggested that they were no longer willing to fully follow the OECD TPG.[120] For example, according to China, profit allocation should be grounded on a contribution analysis, rather than a transactional or profit–based approach.[121] China concluded as follows to challenge the separate entity approach: "a global formulary approach should be a realistic and appropriate option."[122]

In sum, 82 years elapsed in the second (rule–based) era, running from 1933 to 2015 and divided into 42 stages, represented as stages 12-54 in Figure 2 above. These 42 stages comprise the rise (stages 12-19), decline (stages 20-44) and fall (stages 45-54) of the second era. The central driving forces of the rise and fall of the second era include the emergence of the U.S. as a global power in the 1930s and the rise of technological innovation in the 1960s, which made it increasingly hard to find comparable transactions.

### *C. The Third Era: A Structural Analysis (2015-2019)*

The third, standard–based, era runs from 2015 to the present (the third era). It kicked off with the publication in 2015 of the OECD/G20 BEPS Reports offering a new version of the ALP as a standard–based legal system.

The context of the third era of the ITR is a period in–between the demise of the third globalization grounded on the UN system (1945-2015) and the emergence of a still elusive fourth globalization. So the current period has some usual features of the times in–between two globalizations: geopolitical disruptions, anti-globalization backlashes and nationalism.

---

[118] Shu-Yi Oei & Diane M. Ring, *Leak-Driven Law*, 65 UCLA L. REV. 532 (2018).

[119] *See* U.N. Dep't Econ. & Soc. Affs., *Practical Manual on Transfer Pricing for Developing Countries*, D.2 (2017), www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf [hereinafter *U.N. Transfer Pricing Manual*].

[120] *See infra* App'x C, stage 61.

[121] *Id.*

[122] *See infra* App'x B, stage 50.

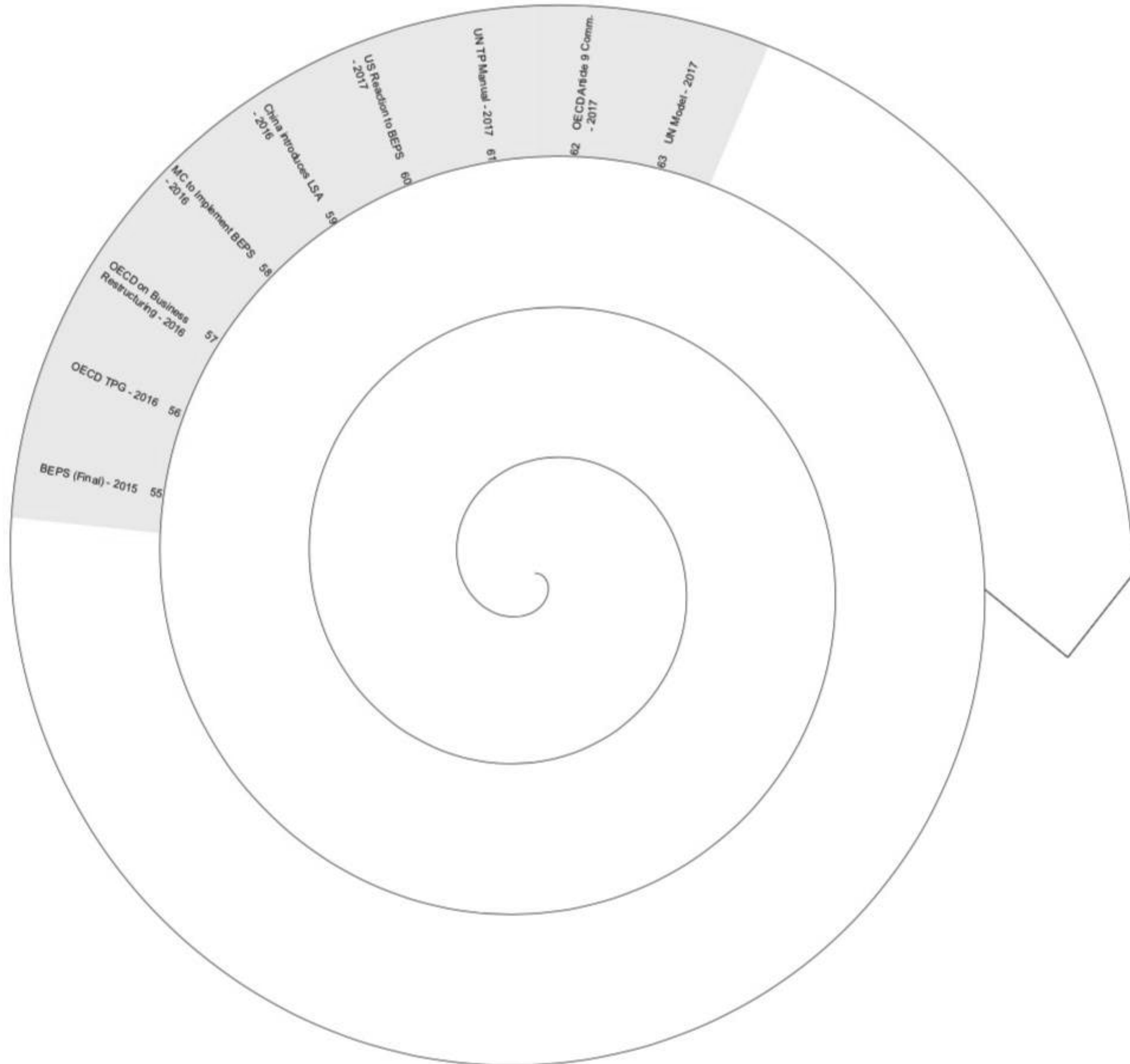


Figure 3 The Allocation Norm: The Third Era 2015-Present

1. Rise of the Third Era: 2015 to the Present

The emerging power shift from the U.S. to Asia that has triggered the third era of the allocation norm implies a return to the standard–based approach, with certain similarities to that of the first era (*see* section III.A). China and India may have an increasingly relevant role in the third era, in relation to the E.U. and the U.S. Moreover, just as the U.S. has been using the OECD Guidelines to export IRC section 482 regulations to the OECD

Model and beyond as of 1979,[123] China and India now seem to be willing to use the UN Transfer Pricing Manual to export Chinese and Indian domestic law on TP to the UN Model and beyond as of 2012.[124]

The tax planning schemes of the largest technology corporations—such as Apple, Microsoft and Google—began to be exposed, particularly as of 2012.[125] This has triggered a strained environment among the U.S., the E.U. and the BRICS countries regarding international taxation and the ways in which MNEs should be taxed.[126]

Four years (2015-2019) have elapsed in the third era, which is divided into nine stages, represented as stages 55-63 in Figure 3 above. These nine stages comprise the rise (stage 55-present) of the third era starting with the publication of the BEPS Reports in 2015.[127]

A number of elements, including technological innovation, the financial crisis of 2008, the Great Recession that followed and high profile TP disputes such as the 2009 *Starbucks* case in the U.K., have ultimately triggered the first structural crisis of the ITR since the 1920s.[128] The G20 and OECD decided in 2013 to work together for the first time to search for solutions.[129] This multilateral effort has produced the *2015 BEPS Reports*.[130]

It is assumed here that the BEPS Reports are designed, in part, to try to bring the BRICS countries, particularly China and India, into the OECD tent and to minimize regulatory divergence between the E.U. and the U.S. On the other hand, the BEPS Project is divorced from the priorities of the BRICS countries. The digital PE has been deferred to 2020[131] and there is a big focus on arbitration, which is an area none of the BRICS countries support. BEPS also serves a political purpose for certain countries (as in the case of the

---

[123] S*ee infra* App'x B, stage 23.

[124] S*ee infra* App'x B, stage 50.

[125] *See infra* App'x B, stage 49.

[126] *Id.*

[127] *See infra* App'x C, stages 55–63.

[128] *See* European Commission Press Release IP/16/2923*, State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth up to €13 Billion* (Aug. 30, 2016), https://ec.europa.eu/commission/presscorner/detail/en/IP_16_2923.

[129] *See* Pascal Saint-Amans & Raffaele Russo, *What the BEPS Are We Talking About?*, OECD FORUM (2013), http://www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.

[130] *See* Org. for. Econ. Co-operation & Dev. [OECD], *OECD/G20 Base Erosion and Profit Shifting Project: Explanatory Statement, 2015 Final Reports*, para. 1 (2015), https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf. *See also* Richard Vann, *The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?*, 62 CANADIAN TAX J. 433 (2014); Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185 (2016); RICHARD S. COLLIER & JOSEPH L. ANDRUS, TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE AFTER BEPS (Oxford University Press, 2017).

[131] Org. for Econ. Co-operation & Dev. [OECD], *OECD/G20 Inclusive Framework on BEPS: Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, Inclusive Framework on BEPS* (May 2019), http://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

U.K.), which is to respond to the growing detachment of OECD legal technology from popular consent.[132]

Four out of fifteen Action Plans crystallized in the *BEPS Reports* are focused on TP, given its potential for facilitating profit shifting. The mission of the recommendations on TP (Action 8, Action 9, Action 10 and Action 13) is to ensure that TP outcomes are in line with a new concept without an *ex-ante* meaning: value creation (the value creation standard).[133] Hence, the BEPS Reports state that article 9 of the OECD Model should be enforced in the light of the value creation principle. Strikingly, it is not clear how the value creation standard, created by the BEPS Reports in 2015, should interact with the two principles created by the 1928 LN Draft Model Convention: the benefit principle and the single tax principle.[134]

As the approach of Actions 8-10 is inevitably subjective (standard–based) rather than objective (rule–based), the net effect on attributing the tax base of MNEs will rely on how MNEs and tax authorities bargain and negotiate. Either under–taxation or over–taxation will likely arise from this strategic game. To avoid under–taxation, tax authorities may tend to maximize their discretionary power to recharacterize transactions, which may lead to strong opposition from MNEs. For similar reasons, to avoid over–taxation, MNEs may upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will probably increase and more tax disputes will likely be created.[135] Moreover, as subjective judgment will be made independently and separately by different national authorities, different jurisdictions might reach conflicting recharacterization conclusions for the same intra-group transaction.[136] The OECD Guidelines (2017) now acknowledge the standard–based character of the ALP as shown in section IV.B below.

Moreover, the OECD Guidelines (2017) recommend a range of alternative *ex-post* procedural regulations for the resolution of disputes. These are: (i) simultaneous tax examinations;[137] (ii) corresponding adjustment; (iii) the mutual agreement procedure;[138] and (iv) arbitration.[139]

The incorporation of supplementary dispute resolution mechanisms introduces the possibility of non-legal actors being introduced into the fray,

---

[132] S*ee infra* App'x B, stage 49.

[133] Allison Christians & Laurens van Apeldoorn, *Taxing Income Where Value Is Created*, 22 FLA. TAX REV. 1, 1 (2018).

[134] *See* Richard S. Collier & Joseph L. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS, Ch. 7 (Oxford University Press, 2017). *See also* Reuven S. Avi-Yonah, *International Tax as International Law* (Univ. Mich., Pub. L. & Legal Theory Rsch. Paper No. 41, John M. Olin Ctr. L. & Econ. Rsch. Paper No. 04-007, Mar. 2004), https://ssrn.com/abstract=516382 or http://dx.doi.org/10.2139/ssrn.516382.

[135] *See* Baistrocchi, *supra* note 3 ch. 3–20.

[136] *See* Avi-Yonah & Xu, *supra* note 130, at 7.

[137] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 4.79 (July 2017), https://doi.org/10.1787/tpg-2017-en.

[138] *Id.*, ch. IV, sec. C.

[139] *Id.*, ch. IV, sec. G.

presenting the challenge of integrating these non-legal disciplines with legal frameworks.[140] The U.S. *Veritas*[141] and *Amazon*[142]cases demonstrate the incorporation of economic knowledge into legal determinations and the legitimate disagreements that can arise between qualified experts. In *Amazon*, 30 experts from a range of disciplines were appointed by the court to determine the appropriate TP treatment of a "buy–in payment" made by a subsidiary to its parent in return for intangible assets, which were in turn also the subject of a cost sharing agreement between those associated enterprises. So determining the *ex-ante* ALP meaning has gradually become an unfeasible task. Moreover, the body of transfer pricing case law is normally fact–specific, hence jurisprudence in this area lacks a public good feature.[143]

The OECD suggested that arbitration would be offered only to unresolved issues in a MAP case. The evolution of the OECD's position in the tax arbitration arena is noteworthy over the span of the past 25 years. Its opinion has ranged from considering that tax arbitration would be an unacceptable option in 1982 ("the adoption of such a procedure [tax arbitration] would represent an unacceptable surrender of fiscal sovereignty")[144] to strongly supporting tax arbitration as of 2007.[145]

The CWI test for valuing intangibles was transplanted to the OECD Guidelines in 2017. It shows the vitality of a standard–based regulation created by the U.S. judiciary in 1963.[146] The innovation of the 2017 version of the CWI test is that it now lacks an *ex-ante* meaning. The tax administration is entitled to use the *ex-post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements.[147] This evolution of the CWI test is yet another clear step towards transforming the ALP into a standard–based regulation, indicating the spiral evolution of article 9 of the OECD Model (*see* Figure 4 below).

In November 2016, over 100 jurisdictions concluded negotiations on the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). It aims to implement a series of tax treaty measures to update international tax rules and lessen the opportunity for tax avoidance by multinational enterprises. The MLI entered into force on July 1, 2018.[148]

The MLI aims to create and/or expand a number of *ex-post* procedures to resolve disputes.[149] For example, it aims to expand the scope of article 9(2)

---

[140] *See infra* App'x B, stage 43.

[141] *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009).

[142] *Amazon.com, Inc. v. Commissioner*, 148 T.C. 108, 223–35 (2017).

[143] *See supra* note 38 (discussing the meaning of case law with a public good feature).

[144] S*ee infra* App'x B, stage 26.

[145] *See infra* App'x C, stage 55.

[146] *See supra* Section III.B.2.

[147] *See* OECD, *supra* note 137, ¶ 6.192.

[148] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, OECD, https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm (last visited Oct. 30, 2020).

[149] *See* Org. for Econ. Co-operation & Dev. [OECD], *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, art. 17, paras. 1–3(b) (Nov. 16,

of the OECD Model (the corresponding adjustment) to all covered tax treaties as a mechanism for solving economic double taxation.[150]

The MLI also contemplates an expansive role for MAPs in the area of TP, as well as the introduction of optional tax arbitration for international TP disputes between states.

*LSAs, China and India:* The notion of location specific advantages (LSAs) was adopted out of the frustrations experienced by emerging countries over what they viewed as the unacceptable result of profit allocation when following the pre-BEPS OECD Guidelines.[151] China is a case in point. Under the OECD approach, Chinese subsidiaries of MNEs were treated as single–function, limited–risk entities, which made routine profit margins but failed to receive any share of the residual profits, or the super profit or economic rent of the MNE groups to which they had made significant contributions. What was particularly offensive was that these profits were often ultimately allocated to entities in low-tax jurisdictions.[152] In fact, this frustration has a long history: it first emerged in the context of the *Vestey* case II in 1932[153] and has now expanded to India (in cases such as *Syngenta*).[154] As noted, this is not the only instance of developing countries adopting a heterodox interpretation of the ALP and article 9 of the OECD Model, but it is a paradigmatic case of how far countries are willing to stretch their interpretation of it.[155]

The Chinese view is that a subsidiary should be regarded as part of the MNE "family", thus enjoying the benefits of that family. In addition, under the pre-BEPS OECD Guidelines, any residual profits derived by MNEs generally belong to the legal owner of the relevant intangibles, which can be referred to as the intangible–centric approach. This approach is more "relaxed" under the post-BEPS OECD Guidelines, as it takes into account factors other than the legal ownership of intangibles, but its essence remains. By contrast, the Chinese view is that some of the residual profit arises from taking advantage of LSAs, which, while external in nature, contribute to the creation of value in MNEs in very much the same way as intangibles. Consequently, local Chinese subsidiaries should be allocated a share of the residual profits. In essence, Chinese authorities view the subsidiary as part of the MNE group when taking advantage of LSAs, as opposed to a standalone entity that only performs specific routine functions.[156]

The notion of LSAs has been recognized in TP analysis, especially in China as of 2015, but its scope and relevance remain uncertain. Attributing

2016), https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.

[150] *See infra* App'x C, stage 58.

[151] *See infra* App'x C, stage 59.

[152] *See infra* App'x C, stage 54.

[153] S*ee id.*

[154] *See id.*

[155] Eduardo A. Baistrocchi, *Tax Disputes Under Institutional Instability: Theory and Implications*, 75 MOD. L. REV 547, 552–53 (2012).

[156] *See, e.g.,* J. Li & S. Ji*, supra* note 55, at 259. *See also* U.N. Transfer Pricing Manual*, supra* note 119.

value to LSAs is inconsistent with the SEA and the ALP. It also deviates from the existing OECD approach to interpreting and applying the principle. It is consistent, however, with the direction of the OECD/G20 BEPS initiative in allocating profit of an MNE on the basis of where value is created. Giving value to LSAs reflects a different way of thinking about what contributes to value creation. In the absence of international consensus on what LSAs are and how or how much they contribute to value creation, the profits of MNEs may be allocated among countries in a way that results in over–taxation or under–taxation of MNEs.[157]

The UN released the first post-BEPS version of the UN Model in 2017.[158] Strikingly, the Commentary to Article 9 of the UN Model does not even quote the BEPS Reports on TP. The UN Model omission suggests BRICS disagreement with the work performed by the OECD and the G20 in the TP area. This disagreement was made visible again in the first post-BEPS version of the UN Transfer Pricing Manual published in 2017.[159]

The BEPS Reports seem to have encouraged the BRICS countries, under the leadership of China, to innovate and probably deviate from the OECD legal technology concept in the area of TP. The following paragraphs of the UN Transfer Pricing Manual (2017) suggest this new dynamic in the international tax arena:

> Having the right to speak does not necessarily mean being ready to speak. Getting involved is still a long way from being equipped to lead. It is therefore imperative that the developing countries continue to build capacity in tax administration to enable them to become more prepared to contribute and lead.[160]
>
> [...] China has overcome this challenge [emerging from the ALP application] by using some practical solutions that are sensitive to unique economic and geographical factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods.[161]

---

[157] Avi-Yonah, Reuven S. and Xu, Haiyan*, Evaluating BEPS 41–42,*. U of Mich. Public Law Research Paper No. 493*,* (January 15, 2016) *https://ssrn.com/abstract=2716125*.

[158] *See U.N. Transfer Pricing Manual*, *supra* note 119. *See also infra* App'x C, stage 61; OECD, *supra* note 149.

[159] *See U.N. Transfer Pricing Manual*, *supra* note 119, ¶ B.1.3.11.

[160] *Id.*, ¶ D.2.1.1.

[161] *Id.*, ¶ D.2.5.3.

LSAs seem to be the first standard added by the OECD to the ALP due to the pressure of China and India. This dynamic reinforces the ALP evolution to the standard end of the spectrum.[162]

**Figure 4 The Allocation Norm: A Spiral Evolution 1908-Present**

[162] *See supra* Section II.

## IV. THE SPIRAL EVOLUTION: ANALYSIS AND IMPLICATIONS

This section offers an analysis of the spiral evolution and its implications in the light of the theoretical framework outlined in Section II above. The analysis focuses on two issues: (1) an assessment of the theory against empirical evidence; and (2) the implications of the spiral evolution, using global digital taxation as an example.

### *A. Assessing the Theory against Empirical Evidence*

The history of international taxation outlined in section III suggests that the hegemon normally prefers a rule–based system over a standard–based one given the ITR's decentralized competitive structure.[163] Indeed, the former limits the decentralization of power within the ITR more than the latter does to a growing, decentralized global network of countries.[164]

ITR evolution from 1933 to 1963 is an example of this rule–based ITR preference under the then U.S. hegemony. When external shocks (such as technological and/or regulatory innovation) emerges making the rule–based ITR unworkable, there seems to be no alternative better option for the hegemon than to accept an ITR shift towards the standard–based end of the spectrum, ideally under the hegemon's control. ITR evolution since 1963 to 2015 is an example of the gradual movement towards the standard–based end of the spectrum under U.S. control via the transplant of U.S. domestic law and case law to the OECD Guidelines and their regular updates.[165] The U.S. eventually lost control of ITR evolution since 2015 onwards, which is correlated with the gradual rise of China and the publication of the BEPS Reports (a constellation of standard–based regulations). The value creation principle is an example of this constellation of norms without an ex-*ante* meaning. This pattern of evolution of the ITR legal architecture seems consistent with the hegemon literature.[166]

The hegemon's role in the international tax sphere has been to provide some underlying purpose and coherence, which the U.S. has done from 1933 until 2015 through, for example, its support for the ALP. The hegemon, which is normally the major capital exporter, is really pursuing the interests of the hegemon's capital, and it uses the ideas and the sense of purpose to generate consent for its hegemony. For example, the U.S. has been pursuing the interests of U.S. multinationals in the period running from 1933 to 2015, and the ALP has been a tool through which it persuaded other countries to accept a set of regulations that made it harder for them to tax U.S. capital. For instance, the crucial 1933 Carroll Report to the League of Nations was

---

[163] *See supra* Section II.B (offering definitions and examples of rule-based and standard-based legal systems).

[164] *See supra* Section II.A (describing the impact of the rule and standard spectrum on the distribution of power within a legal system).

[165] *See supra* Section III.B.

[166] *See supra* note 16 (providing examples of the hegemony literature).

funded by the Rockefeller Foundation.[167] The foundation had begun under Standard Oil owner John D. Rockefeller on 1913. Standard Oil was then the largest U.S. MNE. The funding arrangement of the Carroll Report suggests that the interests of the U.S. and U.S. MNEs were aligned when a solution to the problem of the allocation norm was being discussed and agreed at the League of Nations in the early 1930s.[168]

The Carroll Report was criticized for understating the extent to which formula apportionment methods were actually in use — Spain, Switzerland and some U.S. states are cases in point — in order to strengthen the case for the solution that was actually preferred by the U.S.: the arm's length principle.[169] Presumably the U.S. was against the formula apportionment method in 1933 because it would have given a broader taxing jurisdiction than the ALP to the material countries of source.

A new database shows that the U.S. strategy of supporting the ALP at the League of Nations in the 1930s ultimately proved successful for the interest of U.S. MNEs. Indeed, the proportion of tax treaty cases in the G20 won by the taxpayer has steadily increased since the 1940s and has been consistently greater than 50 percent since the 1980s.[170]

#### 1. Why the Evolution Has Been Spiral

There are structural similarities between the first and third eras of the allocation norm regarding the profits of associated enterprises; namely, they both are legal systems that are closer to the standard end, instead of the rule end, of the regulatory spectrum as defined in section II.B above. The central difference is that the standard–based legal system encapsulated in the third era exhibits increasing levels of complexity *vis a vis* the first era consistent with the growing complexity of international trade itself.

Table 3 below offers an example of the growing complexity of standard–based regulations in the ITR. Indeed, the 2016 version of the OECD Multilateral Instrument (MLI) includes a range of ex-post procedural regulations that are functionally similar to article 5 of the LN Draft Model (1928) but more complex. Whereas the 1928 version of the allocation norm

[167] A grant of $ 90,000 was secured by T.S. Adams to assist the Fiscal Committee in its work on double taxation. The plan was for the League of Nations Secretariat to hire some specialist staff to research existing laws, country practices, and accounting methods. The scope of the work was to include an analysis of the methods of separate accounting and fractional apportionment. *See* the 1930 Report to the Council (n. 91), at 7–8; Carroll Report, *supra* note 41, at 570 (https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1177&context=njilb); *David M. Hudson & Daniel C. Turner, International and Interstate Approaches to Taxing Business Income, 6 NW. J. INT'L L. & BUS. 562, 570 (1984–85). See also* COLLIER & ANDRUS, *supra* note 126, § 1.64.

[168] *See supra* Section III.B.1.

[169] Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 632, 634 (Feb. 17, 1986).

[170] *See* Eduardo A. Baistrocchi & Martin Hearson, *Tax Treaty Disputes: A Global Quantitative Analysis*, *in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES 1512, 1529 (Eduardo A. Baistrocchi ed., 2017), https://ssrn.com/abstract=3045917.

consisted of a sentence–long *ex-post* procedural regulation,[171] the 2016 version of the allocation norm provides a constellation of *ex-post* procedural regulations.[172] The two–page article 17 of the MLI, dealing with dispute resolution regarding corresponding adjustments, is a case in point.

TABLE 3: *EX-POST* PROCEDURAL REGULATIONS IN THE FIRST AND SECOND ERAS

| | **1928** | **2016** |
|---|---|---|
| **LN Draft Model, art. 5** | "The competent administrations of the two Contracting States shall come to an [*ex-post*] arrangement as to the basis for [income] apportionment." | |
| **OECD MLI, art. 17(3)(b)(ii)** | | "[I]ts competent authority shall endeavour to resolve the [corresponding adjustment] case under the provisions of a Covered Tax Agreement relating to mutual agreement procedure [governed by article 25 of the OECD Model]." |

The similarities between the 1928 and 2016 standard–based provisions listed in Table 3 above are meaningful. They both are *ex-post* procedural regulations. They can only provide an *ex-post* meaning to the relevant norms, that is, *after*, instead of before, cross–border investment has been made. Greater complexity of the standard–based legal system emerging in the third era as compared with the first era explains why the evolution of the ITR has been spiral rather than circular.

The ITR evolution may be represented through graphical formats different from a spiral. This includes a pendulum and a straight, horizontal line (line). A pendulum swinging from the rule end to the standard end is an appealing option; but it does not reflect the increasing complexity of the third era *vis a vis* the first era. Hence, a pendulum is a model that would over–simplify the ITR evolution.[173] A line would be as good as a spiral in this area; however, the spiral is preferred here because it can crystalize substantial amounts of data in a more concise and aesthetic way than a line.

Hence, the spiral seems to be the best available format to represent the ITR's centennial evolution due to its stronger explanatory power, efficiency

---

[171] *See infra* App'x A, stage 7.

[172] *See infra* App'x B, stage 58.

[173] Compare Adam Watson's "pendulum" model or long–cycle theory. *See* ADAM WATSON, THE EVOLUTION OF INTERNATIONAL SOCIETY (1992).

and aesthetic considerations in relation to a circle, pendulum and straight, horizontal line.

2. The ALP Evolution: From the Rule End Towards the Standard End of the Spectrum

As shown in section III.B above, the ALP has been involved in a creeping evolution since its inception in 1933. From 1933 to 1963, the ALP was a regulation close to the pure rule end of the spectrum; it then gradually moved to the pure standard end since 1963 to 2019, as defined in section II.B above.

The ALP evolution has been correlated with technological innovation, such as the international trade of intangibles seen in disputes like *Nestle* in the U.S. in 1963,[174] *GlaxoSmithKline* in Canada in 2008[175] and *DSG* in the U.K. in 2009.[176] There has been a correlative decision of the U.S., then accepted by the OECD, to increasingly embed a range of standard–based norms into the ALP to adapt it to technological innovation. The five OECD transfer pricing methods introduced in the OECD Guidelines in 1979 and 1995 are a case in point. These OECD standards include the profit split and transactional net margin methods.[177]

The ALP evolution seems to be from the rule end towards the standard end of the spectrum by means of provisions like Pattern #4 regulations, as defined in Section II.B above; that is, a constellation of standards embedded into a rule–based legal system that eventually transforms the system into a standard–based one.[178]

Both the LN and OECD have implicitly acknowledged this ALP evolution. For example, while both international institutions considered the ALP as a concept with an *ex-ante* meaning in 1933[179] and 1963,[180] the OECD considered the ALP as a concept largely without an *ex-ante* meaning by 2017.[181] Table 3 below reflects this ALP creeping evolution during a period of 83 years (1933–2019).

---

[174] *See supra* Section III.B.2.
[175] *See infra* App'x B, stage 42.
[176] *See infra* App'x B, stage 44.
[177] *See infra* App'x B, stages 23, 35.
[178] *See supra* Sections 3.2, 3.3.
[179] *See infra* App'x A, stage 12.
[180] *See infra* App'x B, stage 19.
[181] *See infra* App'x C, stage 56.

TABLE 4: EVOLUTION OF THE ALP FROM THE RULE END TOWARD THE STANDARD END OF THE SPECTRUM

| ***ALP*** | ***Ex-ante Meaning*** | ***No Ex-ante Meaning*** |
|---|---|---|
| **1933** | "[…] the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise **obviates all problems of allocation** […]."[182] | |
| **1963** | "[…] Article [9] seems to call for very little comment."[183] | |
| **2017** | | "[TP] disputes may arise even though the guidance in these Guidelines is followed in a conscientious effort to apply the arm's length principle. It is possible that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases."[184] |

The initial absence of disputes dealing with the meaning of the ALP suggests that the ALP was a largely rule–based regulation from 1933 to 1963. Indeed, the predicated ALP starting point as a rule in the 1930s is grounded on the lack of transfer pricing disputes in the G20 triggered by the lack of comparable transactions until the emergence of the *Nestle* case in the U.S. in 1963.[185]

In sum, there is a striking similarity in the evolution of the ALP from 1933 to 1963 and the Ireland–U.K. test of corporate residence from 1926 to 2017.[186] Both regulations are examples of rules that eventually evolved as standards due to exogenous forces: technological innovation in the ALP

[182] CARROLL, *supra* note 41, at 177 (emphasis added).

[183] Org. for Econ. Co-operation & Dev. [OECD], *Draft Double Taxation Convention on Income and Capital*, OECD Doc. No. C(63)87, at 93 (1963), https://www.oecd-ilibrary.org/taxation/draft-double-taxation-convention-on-income-and-capital_9789264073241-en.

[184] OECD, *supra* note 137, ¶ 4.1.

[185] *See supra* Section III.B.2. *See also* RESOLVING TRANSFER PRICING DISPUTES: A GLOBAL ANALYSIS, ch. 21, *supra* note 89.

[186] *See supra* Section II.C.1.

arena[187] and changes in the flows of bilateral FDI in the Ireland–U.K. test of residence.[188]

3. The Spiral Evolution, Global Political Shifts and Innovation

Global power shifts and innovation at the technological and financial regulatory levels have probably been two central driving forces in the evolution of the allocation norm regarding the profits of associated enterprises since its origin in the early 20th century. These two elements will be addressed independently.

The transitions from the first era to the second era and from the second era to the third era correlate with power shifts in the world. The transition from the first era to the second era correlates with the power shift from the U.K. to the U.S. in the 1930s. Likewise, the transition from the second era to the third era correlates with an emerging power shift from the West to the East, mainly China, since the early 21st century.[189] Emerging countries again contribute over 50% of global economic output in purchasing power parity terms, as was the case before the first Industrial Revolution.[190] The Cold War (1947–1991) did not have any relevant impact on the evolution of the allocation norm, given the limited role of the Soviet Union in global trade.[191]

The U.K. did not persuade the LN on using a rule–based regulation to solve the emerging international double taxation problem after WWI: the exclusive residence taxation (the U.K. rule). The U.K. rule was only accepted by the Irish Free State in its tax treaty with the U.K. signed in 1926.[192] So the U.K. did not disrupt the standard–based character of the first era of the ITR (1908-1933).

On the global stage, *ex-post* procedural regulations emerging in the first and third eras (1908 to 1933 and 2015 to 2019, respectively) have been the central allocation norm. This is probably so because key countries in international trade have been unable to agree on a rule to solve the allocation problem.[193] By contrast, the second era of the allocation norm (1933 to 2015) represents a period of relative geopolitical stability in the international tax arena. The U.S. was certainly the global hegemon regarding the allocation norm during the second era. For example, the U.S. induced the LN to adopt the ALP as the allocation norm in 1933 (first element) and the U.S. then influenced the OECD on how to adapt the ALP to technological innovation from 1979 onwards (second element).[194]

[187] *See supra* Section III.B.2.

[188] *See supra* Section II.C.1.

[189] Baistrocchi, *supra* note 9, at 733.

[190] *Emerging Economies; Climbing Back*, THE ECONOMIST, (21 January, 2006) at 71.

[191] *See* Irina Dmitrieva, *Tax Treaty Disputes in Russia, in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES 905, *supra* note 3, at 911–16.

[192] *See supra* Section II.C.1.

[193] For example, countries were unable to agree on how to deal with the TP problem in the early 1920s. *See* CARROLL, *supra* note 41, at 15–17.

[194] *See* OECD, *supra* note 103.

The 1933 Carroll Report is an example of the first element, as this report is the core source for article 5 of the LN Draft Model (1933), which, in turn, is a core source for article 9 of the OECD Model as of 1963 to the present.[195]

Section 482 of the U.S. Internal Revenue Code (IRC) is an example of the second element, as these U.S. regulations were key sources for both the 1979 and 1995 OECD TP Guidelines. In effect, the *OECD Transfer Pricing Report* (1979) and the 1995 *OECD TPG* are grounded in the 1968 and 1994 versions, respectively, of IRC section 482 regulations.[196] These two OECD documents address similar issues and, in most instances, reach the same conclusions as the IRC regulations do.[197]

The convergence of the OECD Guidelines and the U.S. IRC section 482 regulations is no coincidence. Rather, it is the result of long–standing U.S. tax policy, aimed at exporting the IRC section 482 regulations to OECD member countries and beyond, with a view to creating an international consensus for applying the ALP under U.S. control, on the one hand, and adapting the ALP to technological innovation, on the other.[198] The OECD Guidelines probably make more effective U.S. influence on OECD soft law than the Commentary on Article 9 of the OECD Model does. This is so because OECD member countries cannot introduce observations or reservations on the OECD TPG, as they can when dealing with the wording of article 9 of the OECD Model or its Commentary.[199]

The global transplanting of the ALP shows U.S. dominance in this area during the second era. The ALP was first transplanted from the U.S. to Europe via France in 1936, then to Latin America via Argentina in 1943, to Australasia via Australia in 1946, subsequently to Asia via Japan in 1986 and, finally, to Africa via South Africa in 1995.[200]

The global transplant of the ALP has normally been a direct consequence of waves of foreign U.S. direct investment (FDI) to the relevant countries and/or regions. For instance, the transplant of the ALP from the U.S. to France in 1932, implemented via the France–U.S. Tax Treaty (1932), was the

---

[195] *See infra* App'x B, stages 12, 17.

[196] *See supra* Section III.B.2.a.

[197] *See* WITTENDORFF, *supra* note 108, at 38–39.

[198] *See id.* at 38 (quoting Surrey, *supra* note 108). Surrey writes on the influence of the US in the OECD:

> The United States believes that the OECD Fiscal Committee is the proper body to undertake the task of establishing the allocation standards to guide countries in reaching accommodations with each other. The OECD Fiscal Committee appointed a Working Party for this purpose. We intend, as a measure of assistance to that Working Party, to lay before it our proposed section 482 regulations as they are developed. […] these regulations may represent a more structurally developed and detailed framework of allocation rules than has been formulated elsewhere […].

[199] WITTENDORFF, *supra* note 108, at 122.

[200] Eduardo Baistrocchi, *Transfer Pricing Dispute Resolution: The Global Evolutionary Path, in* RESOLVING TRANSFER PRICING DISPUTES: A GLOBAL ANALYSIS 835, 837, *supra* note 87, https://ssrn.com/abstract=2337717.

result of the increasing expansion of American MNEs into France after WWI.[201] The ALP has been gradually transplanted worldwide, normally on the basis of a two–stage dynamic: first, from a model tax treaty to treaty law; and second, from treaty law to domestic law. The U.K. is an early representative example. Indeed, the U.K. and the U.S. signed their first comprehensive tax treaty, which incorporated the ALP, in 1945.[202] The U.K. introduced the ALP into its tax treaty law immediately after WWII and domestic regulations were issued a few years later, in 1951.[203]

Most countries explored in this paper followed a similar evolutionary path to dealing with the TP problem, starting at different points in time and going along the path at different paces. The U.S. and China are clear examples. Whereas the U.S. took 94 years to complete the full cycle, as from 1918, when U.S. income taxation was first introduced, China achieved this in just 30 years, from the inception of a Western–style income tax in China in 1980.[204]

The emerging power shift that has triggered the third era of the allocation norm (2015-present) implies a return to the standard–based approach of the first era (1908-1933). China and India have an increasingly relevant say in comparison with the U.S. since 2013.[205] Just as the U.S. has been using the OECD Guidelines to export IRC section 482 regulations to the OECD Model and beyond as of 1979,[206] China and India now seem to be willing to use the UN Transfer Pricing Manual to export Chinese and Indian domestic law on TP to the UN Model and beyond as of 2013.[207]

LSAs appear to be one major innovation proposed by China to the OECD.[208] The OECD has accepted the LSA concept as compatible with the ALP in 2017,[209] after its original rejection before the publication of the BEPS Reports.[210] This OECD acceptance of the LSA is a pragmatic decision. It embeds an additional standard to the ALP within the wording of Pattern #4 (a standard embedded in one or more rule) in the rule–standard spectrum.[211] This embedding of a new standard aims to adjust the ALP to the demands from countries like China to expand the concept of jurisdiction to tax.

Correlated with the emerging power shift from the U.S. to China, the ITR is seemingly heading back to an ecosystem similar to the early stages of the first era, in which there will probably be competing, incompatible regulations. The ongoing clash between the orphan approach, defended by

---

[201] *Id.*

[202] Double Taxation: Taxes on Income, U.K.-U.S., Apr. 16, 1945, 60 Stat. 1377.

[203] Baistrocchi, *supra* note 200, at 837.

[204] *Id.* at 837–38.

[205] *See infra* App'x B, stage 50.

[206] *See supra* Section III.B.2.a; *infra* App'x B, stage 23.

[207] *See infra* App'x B, stage 50.

[208] *See infra* App'x B, stage 54; App'x C, stage 59.

[209] *See infra* App'x B, stage 54; App'x C, stage 56.

[210] *See, e.g.*, OECD, *supra* note 133, paras. 6–7.

[211] *See supra* Section II.B.

the U.S., and the family approach, sponsored by China and India, is a case in point.[212]

4. The Spiral Evolution, Countries and MNEs

Since the 1960s the ITR has grown strongly. Moreover, since the 1980s international investments has increased steeply. Much of this economic internationalization has occurred within transnational business structures. Global estimates indicate that roughly 7,000 MNEs were counted in 1970. From 1990 to 1998 the number increased from 35,000 to 53,607.[213] By 2006 there were 78,000 parent companies with at least 780,000 affiliates.[214] Rixen has developed an illuminating, but incomplete account of the "history of international tax governance and offer[ed] a rationalist reconstruction of its trajectory."[215] His paper argues that as an unintended consequence of its institutional setup, the ITR, which originally only dealt with double tax avoidance, produces harmful tax competition.[216] Despite this negative effect there are only incremental and partial changes of the regime, which are insufficient to curb tax competition.[217] He argues that this development can be explained by considering the properties—and the sequence in which they come up—of the collective action problems inherent in double tax avoidance and tax competition.[218] First, in double tax avoidance, a coordination game with a distributive conflict, governments did not want to endanger the solution they had institutionalized long before tax competition became virulent.[219] Second, governments are unable to resolve the emergent asymmetric prisoners' dilemma of tax competition due to conflicts of interest among big and small country governments and successful lobbying of corporate capital.[220] As a result, the institutional trajectory is characterized by the simultaneous occurrence of stability in the core principles and indirect and incremental changes of the regulations in the form of norm stretching and layering.[221]

Rixen's account is illuminating but incomplete because it bypassed the larger picture: the impact of external shocks on the ITR legal structure over time and space. Indeed, external shocks such as global power shifts and technological and financial regulatory innovations have been correlated with

---

[212] *See* Reuven S. Avi-Yonah & Ajitesh Kir, A Break in the Dam? India's New Profit Attribution Proposal and the Arm's Length Standard (July 8, 2019) (U. Mich. L. & Econ. Rsch. Paper), https://ssrn.com/abstract=3414266.

[213] Rixen, *supra* note 83, at 207.

[214] Org. for Econ. Co-operation & Dev. [OECD], *Multinational Enterprises in the Global Economy*, at 6 (May 2018), https://www.oecd.org/industry/ind/MNEs-in-the-global-economy-policy-note.pdf.

[215] Rixen, *supra* note 83, at 197.

[216] *Id.*

[217] *Id.*

[218] *Id.*

[219] *Id.*

[220] *Id.*

[221] *Id.*

the evolution of the ITR legal architecture from the rule end to the standard end of the spectrum, as defined in section II.B above. For example, the *Nestle* case decided in the U.S. in 1963, marks the decline of the second, rule–based era of the ITR and the emergence of international tax competition among jurisdictions for capital in the context of an increasingly standard–based regulatory framework. The *Nestle* case is an example of a technological innovation impacting the structure of the ITR: the international trade of intangibles that has been facilitating international double non-taxation cases since the 1960s.[222]

This strategic scenario has been reinforced with external regulatory innovation like the end of exchange controls since the 1980s,[223] which, in turn, induced the emergence of non-G20 hubs as locations for intermediate holding companies;[224] indeed, this scenario has encouraged MNEs to strategically locate intangibles in non-G20 hubs, grounded on the separate entity approach introduced in the ITR in the early years of its second era, to minimize the effective tax rates of MNEs.[225] The corporate tax planning schemes that triggered public outrage in 2012 are cases in point.[226]

As shown elsewhere, the ITR is a network market implemented via a two–sided platform.[227] The platform is now the OECD Model and related soft laws. The OECD–based platform, in turn, has two distinct users, MNEs on one side of the platform, and countries on the other side. The ITR platform has been having the net effect of minimizing the tax entry and exit costs to the relevant jurisdictions. Examples of strategic interaction between G20 countries and non-G20 hubs to attract FDI include interaction between Argentina and Chile; Brazil and the Netherlands; Canada and The Netherlands; China and Hong Kong; India and Mauritius; Indonesia and The

---

[222] *See supra* Section III.B.2.

[223] JAMES E. CRONING, GLOBAL RULES: AMERICA, BRITAIN AND A DISORDERED WORLD 138 (2014).

[224] A new logic has been emerging in the strategic interaction among G20 countries and non-G20 country hubs since the emergence of international tax competition in the 1960s. G20 countries increasingly compete against each other for capital, just as private firms compete for market share. The ITR has been facilitating this new logic. In bilateral tax treaties that G20 countries conclude with country hubs, the latter serve as outlets for the bundled products that G20 countries offer to multinational enterprises (MNEs). One component of the bundle is the tax treaty network in its interaction with the relevant domestic laws, which is a vehicle to minimize the tax entry costs and/or tax exit costs. *See* Baistrocchi & Hearson, *supra* note 170, at 1513.This logic illustrates the marketization of international taxation: a growing number of countries deem taxes as negotiable with MNEs as a price for attracting capital. So countries have been increasingly unable to use their tax systems for income redistribution in a context of increasing inequality within local societies.

[225] Damgaard et al., *supra* note 8, at 12.

[226] Aidan Regan, *Apple Won't Have to Pay Nearly $15 Billion in European Taxes,* WASH. POST (July 15, 2020), https://www.washingtonpost.com/politics/2020/07/15/apple-wont-have-pay-nearly-15-billion-european-taxes/. *See also* Joined Cases T-778/16 & T-892/16, Ireland v. Comm'n (July 15, 2020), http://curia.europa.eu/juris/document/document.jsf;jsessionid=2E4EB3A000A2F5962C8B2F3F07745969?text=&docid=228621&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=10005665.

[227] Baistrocchi, *supra* note 9, at 740.

Netherlands; Mexico and Switzerland; Russia and Cyprus; South Africa and Switzerland; South Korea and Belgium; Turkey and The Netherlands; and the U.S. and The Netherlands.[228]

In sum, the ITR two–sided platform has been indeed resilient. It has adapted to global power shifts and technological and regulatory innovation by gradually evolving from the rule end to the standard end of the spectrum since the emergence of the second era.[229] The ITR evolution has implicitly allocated increasing power to a decentralized network of local courts, which in turn, have facilitated the strategic interpretation and application of tax treaty law by countries and MNEs as an attempt to maximize the flow of inward capital and minimize the MNEs effective tax rate, respectively.[230] And G20 countries have been unable to reform the ITR to effectively address the double non–taxation problem because of increasing collective action costs.[231]

### *B. Implications: A Default Rule-Based ITR to Deal with Opportunistic Behavior and Inequality*

It is now time to explore some implications of the spiral evolution theory in new problem areas. The international taxation of the global digital commerce is a challenge the ITR is currently facing.[232]

G20 countries have been unable to reach consensus on how to solve this problem. The OECD has painfully acknowledged this lack of global consensus: "There is no consensus on . . . [the] importance to the location of value creation and the identity of the value creator."[233] This issue has been transformed into what has been aptly named as a global tax war: the battle over taxing global digital commerce.[234]

In the context of the third standard–based era, countries are now experimenting with unilateral, incompatible regulations to deal with this issue. This experimentation is uncoordinated in a manner similar to that seen before the publication of the Four Economists' Report to the LN in 1923.[235]

---

[228] Baistrocchi & Hearson, *supra* note 170, at 1540–41.

[229] *See supra* Section III.B.

[230] Eduardo Baistrocchi, *The International Tax Regime and the BRIC World: Elements for a Theory*, 2013 Oxford J. Legal Stud. 1 (May 10, 2013).

[231] Rixen, *supra* note 83, at 201–02.

[232] Org. for Econ. Co-operation & Dev. [OECD], *OECD/G20 Base Erosion and Profit Shifting Project: Addressing the Tax Challenges of the Digital Economy, Action 1, 2015 Final Report*, ¶ 2 (Oct. 5, 2015), https://doi.org/10.1787/9789264241046-en.

[233] Org. for Econ. Co-operation & Dev. [OECD], *OECD/G20 Base Erosion and Profit Shifting Project*: *Tax Challenges Arising from Digitalisation, Interim Report 2018*, ¶ 36 (Mar. 16, 2018), http://dx.doi.org/10.1787/9789264293083-en.

[234] Arthur J. Cockfield, *Tax Wars: The Battle over Taxing Global Digital Commerce*, 161 TAX NOTES 1331, 1331–32 (Dec. 10, 2018).

[235] *See infra* App'x A, stages 4 & 5.

The tax conflict between the U.K. and France on one hand and the U.S. on the other in digital taxation is a case in point.[236]

The OECD and the IMF are exploring the possibility of introducing multilateral rule–based regulations to resolve the–digital taxation problem in the hope of setting the foundations of a new fourth rule–based era. The exploration includes the global formulary apportionment concept. It is a formula grounded on objective, rather than subjective, elements such as sales, for the allocation of the international tax base to the relevant countries.[237]

The spiral evolution framework suggests the following point. It is unlikely that a multilateral rule–based resolution to the digital taxation problem will emerge in the context of the third era. This era has emerged after the collapse of the third globalization outlined in section 1 above. It shares some elements of the previous periods before and in–between the first and second globalizations: geopolitical tensions, major wars and geopolitical disruptions. Moreover, there is no jurisdiction or group of jurisdictions so far with global influence in global international tax policy comparable to the influence of the U.S. during the second era.

So the question now is what policy options can be drawn from the ITR spiral evolution that may be relevant for solving the digital taxation problem. A potential response to this question can be crystallized in a two–step approach. While exploring rule–based regulations such as those suggested in the Carroll Report in 1933[238] or the OECD Program of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalization of the Economy,[239] standard–based regulations are also worth exploring, such as those attempted by the LN in 1928.[240] The two–step approach may be organized, for example, along the following two elements:

1. *Default Procedural Rule*: If the G20 is unable to solve the digital taxation problem in the near future, the E.U. could work as a laboratory for the creation of a default income allocation formula in the area of digital taxation, taking into account the interest of China and India in this area or vice versa. A minimum global corporate tax rate could be an example of a default rule–based ITR to deal with opportunistic behavior and inequality, i.e., two fundamental problems seen in the second era of the ITR.[241] So, for

---

[236] Chris Giles & Claer Barrett, *UK Braves US Ire by Pressing Ahead with Tax on Tech Companies: Move Comes Hours after Washington Threatened Sanctions against France for Similar Levy*, FIN. TIMES, (July 11, 2019), https://www.ft.com/content/41069548-a3d8-11e9-974c-ad1c6ab5efd1.

[237] Org. for Econ. Co-operation & Dev. [OECD], *OECD/G20 Base Erosion and Profit Shifting Project*: *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS*, https://doi.org/10.1787/beba0634-en.

[238] *See infra*, App'x B, stage 12.

[239] Org. for Econ. Co-operation & Dev. [OECD], *OECD/G20 Base Erosion and Profit Shifting Project: Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, ¶¶ 28, 30, 40 (May 2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.htm.

[240] *See infra* App'x A, stage 7.

[241] The OECD has suggested a minimum corporate income tax rate. *See* Org. for Econ. Co-operation & Dev. [OECD], *Global Anti-Base Erosion Proposal ("GloBE") (Pillar Two),*

example, the local legislature, or its functional equivalent, should have the duty to review the minimum corporate tax rate and local spending policy on a regular basis when the local Gini coefficient does not meet the desirable figure.[242] Then, this default rule–based regulation could be submitted to the OECD-G20 for consideration as an addition to the Multilateral Convention to Implement Tax Treaty–Related Measures to Prevent BEPS (the Multilateral Instrument).[243]

2. *Regulatory Framework for the Transition Period*: The MAP procedure, including tax arbitration, could work as a laboratory for the creation of norms with precedential value for the crucial transition period. So until consensus is reached on a global regulation to the digital taxation issue, the OECD may use the MAP and arbitration decisions in such a way as to allow the OECD to identify global and or regional trends in disputes dealing with the central issues in the digital taxation arena. They include nexus and profit allocation.[244] Then the OECD could transform these ever–changing trends into, for example, commentaries to Article 5, 7 and 9 of the OECD Model.[245] The ingenuity of the decentralized network of courts, and its functional equivalent, interpreting and applying tax treaty law to the digital global commerce, could create new regulations with global impact in this area.

The *Nestle* and *DuPont* cases are examples of innovative concepts created by local courts with an impact on ITR evolution worldwide. The *Nestle* case invented the commensurate–with–income principle in the area of valuation of intangibles;[246] the *DuPont* case created, in turn, the Berry ratio as a TP methodology to determine the proportion of gross profit to operating expenses in cross–border supply chains.[247] Both local judicial inventions have had a lasting global impact.[248]

## V. CONCLUSION

The theory expounded in this paper predicates that there is usually a correlation between global power shifts and the evolution of the ITR. The

---

*Public Consultation Document*, paras. 7–8 (Dec. 2, 2019), http://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf.

[242] This rule may work as follows: A country should have the duty to recalibrate its taxing and spending policy when the local Gini coefficient reaches certain level. This may include, for example, raising the minimum corporate tax rate and spending allocation on education and health care. Org. for Econ. Co-operation & Dev. [OECD], *Income Inequality* (indicator). doi: 10.1787/459aa7f1-en (Accessed on 12 November 2020)

[243] MLI, *supra* note 148, at 1.

[244] OECD, *supra* note 236, ¶ 7.

[245] Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention on Income and on Capital, Condensed Version*, at 92, 130, 181 (July 22, 2010), http://dx.doi.org/10.1787/20745419.

[246] Nestle Co. v. Commissioner, 22 T.C.M. (CCH) 46 (1963); *see also supra* Section III.B.2.

[247] E.I. DuPont de Nemours & Co. v. United States, 608 F.2d 445, 456 (1979).

[248] *See supra* Section III.

theory maintains that the hegemon normally prefers a rule–based system over a standard–based one given the ITR's decentralized competitive structure. This hegemon's preference is based on the assumption that the former limits the decentralization of power within the ITR more than the latter does to a growing, decentralized global network of countries.[249] When external shocks (such as technological and/or regulatory financial innovation) emerges making the rule–based system unworkable, there is normally no better option for the hegemon than to accept an ITR shift towards the standard–based end of the spectrum, ideally under the hegemon's control until the hegemon's collapse.[250]

The hegemon's role in the international tax regime is usually to provide some underlying purpose and coherence, which the U.S. has done from 1933 until 2015 through, for example, its support for the ALP. The hegemon, which is normally the major capital exporter, is really pursuing the interests of the hegemon's capital, and it uses the ideas and the sense of purpose, to generate consent for its hegemony.[251]

In 1725, Giambattista Vico theorized that history can be reconstructed as a spiral (*corsi e recorsi storici*).[252] In a similar vein, this paper shows that the history of the ITR can be reconstructed as a spiral in which its central driving forces are shocks impacting the ITR architecture.[253] Indeed, the ITR found itself in the midst of a three–era spiral evolution: from standards (1908-1933) to rules (1933-2015) and then back to standards (2015 to the present). The spiral trajectory correlates to two global power shifts: first, a power shift from the U.K. to the U.S. in the 1930s and then, an emerging power shift from the West to the East (mainly from the U.S. to China) beginning in the early 21st century.[254]

Strikingly, considerations of global tax justice have been largely irrelevant in the evolution of the ITR over the period covered here.[255] For example, the global tax justice problem was bypassed in both the Economist Report submitted to the League of Nations in 1923[256] and the OECD BEPS Reports submitted to the G20 in 2015.[257]

The spiral evolution of the ITR will not necessarily end in the third standard–based era. The evolution may move back to a rule–based fourth era

---

[249] *See supra* Section IV.

[250] *See supra* Section IV.

[251] *See supra* Section IV.A.

[252] GIAMBATTISTA VICO, THE NEW SCIENCE OF GIAMBATTISTA VICO (Thomas Goddard Bergin & Max Harold Fisch trans., 3d ed. 1948). *See also* Isaiah Berlin, *Corsi e Ricorsi*, 50 J. MOD. HIST. 480, 480 (1978).

[253] The spiral seems to be the best available format to represent the centennial evolution of the ITR. Indeed, the spiral offers a number of advantages *vis a vis* three alternative formats: i) a circle, ii) a straight line and iii) a pendulum. *See supra* Section IV.A.1.

[254] *See supra* Section III.

[255] On global tax justice see, for example, Adam Kern, *Illusions of Justice in International Taxation*, 48 PHIL. & PUB. AFF. 153, 155, 184 (2020). *See also* Tsilly Dagan, *International Tax and Global Justice*, 18 THEORETICAL INQUIRIES L. 1, 2 (2017).

[256] *See supra* Section III.A.1.

[257] *See supra* Section III.C.1.

if certain conditions are met, such as those seen in the second era (1933-2015). This includes the still unforeseeable emergence of a hegemon powerful enough to create and enforce a new rule–based normative system.[258]

It is important to recognize the possibility of a more complex, pluralistic dynamic emerging in the ITR than a hegemonic torch passed on from Europe to the U.S. and soon to China. Less optimistically, it is believed that future research in this area should focus on, for example, the following crucial questions: i) If China doesn't fill the U.S.'s hegemonic shoes, will there be a problematic power vacuum?; ii) Can international organizations like the OECD and G20 buffer the increasing tension between the U.S. and China in the search for multilateral resolutions?; iii) Given increasing global inequality between and within countries, can countries and international organizations take global tax justice seriously when discussing the future of the ITR?[259]

Two centuries ago Napoleon is said to have warned, "Let China sleep; when she wakes, she will shake the world."[260] Napoleon was indeed correct in this prediction. Today China has awakened, and the world is beginning to shake.[261] This paper offers the first analysis of the impact of geopolitics in international taxation. It focuses on the clashes between ruling and rising powers and their impact in the evolution of the ITR since its emergence in the early 20th century. It also shows that history is to shed light on promising ways for the ITR in the 21st century.

---

[258] *See supra* Section III.B.1.

[259] *See World Inequality Database*, WID.WORLD, https://wid.world/world/#sptinc_p99p100_z/US;FR;DE;CN;ZA;GB;WO/last/eu/k/p/yearly/s/false/5.070499999999999/30/curve/false/country (last visited Oct. 26, 2020).

[260] The quote "Quand la Chine s'éveillera, le monde tremblera" is attributed to Napoleon but he never actually wrote it in any of his texts. He is said to have pronounced these words in 1816, during his exile in Saint Helena, after he read narratives of Lord Macartney, the British Ambassador to China in 1792–93. It was later used as the title of a famous essay written by Alain Peyrefitte, the French statesman. See Alain Peyrefitte, Quand la Chine s'éveillera...: ... Le monde tremblera (Français) Broché –1980.

[261] GRAHAM ALLISON, DESTINED FOR WAR: CAN AMERICA AND CHINA ESCAPE THUCYDIDES'S TRAP? VII (2017).

## VI. APPENDIX

Appendices A, B and C provide supporting data and analysis for Section 3 of the paper *The International Tax Regime and Global Power Shifts.* The appendices offer a stage-by-stage breakdown of the three eras of the international tax regime, as shown in the contents below.

### *A. The First Era: A Stage-by-Stage Analysis (1908-1933)*[1]

#### 1. The Rise of the First Era (1908–1928)

*Stage 1 – The Gramophone Case (UK) – 1908.* The United Kingdom first experimented with piercing the corporate veil to reallocate tax liability between a parent and an associated enterprise, as demonstrated in the 1908 case *Gramophone & Typewriter Ltd v Stanley*.[2] In that case, the UK tax authorities had claimed that all profits of a German subsidiary were to be attributed to its English parent company, because all board members of both entities were the same. UK courts rejected this claim on the basis of both the separate entity approach (SEA) and the fact that the German entity was not a sham company.[3] The *Gramophone* case may be the first judicial cross-border ownership dispute in the world involving profit allocation issues for income tax purposes.

*Stage 2 – The First TP Regulation (UK) – 1920.* The UK then experimented with a specific anti-avoidance regulation based on income shifting rather than on a transaction-based arm's length principle (ALP).[4]

---

[1] A methodological point is needed in relation to the *stage* concept as a building block of the spiral evolution of the ITR. There is an inherent bias in the selection of cases and regulations from particular jurisdictions and a hindsight bias with the selection of reports issued by the League of Nations, the OECD and the United Nations. These biases, however, do not impact upon the analysis, because the selections are analysed in the context of a trajectory. The influence of previous chosen developments is demonstrated as having a direct impact upon subsequent major developments.

[2] Gramophone & Typewriter Ltd v. Stanley (1908) 2 KB 89. This UK case offers an early application of the separate entity approach (SEA) in a cross-border tax dispute. A definition of 'piercing the corporate veil' is in order. As a corporation is a separate legal entity and shareholders have an interest in the company rather than in its assets, the corporate veil is used to describe the inability to look behind the legal entity and attribute the actions, assets, debts and liabilities of a company to those standing behind it, notably the shareholders. Courts may sometimes be able to 'pierce' (look through) the corporate veil to make an attribution to the underlying person or persons. *See also* JULIE ROGERS-GLABUSH, IBFD INTERNATIONAL TAX GLOSSARY (7th ed. 2017).

[3] *Gramophone & Typewriter*, 2 KB at 89. The separate entity approach predicates that, in principle, associated enterprises of a given MNE should be deemed as separate legal entities.

[4] *See* Finance (No. 2) Act 1915, 5 Geo. 5 c. 89 (Eng.). The first TP legislation in the UK tax system dates back to 1915. Section 31(3) of the Finance (No. 2) Act 1915 provided that whenever a UK resident earned no profits, or lower profits than otherwise, and this was due to the manner in which the business with a non-British non-resident was and could be arranged because of a close connection between the resident and the non-resident and because of the 'substantial control exercised by the non-resident over the resident', the non-resident could be taxed in the name of the resident as if the resident were an agent of the non-resident. In effect,

This standard-based regulation was introduced at the beginning of World War I and first applied in the 1920 case *Gillette Safety Razor Ltd v. IRC*, in which the UK tax authority claim was successfu1.[5]

*Stage 3 – The Vestey Case I (UK) – 1920.*[6] Interestingly, perhaps the first intercontinental transfer pricing (TP) dispute emerged in the context of the first era, in 1915. It involved the Vestey Brothers Group (Vestey Group), the largest UK MNE in the global food industry, with operations in 50 countries (See Figure 1, Stage 3). The Vestey Group had decided to move its ultimate holding company from London to Buenos Aires in 1915 to create a favourable tax position and, in turn, remain competitive against its rivals.[7]

The American Beef Trust, a US competitor, appeared to be exploiting a TP issue, which resulted in a competitive advantage and was not dealt with

---

the non-resident could be charged UK income taxes on non-UK-source profits (or turnover) to the extent that they reduced the profits of the UK resident.

[5] Ian Roxan, *Transfer Pricing Disputes in the United Kingdom*, *in* RESOLVING TRANSFER PRICING DISPUTES 303, 306–07 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

> The appellant taxpayer was an English company formed in 1915 by Gaines, the former manager of the English operations of Gillette US, to take over selling Gillette razors and blades in the UK and a number of other countries. Previously, Gillette US had manufactured razors and blades in that market, first through a branch, then through a UK subsidiary, and finally through the branch of another US subsidiary, which were in each case managed by Gaines. The appellant company sold razors manufactured by Gillette US and by Gillette US's Canadian subsidiary. The agreement between Gillette US and the appellant provided for the terms on which the appellant was to sell Gillette razors and blades, including the selling prices and minimum quantities. The appellant was to sell no other similar razors or blades. The items were sold to the appellant at a 45-50 per cent discount from the list prices, but the appellant was responsible for the cost of shipping and insurance, as well as advertising material. Its gross profit before working expenses was 6.37 per cent of sales. On appeal to the Special Commissioners, they concluded that there was a close connection between the appellant and Gillette US, and that the latter exercised substantial control over the appellant, so that, under the terms of section 31 of Finance (No. 2) Act 1915, the course of business of the appellant was so arranged as to produce less than an ordinary profit in the UK. Applying section 31(4), the Special Commissioners applied a rate of 12.5 per cent of sales to determine the profit of the appellant. This percentage was lower than it otherwise might have been, as the Gillette name was thought to make it easier to sell the products in the UK. No indication is given as to whether this conclusion was based on any evidence heard, but the percentage appears to have been less than the one applied by the Inland Revenue in the assessment appealed from.

[6] *See supra* Figure 1.

[7] *See* James Kessler, *Evidence of Sir William Vestey, Given 31 July 1919 to the Royal Commission on the Income Tax* ¶ 9501, www.kessler.co.uk/wp-content/uploads/2013/07/Vestey_Royal_Commission_evidence_and_

ensuing_debate.pdf. "[Question:] Can you leave all your profits for an indefinite period, say, in Argentina, for all time, to escape taxation either in America or in this country [the United Kingdom]?' [Response by Lord Vestey:] 'Why not?'"

using the 1915 UK legislation.[8] The strategic decision by the Vestey Group to move its holding company from London to Buenos Aires, based on what appeared to be largely tax considerations, triggered, inter alia, a debate in the House of Lords in 1922 (*Vestey* case I).

The controlling shareholder, Sir William Vestey, in his presentation before the Royal Commission on Income, exposed the fundamental problem of the allocation of the profits of associated enterprises, stating as follows:

> In a business of this nature you can't say how much is made in one country and how much is made in another. [. . .] You kill an animal and the product of that animal is sold in fifty different countries. You cannot say how much is made in England and how much abroad.[9]

*Stage 4 – ICC on Double Taxation (Paris) – 1920.* Examples of taxpayers' demands for regulations to alleviate international double taxation are found in the appeals submitted before the International Chamber of Commerce in 1920, as well as at the Brussels Financial Conference in 1920, which both argue that the newly created League of Nations should do something to eliminate the "evils" of double taxation (See Figure 1, Stage 4).[10]

MNEs were facing the issue of international double taxation during and immediately after the WWI. An example of this issue was a combined tax rate of 73.2% faced by US corporate investors doing business in the UK by 1919.[11] So immediately after WWI, MNEs demanded the League of Nations a solution to this problem. For example, the International Chamber of Commerce (ICC) meeting in Paris, adopted a resolution in 1920 urging:

> […] prompt agreement between the Government of the Allied countries in order to prevent individual or companies from being compelled to pay a tax on the same income in more than one country, taking into consideration the country to which such individual or company belongs has a right to claim the difference between the tax paid and the home tax. [12]

The ICC was effective as it managed to place the issue of international double taxation high on the international diplomatic agenda.[13] Indeed, a few

---

[8] *See* John F. Avery Jones, *Sir Josiah Stamp and Double Income Tax*, *in* STUDIES IN THE HISTORY OF TAX LAW 5, 7 (John Tiley ed., vol. 6, 2013).

[9] Kessler, *supra* note 7, at ¶ 9160.

[10] MITCHELL B. CARROLL, GLOBAL PERSPECTIVES OF AN INTERNATIONAL TAX LAWYER 29 (1978).

[11] SUNITA JOGARAJAN, DOUBLE TAXATION AND THE LEAGUE OF NATIONS 94 n. 24 (2018).

[12] JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 20 (1932).

[13] *See* Clyde J. Crobaugh, *International Comity in Taxation*, 31 J. OF POL. ECON. 262, 273 (1923); EDWIN SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION 114 (1928); Thomas Adams, *Interstate and International Double Taxation*, *in* LECTURES ON TAXATION 101, 103 (Roswell Magill ed., 1932); Ke Chin Wang, *International Double*

days after the ICC 1920 request, the League of Nations responded to this demand as follows:

> Provisional Economic and Finance Committee First Joint Session stated the following: "Issue of double taxation allocated to Finance Section. Agreed that Avenol (France) and Blackett (Great Britain) would prepare a brief report on the history of double taxation in their respective countries and make suggestions as to the procedure that should be adopted by the committee in dealing with the issue."[14]

*Stage 5 – The Economist's Report (Geneva) – 1923*. "In 1923, a committee of four economists submitted a report to the League of Nations that set out the basic principles underlying international tax jurisdiction for the first time."[15] The report pointed out that an income tax based on ability to pay does not answer the question of whose ability to pay is to be considered in each taxing jurisdiction. "To answer this question, the report developed the 'doctrine of economic allegiance', which underlies modern discussions of jurisdiction to tax."[16] Fundamentally, the report endorsed two bases for economic allegiance, which justify a country's levying of taxes: where income is produced (the source jurisdiction) and where it is consumed or saved (the residence jurisdiction).[17]

The 1923 report also addressed the issue of double taxation: regarding the source and residence jurisdictions, which one has the prior claim to tax income deriving from one jurisdiction by a resident of the other and which one has the obligation to prevent double taxation by giving up its claim? On practical grounds, the source jurisdiction should have the prior right because it can generally impose its taxes on income deriving from within it first.[18]

---

*Taxation of Income: Relief through International Agreement 1921 − 1945*, 59 HARVARD L. REV. 73 (1945); Adrian Kragen, *Double Income Taxation Treaties: The O.E.C.D. Draft*, 52 CALIF. L. REV. 306, 306–07 (1964); Mitchell Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad (Part I)*, 2 INT'L LAW. 692, 692–96 (1968); MITCHELL CARROLL, GLOBAL PERSPECTIVES OF AN INTERNATIONAL LAWYER 29 (1978); Michael Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L. J. 1021, 1066–74 (1997); Richard Vann, *The History of Royalties in Tax Treaties 1921-61: Why?*, *in* COMPARATIVE PERSPECTIVES ON REVENUE LAW: ESSAYS IN HONOUR OF JOHN TILEY 167 (John A. Jones et al. eds., 2008); Bret Wells & Cym Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. J. OF TAX L. 1, 7–13 (2013).

[14] SUNITA JOGARAJAN, Double Taxation and the League of Nations 257 (2018).

[15] Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1305 (1996).

[16] *Id.* at 1305.

[17] *See Report on Double Taxation Submitted to the Financial Committee*, League of Nations Doc. E.F.S.73. F,19 (1923). The report identifies four bases for economic allegiance: where wealth is produced, where it is finally located, where rights over it can be enforced and where it is consumed or otherwise disposed of; the first and fourth bases (source and residence, respectively) were identified as the most important.

[18] *See Id.* ("A survey of the whole field of recent taxation shows how completely Governments are dominated by the desire to tax the foreigner [...]From this flows the

However, the 1923 report recommended that in future negotiations between tax jurisdictions, income items should be classified according to whether the primary economic activity giving rise to the income takes place in the source country or in the residence country and that the prior right to tax the income should be divided accordingly between them.[19]

*Stage 6 – The Emergence of the Pure Separate Entity Approach (SEA) – 1927.* Early treaties and the League of Nations are as follows. The League of Nations first introduced the SEA in its Draft of a Bilateral Convention for the Prevention of Double Taxation, Draft Model, 1927. Interestingly, the original version of the SEA did not include the ALP (1927 League of Nations pure SEA). The 1927 League of Nations pure SEA aimed at dealing with the TP problem between, inter alia, associated enterprises, which were then referred to as affiliated companies. Affiliated companies, in turn, were regarded as PEs.[20] Article 5 provided the following:

> Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess permanent establishments.
>
> The real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots, shall be regarded as permanent establishments [. . .]
>
> *Should the undertaking possess permanent establishments in both Contracting States, 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* (emphasis added).[21]

---

consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right.").

[19] *See Id.* The report discussed four methods of avoiding double taxation: taxation based entirely on source (with residual residence-based taxation); taxation based entirely on residence; formulary allocation; and taxation based on source or residence, depending on the type of income. The report rejected the first option, considered the second as an ideal unlikely to be realized and opted for the fourth, possibly modified by the third, as the most practical option. This conclusion retains much of its value today.

[20] Affiliated companies were regarded as PEs based on the *filialtheorie*, a German theory on international taxation. *See* Mitchell B. Carroll, *Taxation of Foreign and National Enterprises*, *in* METHODS OF ALLOCATING TAXABLE INCOME 11, 40 (Vol. 4, 1933) [hereinafter *Carroll Report*], http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/cartaxa.xml;collection=;database=;query=;brand=acdp. *See also* SOL PICCIOTTO, INTERNATIONAL BUSINESS TAXATION 22–24 *(1992).*

[21] *Reports Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion,* League of Nations Doc. 216.M.85 1927 II, 10–11 (1927) [hereinafter *League of Nations Draft Model* (1927)].

The 1927 League of Nations pure SEA crystallises *where income is produced* as the fundamental allocation norm regarding the profits of associated enterprises. This norm can be inferred from the phrasing 'each of the two States shall tax the portion of the income *produced* in its territory (emphasis added)'. This allocation norm was originally implemented by applying the SEA-based norm only on the accounts of the entities (separate accounting principle). Interestingly, a procedural standard was offered as default to solve income allocation disputes. Indeed, negotiation between the contracting states was the default provision if proper accounts were not available ('the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment').

The 1927 League of Nations pure SEA was transplanted worldwide to a number of income tax systems to deal with the TP problem. The pure separate entity approach did not deter tax planning schemes based on TP. For example, Argentina transplanted the pure separate entity approach to its UK-based income tax system in 1932. The *Vestey* case II, involving La Anglo, the Argentine subsidiary of the British Vestey Brothers Company (*see* Figure 1, Stage 10), offers an example of abuse of the 1927 League of Nations regulation.

*Stage 7 – A Procedural Standard – The League of Nations Draft Model – 1928.* The League of Nations' 1927 reference to accounts as the primary source for solving the TP problem was deleted in 1928. The League of Nations then suggested a standard-based regulation to the TP problem in 1928 that was procedural only: a case-by-case negotiation between the competent authorities. Article 5 of the League of Nations Draft Model (1928) reads as follows:

> Income . . . from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated.
>
> The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments [. . .]
>
> Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. *The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment* [. . .] (emphasis added).[22]

---

[22] *Reports Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations Draft Model,* League of Nations, 8 (1928) https://biblio-archive.unog.ch/Dateien/CouncilMSD/C-562-M-178-1928-II_EN.pdf.

The 1928 General Meeting of Governmental Experts voted to accept the SEA and to abandon the German *filialtheorie*.[23] So the 1927 notion of affiliated companies (i.e., subsidiaries) as PEs was abandoned in 1928. From 1928 onwards, PE and subsidiary became two different concepts.

2. The Decline of the First Era (1928–1932)

*Stage 8 – ALP Invention (Germany) – 1925.* The earliest version of the ALP in the world was encapsulated in a 1925 German regulation. It was abrogated by Hitler in 1934.[24]

*Stage 9 – ALP transplant to the US – 1928.* Edwin R.A. Seligman, a prominent US tax scholar educated in Germany, might have contributed to transplanting the 1925 German ALP to US domestic law in 1928.[25] The first US TP regulation, in which the ALP is considered implicit, provided the following:

> In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated owned or controlled directly or indirectly by the same interests), the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in

---

[23] *Id.* at 6, 8, 12. *See also* Jens Wittendorff, *The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?*, TAX NOTES INT'L., 223 (2011).

[24] The first TP legislation in the German tax system dates back to 1925. The topic 'shifting profits abroad' was dealt with in German income tax legislation dating between 1925 and 1934. Section 33 of the Income Tax Act (ITA) 1925 reads:

> (1) 'If, as a result of special agreements between the taxpayer and a party not subject to unlimited taxation, the profit of a domestic trade or business is clearly not in proportion with the profit that would otherwise be achieved in business transactions of comparable or similar nature, said profit, or at least the usual return on capital serving this trade or business, can be taken as the basis for determining the income of the domestic trade or business. In the meaning of this provision, in addition to fixed assets, capital is deemed to include also current assets, in particular goods, products, and inventory. (2) The provision given in Section 1 of 1925 ITA does not apply if the taxpayer provides evidence that neither does he hold a share in the assets or profit of the foreign trade or business, nor does the owner of said foreign entity participate significantly in the profit or the assets of his trade or business'.

*See* German Reichstag, Drucksache, 27 April 1925 – III 1924/25 no. 795, Reichssteuerblatt (RStBl, *German Tax Gazette*) 1925, 196. *See also* Andreas Oestreicher, *Transfer Pricing in Germany*, *in* RESOLVING TRANSFER PRICING DISPUTES 195–96 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[25] Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, UCLA L. REV., 52 1793 (2005), 1793.

> order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.[26]

The US National Report to the League of Nations (1932) considers that this 1928 US regulation encapsulates the ALP.[27]

*Stage 10 – The Vestey case II (Argentina) – 1932.* The 1920 *Vestey* case I (United Kingdom) had intercontinental ramifications showing the inability of the standard-based ALP to deal with problems of international nontaxation. The *Vestey* case II arose in Argentina in 1932. It showed the fundamental problems inherent in a regulation based on the 1927 League of Nations pure SEA when dealing with TP abuses.

The Argentine Senate maintained the following in relation to the facts of the Vestey case II case emerging shortly after the introduction of income taxation in Argentina in 1932. La Anglo was the name of the UK Vestey Group Argentine subsidiary:

> [Certain Argentine] companies avoid paying [Argentine] income taxes on the grounds that they are manufacturing agencies that transfer their products at cost to their overseas holding companies. This includes La Anglo Company [a subsidiary of the Vestey Group, whose holding company moved back to the United Kingdom after World War I]. The meatpacker La Anglo pretends to be a manufacturing company [in Argentina] working at cost for a third entity based overseas [in Liechtenstein or Switzerland]. In fact, that manufacturing company does not exist and the profits are hidden. In Argentina, La Anglo maintains that its profits are taxed in England, and in England, Lord Vestey [La Anglo's controlling shareholder] claims that those profits are taxed in Argentina. Thus, [La Anglo] avoids paying income taxes in either country.[28]

La Anglo's Argentine subsidiary had two sets of accounting books. The official ones submitted to the local tax authorities allocated virtually no income to the Argentine entity, whereas the real ones were hidden from their view. The real accounting records were eventually uncovered by the tax authorities at the public hearings held before the Congress. It has been argued that:

> [C]ertain businessmen had been using irregular accounting practices. They tried to hide their [accounting] books and one of them [Richard Tootell from La Anglo] went to jail for that reason. The most remarkable case happened after La Anglo had denied that

[26] Revenue Act of 1928, ch. 852, § 45, 45 Stat. 791 (1928).

[27] *Carroll Report*, *supra* note 20.

[28] *Diario de Sesiones de la Cámara de Senadores de la Nación*, Período Ordinario, 1, at 201, 250 (1935)

> it had any cost accounting books in Buenos Aires. The Special Commission appointed by Congress inspected the ship Norman Star on the basis of information obtained from two port employees. La Anglo's cost accounting books were found on board, hidden under the label 'Corned Beef', ready to depart for the United Kingdom.[29]

The Vestey I and Vestey II cases in the UK and Argentina, respectively, show the problem of aggressive corporate tax planning by MNEs during the first era. These tax planning techniques were facilitated by the regulatory ecosystem: the separate entity approach without a test for quantifying the allocation of income between associated enterprises, such as the arm's length principle (ALP), fostered international nontaxation opportunities. This explains the League of Nations' concern with tax evasion and the need to search for a new normative system.

### 3. The Collapse of the First Era (1932–1933)

*Stage 11 – The France/US Double Taxation Convention – 1932.* The first tax treaty in the world incorporating the ALP was signed between France and the United States in 1932. This provision was designed to resolve a dispute between the two states that arose due to an accusation by the French tax authorities that US parent companies had systematically overcharged French subsidiaries, causing artificial income shifting to the US[30] The relevant article provided the following:

> 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. The same principle applies mutatis mutandis,

---

[29] PETER H. SMITH, CARNE Y POLÍTICA EN LA ARGENTINA 163 (1968). *See also* DAVID ROCK, ARGENTINA 1516–1987: FROM SPANISH COLONIZATION TO ALFONSÍN 227 (1987). Rock argues that Lisandro de la Torre denounced a variety of fraudulent accounting practices among meat packing enterprises, including their evasion of income tax and exchange control regulations. De la Torre also alleged that members of the government had personally profited from transfer pricing manipulations. These accusations were debated in the Senate amid vehement denials from senior administration figures. The atmosphere of growing recrimination reached a bizarre climax when Enzo Bordabehere, De la Torre's fellow senator from Santa Fe, was shot dead on the floor of the Senate. The *La Anglo* case was the basis of a 1984 film entitled *Asesinato en el Senado de la Nación [Murder at the National Senate]*. The full version of the film is avalialble at: https://youtu.be/GuVoW5cx090.

[30] *Carroll Report, supra* note 20, at 114–15.

> in the event that profits are diverted from an American enterprise to a French enterprise.[31]

Carroll described the original intent of this tax treaty provision encapsulating the ALP as follows:

> As the French were apprehensive about their ability to recapture any profit diverted from the French subsidiary to the American parent corporation, we agreed to incorporate in the treaty for bilateral application the well-known section 45 (now section 482 of the US Internal Revenue Code), which authorized the tax authorities to relocate income as if transactions had been effected on an arm's length basis.[32]

Stages 8, 9 and 10 show three distinctive elements of the allocation norm. First, France, Germany and the US played key roles in the invention and first design of regulations that are predecessors of what is now article 9 of the OECD Model. For example, article IV of the France-US Tax Treaty (1932) is a direct predecessor of article 9(1) of the OECD Model, given the similar wording of both provisions. Second, the original intent of the ALP includes an anti-avoidance purpose, because the concepts of *diversion of profits* and *evasion of taxes*—and how to deal with them—are used in the German, US and France-US TP regulations. Third, the France-US Tax Treaty (1932) signals the fall of the first standard-based era of the allocation rule and the emergence of the second era.

### *B: The Second Era: A Stage-by-Stage Analysis (1933-2015)*

#### 1. The Rise of the Second Era (1933–1963)

*Stage 12 – The Carroll Report – 1933.* The Carroll Report proposed using the SEA *and* the ALP as the allocation norm for addressing TP issues between associated enterprises.[33] This recommendation was grounded in the following reasoning:

> As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments of an enterprise but treated as independent legal entities; and if 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

---

31 *Convention and Protocol Concerning Double Taxation* art. IV, Apr. 27, 1932, 49 Stat. 3145.

32 CARROLL, *supra* note 10, at 29.

33 *Carroll Report*, *supra* note 20, at 202.

> the basis of what it would have earned had it been dealing with an independent enterprise.[34]

Carroll's words suggest that the ALP was deemed as a largely self-enforcing, rule-based norm, given that finding comparables was a relatively easy task in the early 1930s, when the Carroll Report was published. Since the Carroll Report, the ALP has been gradually transplanted worldwide, normally on the basis of a two-stage dynamic: first, from a model tax treaty to treaty law;[35] and second, from treaty law to domestic law. The UK is an early representative example. Indeed, the UK and the US signed their first tax treaty, which incorporated the ALP, in 1945.[36] The UK introduced the ALP into its tax treaty law immediately after World War II and domestic regulations were issued in detail a few years later, in 1951.[37]

*Stage 13 – The League of Nations Draft Model (1933).* The League of Nations Draft Model (1933) incorporated the ALP based on the Carroll Report with a procedural section (the right of appeal). The provision (article 5) stated as follows:

> 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 there exists, 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.[38]

Article 5 of the League of Nations Draft Model (1933) is a direct source for article 9 of the OECD Model. Key concepts in article 5 are the following: a *dominant participation* (as a test of associated enterprises), a *diversion of profit* (this concept suggests the anti-avoidance character of the ALP), *as a result of such situation* (this expression suggests a relation of causality between a dominant participation and diversion of profits) and 'shall' (rather

---

[34] *Id.* at 177.

[35] This dynamic shows the crucial role the League of Nations Draft Model and the OECD Model have played in international tax convergence since the early twentieth century. Indeed, model tax treaties effectively minimise collective action costs; *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1971).

[36] Income Tax Treaty, U.K-U.S., Jun. 6, 1945, 60 Stat. 1377. T.I.A.S. No. 1546.

[37] *See* Veronika Solilová & Marlies Steindl, *Tax Treaty Policy on Article 9 of the OECD Model Scrutinized*, 67 BULL. FOR INT'L. TAX'N. 128 (2013). For an analysis of the leading TP case law in the G20 and beyond in the pre-BEPS Reports Era (1923–2015), see also A GLOBAL ANALYSIS OF TAX TREATY DISPUTES (Eduardo Baistrocchi ed., 2017).

[38] *Fiscal Committee Report to the Council on the Fourth Session of the Committee art. 5,* League of Nations Doc. C.399M.204 1933 II. A. (1933).

than 'may', as it currently stands in article 9 of the OECD Model) in relation to primary adjustments.[39]

*Stage 14 – The League of Nations Draft Model (1935).* The content of article 6 of the League of Nations Draft Model (1935) is identical to that of article 5 of the League of Nations Draft Model (1933). The only difference is the article numbering.[40]

*Stage 15 – The League of Nations Draft Model – Mexico Model (1943).* The 1943 League of Nations conference was held in Mexico because of World War II. There are no substantial differences between the 1933/1935 version and the 1943 version of the allocation norm. As article 7 of the League of Nations Draft Model (1943) (Mexico Model), it comprises 108 words, rather than the 117 words of the 1933/1935 version. There are minor grammatical changes. For instance, certain expressions were slightly reworded: 'which would have been made between independent enterprises' (1933/1935) was replaced by 'which would have existed between independent enterprises' (1943). The full text of article 7 of the Mexico Model (1943) reads as follows:

> 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, there exist in their commercial or financial relations conditions different from those which would have existed 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 laws of the State of such enterprise.[41]

*Stage 16 – The League of Nations Draft Model – London Model (1946).* The League of Nations Draft Model (1946), agreed in London (London Model), retains the ALP under article 7 and deletes the procedural portion (rights of appeal) for the first time since 1927. This deletion signals a high point in the rise of the ALP as a rule-based regulation rather than as a procedural standard. Article 7 of the London Model (1946), which now consists of just 100 words, states as follows:

---

[39] While the ALP, a 1925 German invention, was having an increasingly leading role in dealing with the problem of allocation in the League of Nation Draft Models as of 1933, Hitler abrogated the ALP from German domestic law in 1934. *See* Andreas Oestreicher, *Transfer Pricing in Germany*, *in* RESOLVING TRANSFER DISPUTES: A GLOBAL ANALYSIS 415, 415 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[40] *Fiscal Committee Report to the Council on the Fifth Session of the Committee,* League of Nations Doc. C.252M.124 1935 II. A. (1935).

[41] *Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion,* League of Nations Doc. C.2M.2 1945 II. A. (1945).

> 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, there exist in their commercial or financial relations conditions different from those which would have existed 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.[42]

A word on the global transplanting of the ALP is in order. The ALP was first transplanted from the US to Europe via France in 1936,[43] then to Latin America via Argentina in 1943,[44] to Australasia via Australia in 1946,[45] subsequently to Asia via Japan in 1986[46] and, finally, to Africa via South Africa in 1995.[47] The global transplant of the ALP has normally been a direct consequence of waves of foreign direct investment (FDI) to the relevant countries and/or regions. For instance, the transplant of the ALP from the US to France in 1932, implemented via the France-US Tax Treaty (1932), was the result of the increasing expansion of American MNEs into France after World War I (*see* Stage 11).[48]

Interestingly, in all the cases studied here, the original intent behind importing the ALP into domestic and/or treaty law has been anti-avoidance, i.e., protecting the corporate income tax base from base erosion. For instance, the anti-avoidance function of the ALP was made manifest by the US

---

[42] *League of Nations Fiscal Committee London and Mexico Model Tax Conventions Commentary and Text,* League of Nations Doc. C.88M.88 1946 II. A. (1946).

[43] *See Convention and Protocol between the United States of America and France*, *supra* note 31, at art. IV (which entered into force on 1 Jan 1936). *See also* Eduardo Baistrocchi, *Transfer Pricing Dispute Resolution: The Global Evolutonary Path, in* RESOLVING TRANSFER PRICING DISPUTES: A GLOBAL ANALYSISM 835, 835-883 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[44] Eduardo Baistrocchi, *Transfer Pricing Disputes in Argentina, in* RESOLVING TRANSFER DISPUTES: A GLOBAL ANALYSIS 669, 679 (Eduardo Baistrocchi ed., 2012).

[45] Richard J. Vann, *Transfer Pricing Disputes in Australia, in* RESOLVING TRANSFER DISPUTES 359, 367 (Eduardo Baistrocchi ed., 2012).

[46] Toshio Miyatake, *Transfer Pricing Disputes in Japan*, *in* RESOLVING TRANSFER DISPUTES 415, 415 (Eduardo Baistrocchi ed., 2012).

[47] Lee Corrick, *Transfer Pricing Disputes in Africa*, *in* RESOLVING TRANSFER DISPUTES 790, 797 (Eduardo Baistrocchi ed., 2012).

[48] Carroll, *supra* note 10, at 40. ("[A]s the French were apprehensive about their ability to recapture any profit diverted from the French subsidiary to the American parent corporation, we agreed to incorporate in the treaty for bilateral application the well-known section 45 (now section 482 of the U.S. Internal Revenue Code), which authorised the tax authorities to relocate income as if transactions had been effected on an arm's length basis."); *see also id.* at 29.

Congress in 1928,[49] by the Canadian Parliament in 1939,[50] by the Japanese National Diet in 1986[51] and by the Brazilian National Congress in 1996.[52]

Most countries explored in this paper followed a similar evolutionary path, starting at different points in time and going along the path at different paces. The UK and China are clear examples. Whereas the UK took 209 years to complete the full cycle, as from 1799, when income taxation was first introduced, China achieved this in just thirty years, from the inception of a Western-style income tax in China in 1980.[53]

*Stage 17 – The OECD Draft Model (1963).[54]* The evolution of the wording of article 9 of the OECD Model can be divided into two periods. The first period runs from 1963 to 1977, during which time article 9 consisted of only one paragraph, addressing the primary adjustment problem.[55] The second period runs from 1977, when a second paragraph was added to article 9 to deal with the issue of corresponding adjustments, to the present.

The OECD Draft Model (1963) incorporates the ALP in article 9 as the central allocation norm regarding the profits of associated enterprises. The OECD acknowledges that the direct sources for article 9 of the OECD Model are the League of Nations Mexico Model (1943) and the London Model (1946).

Article 9 of the OECD Draft Model (1963) reads as follows:

> 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

---

[49] Avi-Yonah, *supra* note 15, at 29, 32–33.

[50] David G. Duff & Byron Beswick, *Transfer Pricing Disputes in Canada, in* RESOLVING TRANSFER PRICING DISPUTES 95, 101 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[51] *Id*.

[52] Isabel Calich & João D. Rolim, *Transfer Pricing Disputes in Brazil, in* RESOLVING TRANSFER PRICING DISPUTES 519, 524 (Eduardo Baistrocchi & Ian Roxan eds., 2012).

[53] Baistrocchi, *Transfer Pricing Dispute Resolution: The Global Evolutionary Path*, *in* RESOLVING TRANSFER PRICING DISPUTES 835, 837–38 (Eduardo Baistrocchi & Ian Roxan eds., 2012); J. Li, *Transfer Pricing Disputes in China, in* RESOLVING TRANSFER PRICING DISPUTES 634, 634 (Eduardo Baistrocchi & Ian Roxan eds., 2012)

[54] *See supra* Figure 2.

[55] The English text of article 9(1) of the OECD model (1977) is identical to article 9(1) of the OECD Draft Model (1963). *See* Georg Kofler, *Tax Disputes and the EU Arbitration Convention*, *in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES 205, 216 (Eduardo Baistrocchi ed., 2012). *Compare* Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, at 30 (1977) https://doi.org/10.1787/9789264055919-en *with* Org. for Econ. Co-operation & Dev. [OECD], *Draft Double Taxation Convention on Income and on Capital*, at 47 (1963) https://doi.org/10.1787/9789264073241-en.

> 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.

There are a number of differences in the wording of the allocation norm as crystallised in article 7 of the London Model (1946) as compared to article 9 of the OECD Draft Model (1963). They include the following: the concept of a 'dominant participation' was replaced by 'participation in the management, control or capital'; the word 'shall' was replaced by 'may'; and the word 'diverted' was replaced by 'accrued'. The Fiscal Committee stated that these asymmetries in the wording should not be deemed as an intention to innovate in respect of the ALP as designed in the Mexico and London Models:

> The rules proposed by the Fiscal Committee in these Articles are not an innovation. Most of the existing double taxation agreements contain solutions based on the Mexico and London Model Conventions of the League of Nations, and are thus to some extent uniform. The Fiscal Committee considered that the principles underlying those solutions are still valid. It has, therefore, readopted them, formulating them as clearly as possible and defining their practical application on a basis which is acceptable to all Member countries. The Fiscal Committee has not entered in detail into all the problems which can arise when an enterprise in one country makes profits in another, or attempted to draw up precise rules for each individual case. Indeed, this would not have been possible in the relatively restricted scope of an Article in a Convention, in view of the very many forms that international business assumes nowadays. Moreover, the settlement of any special cases which may arise should not give rise to serious difficulties when satisfactory general directive have been established and agreed by all States concerned.[56]

[56] For background material on article 9 of the OECD Draft Model (1963), *see* Org. for Eur. Econ. Co-operation & Dev. [OEEC], THIRD REPORT OF THE FISCAL COMMITTEE TO THE COUNCIL, OEEC Doc. C/60/157 ¶ 29(E) (1960).

> This Article [Article XVI] deals with associated enterprises (parent and subsidiary companies and companies under common control) and provides that in such cases the taxation authorities of a particular country may, for the purpose of calculating tax liabilities, re-write the accounts of the enterprises if, 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

*Stage 18 – The Commentary on Article 9 of the OECD Draft Model (1963).*[57] The Commentary on Article 9 of the OECD Draft Model (1963) is one paragraph long, consisting of 138 words. It states:

> This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if 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. 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.

Two points are noteworthy here. On the one hand, the language of the Commentary on Article 9 of the OECD Draft Model (1963) suggests the dual purpose of the article: (i) to protect taxpayers from primary adjustments that are incompatible with the ALP ('[n]o 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'); and (ii) to protect the corporate tax base from BEPS based on TP ('the taxation authorities [...] may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that country').[58] On the other hand, the phrasing 'the Article seems to call for very little comment' is remarkable. It reflects the OECD's perception of the ALP, by the early 1960s, as a largely rule-based, self-enforcing allocation norm.

---

> Article seems to call for very little comment. It should perhaps be mentioned that the provisions of the Articles apply only if special conditions have been made or imposed between the two enterprises. 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.

[57] *See supra* Figure 2.

[58] Org. for Econ. Co-operation & Dev. [OECD], *Draft Double Taxation Convention on Income and on Capital*, ¶ 1 at 94 (1963) https://doi.org/10.1787/9789264073241-en.

2. The Decline of the Second Era (1963–2010)

*Stage 19 – The Nestle Case (1963).*[59] *The Nestle Company, Inc. v. Commissioner*, decided in the US in 1963, is the world's first TP dispute regarding intangibles for which no comparable was available.[60] *Nestle* involved the payment of royalties in return for patents and the valuation of those patents. The Tax Court analysed the royalty rate for a valuable intangible, including a renegotiation of the rate to reflect profitability.[61]

The *Nestle* case, decided in the very same year in which the OECD introduced the OECD Draft Convention including the ALP in article 9, signals the beginning of the decline of the ALP (i.e., as a self-enforcing rule). Indeed, intangibles emerged from 1963 onwards as the Achilles heel of the ALP because of the increasing unavailability of comparables.

*Nestle* created the commensurate-with-income (CWI) standard, which would become a crucial valuation method of intangibles.[62] Indeed, the CWI standard was first transplanted from the *Nestle* case to the 1986 US tax reform and the regulations of article 482 of the IRC and then from US domestic law to the OECD Guidelines in 1995.[63]

*Stage 20 – The European Commission's Proposal on TP (1976).*[64] The first exploration of a procedural solution to the TP problem in the second era began in the EU in 1976. It crystallised in the European Commission's proposal for a directive to eliminate double taxation in the case of transfers of profits between associated enterprises.[65] This proposal was the impetus that led up to the EU Arbitration Convention (1990).[66]

*Stage 21 – The OECD Draft Model (1977).*[67] A second paragraph was added to article 9 of the OECD Model in 1977. It deals with the appropriate adjustment process, the purpose and working of which is outlined in the

---

[59] *See supra* Figure 2.

[60] Nestle Co., Inc. v. Commissioner, 22 T.C.M. (CCH) 46 (1963).

[322] *Id.*

[62] Several commentators have suggested that the phrase "commensurate with income" derives from *Nestle*, *supra* note 60, at 46. *See, e.g.*, IRS Notice 88-123, 1988-2-C.B. 458, 475 (1988) [hereinafter *U.S. White Paper* (1988)]. The opinion states that "[s]o long as the amount of the royalty paid was commensurate with the value of the benefits received and was reasonable, we would not be inclined to, nor do we think we would be justified to, conclude that the increased royalty was something other than what it purported to be." *Nestle, supra* note 60, at 46.

[63] *See* Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing Guidelines*, ¶ 35 at 14 (1995).

[64] *See supra* Figure 2.

[65] *Transfer Pricing and the Arbitration Convention*, EUR. COMM'N, https://ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/transfer-pricing-arbitration-convention_en (last updated Sep. 1, 2020).

[66] *See* Kofler, *supra* note 55, at 211.

[67] *See supra* Figure 2. Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, at 30 (1977) https://doi.org/10.1787/9789264055919-en.

Commentary on Article 9 of the OECD Model (1977). Article 9(2) of the OECD Model (1977)[68] provides as follows:

> 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 Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Three elements of article 9(2) of the OECD Model (1977) are particularly relevant here. First, the purpose of article 9(2) is broader than that of article 23 on methods for the alleviation of double taxation. Indeed, while article 9(2) aims to solve the problem of economic double taxation, article 23 is focused only on resolving juridical double taxation. Second, there is an asymmetry between article 9(1) and article 9(2). Indeed, while article 9(1) seems to grant contracting states the option to implement primary adjustment (it uses the word 'may'), article 9(2) establishes the contracting states' duty to implement corresponding adjustments if certain conditions are met (it uses the word 'shall' rather than 'may'). Finally, article 9(2) implicitly refers to the MAP, which may suggest an early evolution towards transforming article 9 into a standard-based procedural regulation.

*Stage 22 – The Commentary on Article 9 of the OECD Model (1977).*[69] The Commentary on Article 9 of the OECD Model expanded 7.6 times in a short period of time: from 138 words in 1963 to 1,049 words in 1977.[70] This expansion suggests that the application of the ALP, as encapsulated in article 9 of the OECD Model, had become increasingly complex since 1963. Interestingly, key problems in the application of the ALP, including asymmetries of information and TP disputes, are acknowledged for the first time in the OECD Commentary on Article 9 (1977).[71]

---

Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, at 30 (1977) https://doi.org/10.1787/9789264055919-en.

[69] *See supra* Figure 2.

[70] *Compare* Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, at 88–90 (1977) https://doi.org/10.1787/9789264055919-en *with* Org. for Econ. Co-operation & Dev. [OECD], *Draft Double Taxation Convention on Income and on Capital*, at 93 (1963) https://doi.org/10.1787/9789264073241-en.

[71] Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, at 88–90 (1977) https://doi.org/10.1787/9789264055919-en.

The purpose of the Commentary on Article 9 of the OECD Model (1977) was twofold. On the one hand, it aimed to clarify certain elements of the OECD Commentary on Article 9(1) (1963). On the other hand, it intended to explain the working of the secondary adjustment and to suggest that MAPs, as encapsulated in article 25 of the OECD Model, should be used by contracting states to solve transfer pricing disputes in the corresponding adjustment area.

The Commentary on Article 9(1) of the OECD Model (1977) clarifies that the expression 'open market commercial terms', as used in the OECD Commentary on Article 9(1) (1963), is synonymous with the ALP. This clarification is made by adding a few words in brackets at the end of the last sentence of the Commentary.[72] The OECD seems to be trying to avoid the creation of an allocation norm different from the ALP regarding the profits of associated enterprises.

The Commentary on Article 9(2) of the OECD Model (1977) focuses on the appropriate adjustment.[73] It acknowledges that the operation of article 9(1) can create problems of economic double taxation that may not be solved by article 23, as that article normally deals with problems of juridical double taxation. So article 9(2) of the OECD Model creates a new mechanism to solve problems of economic double taxation: the appropriate adjustment (*see* paragraph 2 of the Commentary on Article 9(2) of the OECD Model, 1977).

Needless to say, the working of the appropriate adjustment is subject to relatively high collective action costs, as it can only be activated if both contracting states agree on the primary adjustment (*see* paragraph 3 of the Commentary on Article 9(2) of the OECD Model, 1977). Moreover,

---

[72] *Id.* ¶ 1 at 88.

> This Article deals with associated enterprises (parent and subsidiary companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. 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 (*on an arm's length basis.*) (emphasis added).

[73] *Id*. ¶¶ 2–8 at 88–89.

> 2. *The re-writing of transactions between associated enterprises in paragraph 1 may give rise to economic double taxation* (taxation of the same income in the hands of different persons) *insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has_already been taxed in the hands of its associated enterprise in State B. Paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation.*

Contracting States are expected to agree on how to implement the appropriate adjustment (*see* paragraph 4 of the Commentary on Article 9(2) of the OECD Model, 1977). This expectation of a negotiation between contracting states for solving TP disputes suggests a gradual return to a standard-based procedural solution, similar to the one explored by the League of Nations in 1928.

The secondary adjustment procedure is beyond the scope of article 9(2) of the OECD Model (1977). The procedure aims to offer a complete resolution of the economic double taxation left unsolved by the appropriate adjustment (*see* paragraphs 5 and 6 of the Commentary on Article 9(2) of the OECD Model, 1977). Procedural elements related to article 9(2), such as the length of time during which the relevant residence state is to be under obligation to make an appropriate adjustment, are not covered by this provision (*see* paragraph 7 of the Commentary on Article 9(2) of the OECD Model, 1977).

The Commentary on Article 9 of the OECD Model (1977) then refers, for the first time in history, to disputes regarding TP, in particular appropriate adjustments, and suggests using MAPs under article 25 as a procedural solution (*see* paragraph 8 of the Commentary on Article 9(2) of the OECD Model, 1977). This reference to MAPs in the context of TP is another signal of the gradual transformation of the ALP into a procedural, standard-based regulation.

There are various examples of disputes on the application of article 9(2) of the OECD Model. The Swiss Supreme Court initially ruled that a transfer of profits further to a secondary adjustment was to be characterised as a constructive dividend subject to Swiss withholding tax. Since then, however, the Swiss Federal Administration has relaxed its practice and generally considers that a transfer further to a secondary adjustment made in the framework of a MAP triggers no withholding tax.[74]

The Observations on the Commentary on Article 9 of the OECD Model (1977) are also meaningful. Both Australia and New Zealand refer to problems in the enforcement of article 9(2) due to asymmetries in the information available and suggest a procedural solution as well.[75] Seven

---

[74] ARRÊTS DU TRIBUNAL FÉDÉRAL SUISSE [ATF] [Federal Court of Switzerland] 5 Apr. 1984, ATF 110 Ib, 127; *see* Danon, *Tax Treaty Disputes in Switzerland*, *in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES, 613, 646 (Eduardo Baistrocchi ed., 2012).

[75] Org. for Econ. Co-operation & Dev. [OECD], *Model Double Taxation Convention on Income and on Capital*, ¶¶ 9–10 at 88–90 (1977) https://doi.org/10.1787/9789264055919-en

> 9. In negotiating conventions with other Member countries, *Australia and New Zealand* would wish to be free to propose a provision to the effect that, if the *information available* to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

OECD member countries have made reservations on article 9(2) of the OECD Model. This suggests that they were initially unhappy with the secondary adjustment process.[76]

*Stage 23 – The OECD Transfer Pricing Report (1979).*[77] The OECD Committee on Fiscal Affairs published its Transfer Pricing Report in 1979. In it, the OECD acknowledged for the first time that the application of the ALP is often complex and difficult, and the report's 107 pages represent an attempt to deal with these issues. The central purpose of the report is given as follows:

> The process of establishing an arm's length price is often complex and difficult and the difficulties are likely to be greater for both taxpayers and tax authorities if there is a lack of a common approach to the matter. The 1963 OECD Draft Double Taxation Convention on Income and on Capital laid a foundation for such a common approach in providing a common concept and a common language but the need now is to develop practical means of applying one. It is another purpose of this report therefore to establish as far as possible such an approach with the objective not only of enabling the interest of the national authorities involved to be protected but also of enabling the double taxation of the enterprises involved to be prevented. The aim is also to provide guidance of universal validity and it is considered that the conclusions in the report are equally applicable, for example, whether the relevant transactions are between entities in developed countries or entities in developed and developing countries.[78]

The OECD Transfer Pricing Report (1979) endorsed the ALP as the main allocation norm regarding the profits of associated enterprises. The report also embedded a number of standards (particularly three TP methods) to the ALP rule because 'the need now is to develop practical means of applying one [common approach]'. The three TP methods are: (i) the comparable uncontrolled price method; (ii) the resale price method; and (iii) the cost plus method.

Interestingly, the OECD Transfer Pricing Report (1979) emphasised the dual purpose of the ALP. First, it serves as a mechanism to protect taxpayers from economic double taxation ('enabling the double taxation of the

---

> 10. Australia would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise." (emphasis added).

[76] *Id*. ¶ 11 at 90 ("Belgium, Finland, Germany, Italy, Japan, Portugal and Switzerland reserve the right not to insert paragraph 2 in their conventions.")

[77] *See supra* Figure 2.

[78] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing and Multinational Enterprises*, ¶ 6 at 10 (1979) https://doi.org/10.1787/9789264167773-en.

enterprises involved to be prevented'). Second, it aims to protect the corporate tax base from base erosion and profit shifting caused by TP abuse ('with the objective [...] of enabling the interest of the national authorities involved to be protected'). Finally, the 1979 identifies the global scope of this soft law when it refers to develop and developing countries.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) are the most important innovation involving the OECD Model regarding TP since the late 1970s. The OECD Guidelines are now the authoritative statement of the ALP, as they lay down the most comprehensive soft law on the allocation norm regarding the profits of associated enterprises since the inception of corporate income tax systems in the G20.[79] The OECD Guidelines, which were first launched in 1995, based on a 1979 OECD report,[80] have been updated in 2009, 2010 and 2017. The 2017 update of the OECD Guidelines is a crucial product of the BEPS Reports (*see* Stage 56).

*Stage 24 – The UN Model (1980).[81]* The UN published its Model Double Taxation Convention between Developed and Developing Countries (UN Model) in 1980. The purpose of the UN Model (1980), and the difference between it and the OECD Model, was given as follows:

> The United Nations Model Convention represents a compromise between the source principle and the residence principle, although it gives more weight to the source principle than does the OECD Model Convention. As a correlative to the principle of taxation at source the articles of the Model Convention are predicated on the premise of the recognition by the source country that (a) taxation of income from foreign capital would take into account expenses allocable to the earning of the income so that such income would be taxed on a net basis, that (b) taxation would not be so high as to discourage investment and that (c) it would take into account the appropriateness of the sharing of revenue with the country providing the capital. In addition, the United Nations Model Convention embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either foreign tax credit or exemption as in the OECD Model Convention.[82]

---

[79] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at 3 (2010) https://doi.org/10.1787/tpg-2010-en.

[80] *Id*.

[81] *See supra* Figure 2.

[82] U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 at 5–6 (1980).

This paragraph highlights the differing purposes of the OECD Model and the UN Model. Nevertheless, article 9 of the UN Model (1980) reproduces verbatim article 9 of the OECD Model (1977). As there are asymmetries in other articles of the OECD and the UN Models, the reference in article 9(2) to such other articles may have asymmetric results.[83]

There is no evidence in the UN Model (1980) of any attempt from the emerging and developing world to create a legal technology incompatible with the OECD Model. The BRICS countries played a minor role in the drafting of the UN Model (1980). For instance, neither China nor Russia took part in the drafting of the UN Model (1980), as neither had yet joined the global economy.

*Stage 25 – The Commentary on the UN Model (1980). See Figure 2.* The UN Model (1980) reproduces the Commentary on Article 9 of the OECD Model (1977). It only adds a section entitled General Considerations, which states the following:

> *Article 9* of the United Nations Model Convention reproduces article 9 of the OECD Model Convention.
>
> This article deals with associated enterprises, i.e., parent and subsidiary companies and companies under common control. It *should be considered in conjunction with article 25 on mutual agreement procedure and article 26 on exchange of information*, just as article 9 of the OECD Model Convention has to be considered with articles 25 and 26 of that Convention.
>
> The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorises a determination on the basis of the arm's-length principle.[84]

In this section, the UN Model innovates in respect of the OECD Model in an important dimension. Indeed, the UN explicitly refers to the MAP and exchange of information provisions, within the meaning of articles 25 and 26. It appears, then, that the UN was aware of both the relevance of procedural solutions and the need to solve asymmetries of information (MAP and the exchange of information) to facilitate the application of the ALP. The OECD first made the connections between article 9 and articles 25 and 26 years later, in 1982 and 1992, respectively (*see* Stages 26 and 32).

The Commentary on Article 9 of the UN Model (1980) also refers to a requirement for domestic legislation to make the ALP applicable. Perhaps the UN made a mistake here, as this point should have been in the UN

[83] Stig Sollund & Marcos Aurélio Pereira Valadão, *The Commentary on Article 9 – The Changes and Their Significance and the Ongoing Work on the UN Transfer Pricing Manual*, 66 BULL. FOR INT'L TAX'N 608, 608–11 (2012).

[84] U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, *supra* note 82, at 105–06 (emphasis added).

Commentary on Article 7 (rather than Article 9), because there is a reference to the interactions between a head office and its PE.

*Stage 26 – Corresponding Adjustment and MAPs (OECD) (1982).*[85] The OECD took another step towards gradually transforming the ALP into a standard-based procedural regulation in the early 1980s. This step was crystallised in a report entitled Transfer Pricing, Corresponding Adjustment and the Mutual Agreement Procedure (the 1982 Report).[86]

The 1982 Report outlined a TP dispute resolution system fundamentally based on the MAP procedure, as defined by article 25 of the OECD Model. To this end, the 1982 Report for the first time explicitly linked article 9(2) with article 25. It then expanded the scope of article 25 of the OECD Model from juridical double taxation to economic double taxation. The 1982 Report timidly suggested the possibility of tax arbitration for TP disputes but rejected it on the grounds that tax arbitration would 'represent an unacceptable surrender of fiscal sovereignty'.[87]

In sum, OECD policy since the early 1980s has been to channel the resolution of TP disputes to the MAP system, rather than to standard local tax procedures. Tax arbitration was excluded as an option, at least until the issuance of the OECD Guidelines (1995) (*see* Stage 35).

*Stage 27 – US Legislative Developments (1986).*[88] In the United States, the Reagan administration was concerned with the unsatisfactory application of the ALP regarding the TP of intangible property, given the increasing lack of comparables. The Tax Reform Act of 1986 amended section 486 of the IRC by providing that any income from a transfer or license of intangible property must be commensurate with the income attributable to the intangible.[89] The CWI standard would be implemented by introducing amendments to the IRC section 482 regulations.[90]

---

[85] *See supra* Figure 2.

[86] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, ¶¶ 115(b)(ii)-(c) at 38–40 (1984) https://doi.org/10.1787/9789264167803-en (on the possibility of mandatory corresponding adjustments subject to arbitration, recommending that

> for the avoidance of doubt, that it should be made clear, by an addition to the Commentary on *Article 25 of the Model Convention*, that this Article *provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation. . . . The Committee does not, for the time being, recommend the adoption of a compulsory arbitration procedure to supersede or supplement the mutual agreement procedure.* In its view the need for such compulsory arbitration has not been demonstrated by the evidence available *and the adoption of such a procedure would represent an unacceptable surrender of fiscal sovereignty*" (emphasis added).

[87] *Id.*

[88] *See supra* Figure 2.

[89] *U.S. White Paper* (1988), *supra* note 62, at 458.

[90] Org. for Econ. Co-operation & Dev. [OECD], *Intercompany Transfer Pricing Regulations Under U.S. Section 482 Temporary and Proposed Regulations*, at 3 (1993).

The language contained in the legislative history for the 1986 US Congress advocated the abandonment of the ALP.[91] Thus, the 1986 tax reform triggered strategic interaction between the US and the OECD to adapt the ALP to technological innovation. This interaction ran from the 1986 tax reform in the US to the publication of the OECD Guidelines (1995), which replaced the OECD Transfer Pricing Report (1979). It is noteworthy that the 1979 and 1995 OECD TP reports were structured very similarly to the IRC section 482 regulations of 1968 and 1994, respectively, addressing the same issues and reaching the same conclusions in most instances. The convergence of the OECD reports and the IRC section 482 regulations is not a coincidence. Rather, it is the consequence of long-standing US tax policy to export section 482 regulations to other countries, with a view to creating international consensus on the application of the ALP.[92] US-OECD strategic interaction in the TP and intangibles arena continues in Stage 29.

*Stage 28 – The OECD Thin Capitalization Report (1987).*[93] The forerunner to the Commentary on Article 9(1) of the OECD Model (1992) was the OECD Thin Capitalisation Report (1987).[94] The global transplant of the ALP has normally been a direct consequence of waves of foreign direct investment (FDI) to the relevant countries and/or regions. For instance, the transplant of the ALP from the US to France in 1932, implemented via the France-US Tax Treaty (1932), was the result of the increasing expansion of American MNEs into France after World War I (*see* Stage 11).

> The basis for this view is as follows. Article 9(1) allows the tax authority of a Contracting State to adjust the taxable profit of an enterprise of that State to include profits which have not accrued to it in its accounts but which would have accrued to it in the arm's length situation. Thus, if profits have not accrued to the enterprise in its accounts because it has paid what it has described as interest to an associated enterprise and this payment has been deducted in arriving at the profits shown in the accounts but, in the arm's length situation, the payment would not have been deductible, then, in adjusting the taxable profits of the enterprise to include the payment, the tax authority would be acting in conformity with Article 9(1). Provided therefore that the re-categorisation of interest as a distribution of profit under domestic thin capitalisation rules has the effect of including in the profits of a domestic enterprise only

[91] Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation* 20 (U. Mich L. & Eng'g, Olin Working Paper 07-017, 2007), http://www.ssrn.com/abstract=1017524.

[92] Jens Wittendorff, *The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?*, 62 TAX NOTES INT'L 223, 227 (2011).

[93] *See supra* Figure 2.

[94] Org. for Econ. Co-operation & Dev. [OECD], *OECD Thin Capitalisation Report* (1987).

> profit which would have accrued to it in the arm's length situation there is nothing in Article 9 to prevent operation of those rules.

In sum, the OECD Thin Capitalisation Report (1987) deals with three elements related to article 9(1) of the OECD Model, all of which were included to the Commentary on Article 9 of the OECD Model (1992): (i) article 9(1) does not prevent the application of domestic regulations on thin capitalisation; (ii) article 9(1) may be used to recharacterize certain transactions; and (iii) the application of thin capitalisation rules should produce results compatible with the ALP.

*Stage 29 – The US White Paper (1988).*[95] IRS Notice 88-123 (US White Paper, 1988) recommends that the US should continue to adhere to the ALP. It portrays the suggested TP methods, including the CWI standard and the profit split method, as compatible with the ALP. [96] The US White Paper outlines the US position as follows:

> The problems that have been encountered in relation to transfers of intangible property are both legal and administrative. The 1986 Act clarifies the legal standard for determining arm's length pricing by stating that transfer prices for intangible property must be "commensurate with income." [This White Paper] discusses Congress' 1986 change to section 482 and explains that this standard requires periodic, and generally prospective, adjustments to transfer prices to reflect significant changes in the income attributable to intangible property. In any event, transfer prices must be determined on the basis of true comparables if they in fact exist. [The White Paper] concludes that the commensurate with income standard is fully consistent with the arm's length principle.[97]

US-OECD strategic interaction in the TP and intangibles arena continues in Stage 34.

*Stage 30 – The First Bilateral APA in the OECD (1990).*[98] The first bilateral APA was concluded between Australia and the US in relation to Apple in 1990.[99] This is an additional step toward transforming the ALP into a standard-based procedural regulation because the ALP has been increasingly grounded in negotiations between the contracting states.[100]

---

[95] *See supra* Figure 2.

[96] U.S. DEP'T OF TREAS., A STUDY OF INTERCOMPANY PRICING (U.S. Dep't Treas. ed., 1988) [hereinafter *US White Paper*].

[97] *Id.* at 1.

[98] *See supra* Figure 2.

[99] Vann, *supra* note 45, at 359–414.

[100] *Id.*

*Stage 31 – The EU Arbitration Convention (1990).*[101] The current legal framework on arbitration at the EU level is limited to the EU Arbitration Convention of 1990.[102] It foresees a multi-phase process for the elimination of double taxation in TP cases by agreement between the contracting states, including proceedings before an arbitration panel. To date, experience is limited because very few cases have gone on to arbitration. At the beginning of 2015, 1319 MAP cases remained ‘open’ under the Convention, 439 further cases were initiated that year, and only 245 were completed — leaving an inventory of 1513 cases. The indication is that a backlog of cases is forming under the Convention. The new Council proposal aims to broaden the scope of the EU Arbitration Convention of 1990 and ensure cases do not ‘get stuck’ in the procedure or fail to reach a resolution. It is unclear, however, whether the new dispute resolution procedure will resolve the issues of backlog.[103]

Tax administrations provide input on certain substantive topics as well as on the practical application of the EU Arbitration Convention (1990). However, the mere existence of the Convention is enough to exert a deterrent effect; i.e., it creates an incentive for tax administrations to resolve the relevant cases in the given time frame without referring them to an arbitration panel.[104]

Figure 32, The Commentary on Article 9 of the OECD Model (1992).[105] The 1992 update of the Commentary on Article 9 of the OECD Model[106] appears to be a turning point and a catalyst for further expansion of the role of standard-based procedural solutions to the allocation problem given the impact of intangibles on the application of the ALP. The OECD Commentary on Article 9 (1992) begins by reiterating a sentence introduced in 1963 and maintained in the 1977 update, “. . .[t]his paragraph [i.e., article 9(1) of the OECD Model] seems to call for very little comment.”[107] However, the OECD Commentary on Article 9 (1992) now explicitly refers to two OECD reports, covering over 200 pages; (i) the OECD Transfer Pricing Report (1979), and (ii) the OECD Thin Capitalisation Report (1987). Thus, the OECD Commentary on Article 9 has been the longest of the OECD Commentaries to the OECD Model since 1992. This unparalleled length suggests the central relevance of the allocation norm regarding the profits of associated enterprises in international taxation.

The new paragraph 2 of the Commentary on Article 9(1) of the OECD Model states– for the first time — that article 9(1) may be used to recharacterize transactions if certain conditions are met. This proposition is

---

[101] *See supra* Figure 2.

[102] 1990 O.J. (L 225) 10.

[103] *Proposal for a Council Directive on Double Taxation Dispute Resolution Mechanisms in the European Union*, COM (2016) 686 final (Oct. 25, 2016).

[104] G. Kofler, *Tax Disputes and the EU Arbitration Convention*, *in* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES (E. Baistrocchi ed., 2017).

[105] *See supra* Figure 2.

[106] Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention on Income and on Capital: Commentary on Article 9*, ¶ 1(1992).

[107] *Id.* at 1.

grounded in the OECD Thin Capitalisation Report (1987).[108] It also maintains that domestic thin capitalisation regulations may be consistent with the ALP. [109] The purpose here seems to be to offer contracting states the option of complementing a tax treaty's specific anti-avoidance rule (SAAR; i.e., the ALP) with a domestic SAAR (i.e., thin capitalisation) in allocating the profits of associated enterprises. Finally, the OECD Commentary on Article 9 (1992) states that it should be applied retroactively (in other words, to existing tax treaties).[110]

The new paragraph 3 of the Commentary on Article 9(1) of the OECD Model, introduced in 1992, refers for the first time to the problem of valuating intangibles. This paragraph also validates for the first time the three TP methodologies put forth in the OECD Transfer Pricing Report (1979): (i) the comparable uncontrolled price method; (ii) the resale price method; and (iii) the cost plus method.[111]

In addition, the Commentary on Article 9 of the OECD Model (1992) attempts for the first time — to link the OECD Transfer Pricing Report (1979) to customary international law in search of legitimacy. Paragraph 3 of the OECD Commentary on Article 9 (1992) states that the conclusions of the Transfer Pricing Report "represent internationally agreed principles and provide valid guidelines for the application of the arm's length principle

---

[108] *Id.* at 141. ¶ 2 of the 1992 OECD Model reads as follows:

> As discussed in the Committee on Fiscal Affairs' Report on Thin Capitalisation, there is an interplay between the tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:
>
> a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
>
> b) the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
>
> c) 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 arm's length profit, and that this principle should be followed in applying existing tax treaties.

[109] *Id*. at ¶ 2(a).

[110] *Id*. at ¶ 2(c).

[111] *Id*. at ¶ 3. Para. 3 of the Commentary on Article 9(1) reads as follows:

> The Committee has also studied the transfer pricing of goods, technology, trade marks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms. Its conclusions, which are set out in the report entitled "Transfer Pricing and Multinational Enterprises", represent internationally agreed principles and provide valid guidelines for the application of the arm's length principle which underlies the Article.

which underlines the Article."[112] The OECD Commentary does not ground this proposition.[113]

The new paragraph 4 of the Commentary on Article 9(1) of the OECD Model (1992) refers to a number of issues that denote the increasingly standard-based procedural character of the ALP. These issues include: (i) a reversal of the burden of proof; (ii) presumptions; (iii) information asymmetries; and (iv) incompatible solutions to these procedural issues provided by contracting states.[114] Paragraph 4 of the OECD Commentary on Article 9(1) (1992) also states that these incompatibilities should be dealt with by means of two procedural settings: (i) corresponding adjustment; and (ii) MAPs.[115]

For the first time, the new paragraph 11 of the Commentary on Article 9(2) of the OECD Model (1992) openly refers to the problem of TP disputes in the context of appropriate adjustment. It recommends using MAPs as a procedural solution.[116]

---

[112] *Id.*

[113] *Id.*

[114] OECD, *supra* note 106, at ¶ 4. Para. 4 of the Commentary on Article 9(1) reads as follows:

> The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of the proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. 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. Also, almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of the proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustment 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.

[115] *Id.*

[116] *Id*. at ¶ 11. Para. 11 of the Commentary on Article 9(1) reads as follows:

> If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof (see in particular paragraphs 9, 10, 22, 23, 29 and 30 of the Commentary on Article 25).

*Stage 33 – OECD Reaction to US TP reform (1993).*[117] The OECD broadly accepted the new US approach to intangibles (the CWI standard) as a valuation method compatible with the ALP.[118] The OECD decided to consider the introduction of the CWI standard in the revision of the OECD Transfer Pricing Report (1979), which would subsequently be implemented in the OECD Guidelines (1995):

> The problems currently being encountered in the transfer pricing area by the United States are not new and are similar to those encountered by other Member countries of the OECD. The Task Force wishes to emphasise again that these difficulties, which are inherently global in nature, cannot be resolved unilaterally. A multilateral approach is required which builds upon widely accepted principles of international taxation. The recent discussions in the United States regarding the proposed Regulations provide a new approach to the determination of transfer prices that will be considered in the revision of the OECD's guidelines set out in the 1979 report entitled "Taxation and Multinational Enterprises."[119]

Interestingly, the OECD Task Force "also recommended that the [US] Temporary Regulations not to be finalised before [the OECD] completes the

---

117 *See supra* Figure 2.

118 Organisation for Economic Co-operation and Development [OECD], *Intercompany Transfer Pricing Regulations under US Section 482 Temporary and Proposed Regulations*, OCDE/DE(93)131 (Paris 1993). On the question of compatibility, *see Id*. at ¶ 2.5:

> One of the main issues raised by the Task Force in connection with the proposed Regulations issued by the United States in 1992 was the consistency of the regulations with the arm's length standard. Of particular concern was the commensurate with income standard applicable to transfers or licenses of intangible property that was added to section 482 by the 1986 Tax Reform Act. The Task Force Report indicates that to the extent that the implementation of the commensurate with income standard involves the use of hindsight, there is a risk that the arm's length standard will be violated because the application of the arm's length standard depends on the evaluation of the facts and circumstances surrounding transactions at the time they take place. The Task Force Report suggests that the inconsistency between profit approaches used to implement the commensurate with income standard and the arm's length principle could be resolved by limiting the application of such methods to profits that were predictable or reasonably foreseeable by the taxpayer at the time the transaction was entered into. The Task Force concluded that "as long as the objective is to exclude from consideration all events which were not known and could not reasonably have been predicted by the parties at the time the transfer was made, the Task Force would not regard the arm's length standard as necessarily having been breached, although this could raise serious practical problems." The revised Regulations do not take such a narrow approach.

119 *Id*. at ¶ 1.1.

review of the OECD 1979 Report".[120] Nonetheless, the US decided not to follow the OECD recommendation on the timing of this reform and the final US Regulations were issued before the publication of the OECD Guidelines (1995).

*Stage 34 – Final US Regulations (1994).*[121] The most significant innovation of the final US Regulations is the introduction of the CWI concept and the elevation of profit split to a status equal to all other methods in order to reach an arm's length result.[122] These innovations aimed at adapting the ALP to intangibles by means of standard-based procedural regulations. All these US innovations were later introduced in the OECD Guidelines (1995). This dynamic suggests that the US remained strong enough throughout the 1990s in the OECD world and beyond to lead in driving the evolution of the ALP, as encapsulated in article 9 of the OECD Model, in pursuit of dealing with technological innovations.

*Stage 35 – The OECD Guidelines (1995).*[123] The central innovation of the 1995 version of the OECD Guidelines was twofold: first, the creation of two additional TP methods (the profit split method and the transactional net margin method); and second, a section on procedural fairness in TP disputes. These two innovations were the product of the increasing difficulties of applying the ALP, particularly when no comparables are available, and the consequent expansion in the volume of TP disputes.

*Stage 36 – The Commentary on Article 9 of the OECD Model (1998).*[124] The OECD released a new version of the OECD Model in 1998. The Commentary on Article 9 of the OECD Model (1998) explicitly refers to the OECD Guidelines (1995) as part of the Commentary, thus replacing the OECD Transfer Pricing Report (1979). With this, the size of the OECD Commentary on Article 9 expanded from about 200 pages to over 300 pages.

*Stage 37 – The UN Model (1999).*[125] The first two paragraphs of article 9 of the OECD Model and the UN Model have been identical since the inception of the UN Model in 1980. The third paragraph of Article 9 of the UN Model, which has no equivalent in the OECD Model, aims to restrict the scope of article 9(2) on corresponding adjustments.[126] Article 9(3) of the UN Model (2001) reads as follows:

> The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the

[120] *Id*. at ¶ 4.4.

[121] *See supra* Figure 2.

[122] Avi-Yonah, *supra* note 15, at 1343.

[123] *See supra* Figure 2.

[124] *Id*.

[125] *Id*.

[126] Department of Economic & Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries*, U.N. Doc. ST/ESA/PAD/SER.E/21 (New York, 2001).

> enterprises concerned is liable to penalty with respect to fraud, gross negligence or willful default.

As stated in article 9(3) of the UN Model (2001), the intent here is to allow the contracting states to apply a treatment different from that of articles 9(1) and (2) when there is misconduct on the part of the taxpayer, such as tax fraud and the like. In this respect, paragraph 9 of the Commentary on Article 9 of the UN Model (2001) states that "[m]ember countries may consider such double penalties as too harsh," but it should be borne in mind that "cases involving levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner."[127]

In sum, for the first time, the UN decided to innovate in the area of the allocation norm by adding a new paragraph to article 9 in 1999. The Commentary on Article 9 of the UN Model (2001) suggests that the insertion of this provision was prompted by the UN's perception of the existence of abuse by certain taxpayers regarding the allocation norm.[128]

*Stage 38 – The Commentary on Article 9 of the OECD Model (2000).*[129] The Commentary on Article 9 of the OECD Model was substantially revised in 2000 with the addition of an explicit reference to the OECD Guidelines (1995).[130] This reference took the form of a single paragraph added to the OECD Commentary on Article 9 itself. It provides the following:

> This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common

---

[127] *Id.*

[128] *Id*. at ¶ 9. The Commentary on Article 9(3) reads as follows:

> The Group of Experts has made an amendment in 1999 to article 9 by inserting a new paragraph 3. Paragraph 2 of article 9 requires a country to make an *'appropriate adjustment' (a correlative adjustment)* to reflect a change in the transfer price made by a country under article 9, paragraph 1. *The new paragraph 3 provides that the provisions of paragraph 2 shall not apply where the judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default.* In other words, in case a final order has been passed in a judicial, administrative or other legal proceeding pointing out that in relation to the adjustment of profits under paragraph 1 one of the enterprises is visited with a penalty for fraud, gross negligence or wilful default, there would be no obligation to make the correlative adjustment under paragraph 2. *This approach means that a taxpayer may be subject to non-tax and tax penalties.* Member countries may consider such double penalties as too harsh. Some members pointed out that cases involving levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner (emphasis added).

[129] *See supra* Figure 2.

[130] Org. for Econ. Co-operation & Dev. [OECD], *Model Tax Convention on Income and on Capital: Commentary on Article 9*, ¶ 1 (Apr. 29, 2000).

> control) on other than arm's length terms. The Committee has spent considerable time and effort (and continues to do so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement.

This new paragraph shows that, as of 2000, the OECD openly acknowledged substantial difficulties in applying article 9 of the OECD Model. Indeed, the deeply rooted OECD phrasing, according to which "this paragraph [i.e., article 9(1)] seems to call for very little comment," which was introduced in 1963 and repeated in 1977 and 1992, was replaced in 2000 by the Committee's telling words above regarding the "considerable time and effort" it has spent on examining various issues surrounding article 9 of the OECD Model and its application.

The OECD seems to have grown increasingly concerned with the problem of legitimacy in the OECD Guidelines. This concern can be inferred from the evolution of the wording of the Commentary on Article 9 of the OECD Model on this front. In 1992, the OECD Commentary stated that the OECD Transfer Pricing Report (1979) "represent[s] internationally agreed principles and provide[s] valid guidelines for the application of the arm's length principle which underlies the Article."[131] In 2000, the OECD stated that the OECD Guidelines (1995) "represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement."

In sum, the Commentary on Article 9 of the OECD Model (2000) refers to the OECD Guidelines (1995) (259 pages) rather than the OECD Transfer Pricing Report (1979) (107 pages). Since 2000, the OECD Commentary on Article 9 has been almost as long as the condensed version of the entire OECD Model and the various OECD Commentaries on all its other articles (308 pages). This is clearly indicative of the increasing difficulties in the application of article 9 of the OECD Model and the ensuing need for increasingly expansive soft law on this article.

[131] OECD, *supra* note 106, at ¶ 3.

*Stage 39 – The Commentary on Article 9 of the OECD Model (2003).*[132] Neither article 9 nor its Commentary was amended in the 2003 update of the OECD Model.[133]

*Stage 40 – Improving the Process for Resolving Disputes (2004).*[134] In 2004, the OECD Committee on Fiscal Affairs released a progress report on its work for improving the resolution of cross-border tax disputes. The report is entitled *Improving the Process for Resolving International Tax Disputes*. It included 31 proposals aimed at improving the way treaty disputes are solved through MAPs.[135]

In this report, there is a new OECD proposal linking the secondary adjustment with MAPs. The OECD stated this proposal as follows: "The relationship between secondary adjustments and the MAP process could be reviewed with a view toward greater emphasis on the desirability, but not the requirement, that such issues be considered in the MAP process."[136]

In sum, this report shows how OECD policy induces contracting states and taxpayers to solve all central TP disputes in the context of MAPs, rather than by local unilateral dispute resolution mechanisms. This is another step towards transforming the ALP into a standard-based procedural regulation, as the MAP mechanism facilitates negotiations between contacting states in this area.

In July 2009, the OECD released an updated version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.[137] The update was focused on administrative approaches for avoiding and resolving TP disputes. The additions are basically in the area of corresponding adjustments, MAPs, and arbitration.[138]

The OECD Guidelines (2009) acknowledged that the dispute resolution mechanisms suggested in the OECD Guidelines (1995) (i.e., corresponding adjustments under MAPs) are not enough for solving all TP problems. Hence, the OECD suggested granting taxpayers the option of requesting arbitration for unresolved TP issues that have prevented competent authorities from reaching a mutual agreement within 2 years. The OECD Guidelines (2009) also referred to supplementary dispute resolution mechanisms in addition to arbitration, including mediation and the referral of factual disputes to third parties.[139]

---

[132] *See supra* Figure 2.

[133] *Org. for Econ. Co-operation & Dev. [OECD], Model Tax Convention on Income and on Capital* (Jan. 28, 2003).

[134] *See supra* Figure 2.

[135] *See generally* E. BAISTROCCHI & I. ROXAN, RESOLVING TRANSFER PRICING DISPUTES (2012).

[136] Org. for Econ. Co-operation & Dev. [OECD], *Improving the Process for Resolving International Tax Disputes* (Jul. 27, 1993).

[137] Org. for Econ. Co-operation & Dev. [OECD], Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2009).

[138] *Id*. at ¶¶ 4.29–31, 4.33–35 & 4.39.

[139] *Id*. at ¶ 4.40. Paragraph 4.40 states as follows:

> While corresponding adjustment and mutual agreement procedures have proved to be able to resolve most transfer pricing conflicts,

The incorporation of supplementary dispute resolution mechanisms introduces the possibility of nonlegal actors being introduced into the fray, presenting the challenge of integrating these nonlegal disciplines with legal frameworks. The US *Veritas*[140] and *Amazon*[141]cases demonstrate the incorporation of economic knowledge into legal determinations and the legitimate disagreements that can arise between qualified experts. In *Amazon*, 30 experts from a range of disciplines were appointed by the court to determine the appropriate TP treatment of a 'buy-in payment' made by a subsidiary to its parent in return for intangible assets, which were in turn also the subject of a cost sharing agreement between those associated enterprises.

The judgment of the court in *Amazon* states that '[o]ne does not need a PhD in economics to appreciate the essential similarity between the DCF methodology that Dr Hatch employed in *Veritas* and the DCF methodology employed by Dr Frisch here'. It may certainly be true that a PhD in economics is not necessary, but one may be useful if the trend of incorporating the evidence presented by thirty or more experts utilizing complex TP methodologies is to continue. The concern is that legal norms and frameworks will be forced to give way to a 'battle of the experts'. There is no clear reason why economic analysis should appear to take precedence over legal analysis, but *Amazon* and *Veritas* indicate that, as transactions become more complex, courts become more ready to defer to expert opinion. The upshot of this is that where the OECD Guidelines are not fully operative as the dominant source of authority in a jurisdiction, expert testimony may fill that void.

Interestingly, the OECD Guidelines (2017) now acknowledge the standard-based character of the ALP, as follows:

> [TP] disputes may arise even though the guidance in these Guidelines is followed in a conscientious effort to apply the arm's length principle. It is possible that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the

---

> serious concerns have been expressed by taxpayers. For example, because transfer pricing issues are so complex, taxpayers have expressed concerns that there may not be sufficient safeguards in the procedures against double taxation. These concerns are mainly addressed with the introduction in the 2008 update of the OECD Model Tax Convention of a new paragraph 5 to Article 25 which introduces a mechanism that allows taxpayers to request arbitration of unresolved issues that have prevented competent authorities from reaching a mutual agreement within two years. There is also in the Commentary on Article 25 a favourable discussion of the use of supplementary dispute resolution mechanisms in addition to arbitration, including mediation and the referral of factual disputes to third party experts.

[140] Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009).

[141] Amazon.com, Inc. v. Commissioner, 148 T.C. No. 8 (2017).

> complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.[142]

Moreover, the OECD Guidelines (2017) recommend a range of six alternative methods for the prevention and resolution of disputes. These are: (i) TP compliance practice;[143] (ii) corresponding adjustment and the mutual agreement procedure;[144] (iii) simultaneous tax examinations;[145] (iv) safe harbours;[146] (v) advance pricing agreements;[147] and (vi) arbitration.[148]

In sum, the OECD Guidelines (2017) accept that 'transfer pricing issues are so complex' and prone to disputes and it recommends a range of six alternative dispute resolution methods for their prevention and resolution. The OECD Guidelines (2017) are yet another clear step towards transforming the ALP into a standard-based procedural regulation, indicating the spiral evolution of article 9 of the OECD Model (*see* Figure 4).

*Stage 41 – The OECD on Improving the Resolution of Tax Disputes (2007).*[149] The first OECD report explicitly suggesting arbitration for TP disputes is *Improving the Resolution of Tax Treaty Disputes* (a report adopted on 30 January 2007 by the Committee on Fiscal Affairs). This proposal is worded as follows:

> [S]ome States may wish to include paragraph 5 [of article 25, dealing with arbitration] but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on a case-by-case basis.[150]

So the OECD suggested that arbitration would be offered only to unresolved issues in a MAP case. The evolution of the OECD's position in the tax arbitration arena is noteworthy over the span of the past twenty-five years. Its opinion has ranged from considering that tax arbitration would be an unacceptable option in 1982 ('the adoption of such a procedure [tax

---

[142] Org. For Econ. Co-operation & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at 171 (July, 2017) http://dx.doi.org/10.1787/tpg-2017-en.

[143] *Id.*, ch. IV, § B.

[144] *Id.*, ch. IV, § C.

[145] *Id*., ch. IV, § D

[146] *Id*., ch. IV, § E

[147] *Id*., ch. IV, § F.

[148] *Id*., ch. IV, § G.

[149] *See supra* Figure 2.

[150] Org. for Econ. Co-operative & Dev. [OECD], *Improving the Resolution of Tax Treaty Disputes*, at ¶ 48 (February, 2007).

arbitration] would represent an unacceptable surrender of fiscal sovereignty')[151] (*see* section Stage 26) to strongly supporting tax arbitration as of 2007. Interestingly, the spiral evolution of article 9 of the OECD Model has been confirmed in the OECD Guidelines (2017).[152]

*Stage 42 – GlaxoSmithKline (Canada) (2008).*[153] *Canada v. GlaxoSmithKline Inc*. (2012) illustrates two points: (i) the difficulty in applying the ALP to new business models involving intangibles and (ii) the substantial amount of discretion the OECD Guidelines grant to courts on how to identify comparable transactions.[154]

In *GlaxoSmithKline* (2012), the Supreme Court of Canada addressed the transfer price of an active pharmaceutical ingredient (API) called ranitidine that the taxpayer had acquired from a nonresident affiliate at much higher prices than the ones that other Canadian drug companies had paid to acquire it from arm's length producers. Ranitidine was the API in a drug called Zantac, which the taxpayer and other members of a multinational group of enterprises (Glaxo World) promoted as a more effective treatment for stomach ulcers than surgery or a competing drug called Tagamet.

Although Glaxo World held a patent on Zantac, Canadian law allowed other companies to sell generic versions of patented drugs in exchange for a four percent royalty to the patent owner. During the years at issue (1990-1993), the taxpayer acquired ranitidine from a non-arm's length distributor at prices ranging from CAD 1,512 to CAD 1,651 per kilogram, whereas generic drug companies acquired ranitidine for prices ranging from CAD 193 to CAD 304 per kilogram. The Canada Revenue Agency reassessed the

[151] Martin Hearson and Todd Tucker*, 'An Unacceptable Surrender of Fiscal Sovereignty': Arbitration and Sovereignty in the Double Taxation Regime (December 10, 2019) https://ssrn.com/abstract=3458663 or* http://dx.doi.org/10.2139/ssrn.3458663.

[152] Org. for Econ. Co-operative & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at 226 (July 2017) http://dx.doi.org/10/1787/tpg-2017-en. Endorses tax arbitration in the area of TP as follows:

> As trade and investment have taken on an increasingly international character, the tax disputes that, on occasion, arise from such activities have likewise become increasingly international. And more particularly, the disputes no longer involve simply controversy between a taxpayer and its tax administration but also concern disagreements between tax administrations themselves. In many of these situations, the MNE group is primarily a stakeholder and the real parties in interest are the governments involved. Although traditionally problems of double taxation have been resolved through the mutual agreement procedure, relief is not guaranteed if the tax administrations, after consultation, cannot reach an agreement on their own and if there is no mechanism, such as an arbitration clause similar to the one of paragraph 5 of Article 25, to provide the possibility of a resolution. However, where a particular tax treaty contains an arbitration clause similar to the one of paragraph 5 of Article 25, this extension of the mutual agreement procedure makes a resolution of the case still possible by submitting one or more issues on which the competent authorities cannot reach an agreement to arbitration.

[153] *See supra* Figure 2.

[154] GlaxoSmithKline Inc. v. Her Majesty the Queen, [2012] S.C.R. 52 (Can.).

taxpayer under domestic law on the basis that the amount paid for the ranitidine exceeded the amount that would have been paid to an arm's length supplier.

At the trial, the tax authorities argued that the generic companies' purchases of ranitidine from arm's length manufacturers established a comparable uncontrolled price, while the taxpayer argued that its circumstances differed from those of the generic drug companies because its business model depended on Zantac's brand image as a superior product and because the ranitidine that it purchased from its non-arm's length supplier was manufactured according to Glaxo World's standards of good manufacturing practices, granulated to Glaxo World's standards, and produced in accordance with Glaxo World's health, safety and environmental standards. On this basis, the taxpayer argued, independent licensees in Europe were a better comparator than the generic drug companies because they purchased ranitidine under the same business circumstances as the taxpayer. To support their arguments, the tax authorities also relied on the cost plus method, while the taxpayer relied on the resale price method.

Glaxo Canada appealed to the Tax Court of Canada, where, with one minor revision, the reassessment was upheld on the basis that the license and supply agreements were to be considered independently. The Federal Court of Appeal allowed the appeal and remitted the matter back to the Tax Court for redetermination of the 'reasonable amount' payable for Glaxo Canada's ranitidine transaction.

The Supreme Court of Canada decided that the appeal and cross-appeal should be dismissed. The court grounded its decision as follows:

> The OECD's 1979 Guidelines and the OECD's 1995 Guidelines are not controlling as if they were a Canadian statute. However, they suggest a number of methods for determining whether transfer prices are consistent with prices determined between parties dealing at arm's length. [155]
>
> [...] A proper application of the arm's length principle requires that regard be had for the 'economically relevant characteristics' of the arm's length and non-arm's length circumstances to ensure they are 'sufficiently comparable'.[156]
>
> [T]ransfer pricing is not an exact science and it is highly unlikely that any comparisons will yield identical circumstances and the court will be required to exercise its best informed judgment in establishing a satisfactory arm's length price.[157]
>
> In this case, Glaxo Canada was paying for at least some of the rights and benefits under the Licence Agreement

[155] *Id.*
[156] *Id.*, col. 1, ¶ 2.
[157] *Id.*, col. 1, ¶ 3.

> as part of the purchase prices for ranitidine from Adechsa [a related non-resident enterprise]. As such, the Licence Agreement could not be ignored in determining the reasonable amount paid to Adechsa under [the relevant Canadian law], which applies not only to payment for goods but also to payment for services. Considering the Licence and Supply Agreements together offers a realistic picture of the profits of Glaxo Canada. The prices paid by Glaxo Canada to Adechsa were a payment for a bundle of at least some rights and benefits under the Licence Agreement and product under the Supply Agreement. The generic comparators used by the Tax Court do not reflect the economic and business reality of Glaxo Canada and, at least without adjustment, do not indicate the price that would be reasonable in the circumstances, had Glaxo Canada and Adechsa been dealing at arm's length. It is only after identifying the circumstances arising from the Licence Agreement that are linked to the Supply Agreement that arm's length comparisons under any of the OECD methods or other methods may be determined.[158]

In sum, the Supreme Court of Canada reversed the Tax Court decision, which had applied a TP regulation to reduce the transfer price of an API that the taxpayer had acquired from an off-shore associated enterprise at prices much higher than those paid by other Canadian drug companies for an ingredient with identical chemical and biological characteristics. This Canadian case is consistent with a trend in the G20 during the pre-BEPS Reports era: the ratio of cases won by the taxpayer has steadily increased since the 1940s and has been consistently greater than fifty percent since the 1980s.[159]

*Stage 43 – The OECD Guidelines (2009).*[160] In July 2009, the OECD released an updated version of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.[161] The update was focused on administrative approaches for avoiding and resolving TP disputes. The additions are basically in the area of corresponding adjustments, MAPs and arbitration.[162]

The OECD Guidelines (2009) acknowledged that the dispute resolution mechanisms suggested in the OECD Guidelines (1995) (i.e., corresponding adjustments under MAPs) are not enough for solving all TP problems. Hence, the OECD suggested granting taxpayers the option of requesting arbitration

---

[158] *Id.*, col. 1, ¶ 4.

[159] Eduardo Baistrocchi and Martin Hearson, A GLOBAL ANALYSIS OF TAX TREATY DISPUTES 1529 (Cambridge University Press, 2017) https://ssrn.com/abstract=3045917.

[160] *See supra* Figure 2.

[161] Org. for Econ. Co-operation & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2009).

[162] Id. at ¶¶ 4.29–4.31, 4.33–4.35, 4.39.

for unresolved TP issues that have prevented competent authorities from reaching a mutual agreement within 2 years. The OECD Guidelines (2009) also referred to supplementary dispute resolution mechanisms in addition to arbitration, including mediation and the referral of factual disputes to third parties.[163]

The incorporation of supplementary dispute resolution mechanisms introduces the possibility of nonlegal actors being introduced into the fray, presenting the challenge of integrating these nonlegal disciplines with legal frameworks. The US *Veritas*[164] and US *Amazon*[165] cases demonstrate the incorporation of economic knowledge into legal determinations and the legitimate disagreements that can arise between qualified experts.[166]

The judgment of the court in *Amazon* states that '[o]ne does not need a PhD in economics to appreciate the essential similarity between the DCF methodology that Dr Hatch employed in *Veritas* and the DCF methodology employed by Dr Frisch here'. It may certainly be true that a PhD in economics is not necessary, but one may be useful if the trend of incorporating the evidence presented by thirty or more experts utilizing complex TP methodologies is to continue. The concern is that legal norms and frameworks will be forced to give way to a 'battle of the experts'. There is no clear reason why economic analysis should appear to take precedence over legal analysis, but *Amazon* and *Veritas* indicate that, as transactions become more complex, courts become more ready to defer to expert opinion. The upshot of this is that where the OECD Guidelines are not fully operative as the dominant source of authority in a jurisdiction, expert testimony may fill that void.

*Stage 44 – DSG Retail Ltd (UK) (2009).*[167] *DSG Retail Ltd v. HMRC* (2009) is a representative case for showing that the evolution of the ALP into a standard-based procedural regulation has a number of implications for the

---

[163] *Id*. ¶ 4.40 states as follows:

> While corresponding adjustment and mutual agreement procedures have proved to be able to resolve most transfer pricing conflicts, serious concerns have been expressed by taxpayers. For example, because transfer pricing issues are so complex, taxpayers have expressed concerns that there may not be sufficient safeguards in the procedures against double taxation. These concerns are mainly addressed with the introduction in the 2008 update of the OECD Model Tax Convention of a new paragraph 5 to Article 25 which introduces a mechanism that allows taxpayers to request arbitration of unresolved issues that have prevented competent authorities from reaching a mutual agreement within two years. There is also in the Commentary on Article 25 a favourable discussion of the use of supplementary dispute resolution mechanisms in addition to arbitration, including mediation and the referral of factual disputes to third party.

[164] Veritas Software Corp. v. Commissioner, 133 T.C. 297, 325 (2009).

[165] Amazon.com, Inc. v. Commissioner, 148 T.C. No. 8 (2017).

[166] *See supra* Stage 40.

[167] *See supra* Figure 2.

structure of TP dispute resolution at the outset of the twenty-first century.[168] This includes shifting the ultimate decision-making down the legal hierarchy by relying on APAs, tax litigation and other similar procedures to solve international tax disputes, with the increasing importance of experts. This is particularly the case in Australia and Canada, where most recent TP litigation is very much a battle of experts.[169]

*DSG* concerned the provision of extended warranties and service contracts on consumer goods sold under the Dixons brand and related brands over a number of years. Almost all of the risk on the transactions (initially as reinsurance and later as insurance) was taken by DISL, an Isle of Man enterprise in the same group, but the warranties were sold to consumers at the time of sale of the products by a group company in the UK acting as agent for an independent insurer or service company reinsured or insured by DISL. The contention of Her Majesty's Revenue and Customs (HMRC) was that DISL benefited from overly generous terms and that the profit of DSG, a UK enterprise, should be increased.

The Special Commissioners outlined the law on TP, identifying that the key difference between section 770 and schedule 28AA of the Income and Corporation Taxes Act (1988) is that, under section 770, only the price at which the transaction (or equivalent granting of facilities) occurred can be adjusted, on the basis that the terms and conditions are otherwise fixed, whereas under schedule 28AA, the terms can also be adjusted to arm's length terms. The Special Commissioners also discussed how to apply the OECD Guidelines, noting that, while the legislation requires them to be taken into account only under schedule 28AA, they are also relevant to the interpretation of section 770, given that "the approach of the OECD model is a useful aid which we should apply in the absence of any other guidance as they are the best evidence of international thinking on the topic."[170]

Making extensive use of the testimony of expert witnesses, economists and insurance experts, the Special Commissioners considered the alternatives of applying the CUP and profit split methods. They took into account and turned down a range of proposed comparables: enterprises and sources of statistics. The most comparable enterprise was in a significantly different position in terms of bargaining power, for which it was considered that no adjustment was possible.

The accepted approach to applying the profit split method was based on determining rates of return on capital in principle, using a formula based on the capital asset pricing model. This approach does not actually seem to be a typical application of the OECD Guidelines on the profit split method, and it was criticised by one expert as lacking the functional analysis required by the

[168] DSG Retail Ltd and others v. Revenue and Customs Commissioners [2009] STC (SCD) 397.

[169] *See*, Chevron Australia Holdings Pty Ltd. v. Commissioner of Taxation [2017] FCAFC 62 § 1.2.4.31.; Stage 52, *infra*.

[170] *Supra* note 168, at ¶ 152.

OECD Guidelines. However, the Special Commissioners concluded that the Guidelines were satisfied:

> [W]e consider that Mr Gaysford [an expert witness for HMRC] is using a profit split method based on the total profit with a mixture of contribution analysis and residual analysis approach. This looks to the functions of the parties, DISL providing insurance in circumstances where Cornhill, an independent party, had previously agreed a return which to a large degree represented its capital employed; and the Appellant Group providing the whole business by virtue of its point of sale advantage in circumstances where it has particularly strong bargaining power. External data in the form of the cost of equity is used to assess the value of DISL's contribution rather than to determine directly the division of profit. It is a mixture of the contribution analysis and residual analysis [...] The result [...] replicates the outcome of bargaining between independent enterprises in the free market (para 3.21 of the Guidelines) [...] We therefore consider that Mr Gaysford's approach is in principle in accordance with the OECD Guidelines.[171]

Mr Gaysford was an economist. Counsel for the taxpayers criticised part of his evidence on the application of the profit split method as an "economic analysis divorced from reality," but the Special Commissioners noted that the OECD Guidelines require "an economically valid basis" for the application of this method.[172]

Rather than developing their own calculations based on their conclusions, the Special Commissioners provided a decision in principle explaining how TP adjustment should be calculated and leaving it to the parties to agree on the actual numbers if possible or to return to the court if not. The result accepted a goodly portion of the position argued by HMRC. This approach to the decision in principle is a standard element of the procedure before the Special Commissioners, often used very effectively and enabling the parties to have decisions from the court on broad issues (often issues of law) that prove sufficient to enable the parties to agree on technical details without troubling the Special Commissioners further. In fact, it was understood that the parties had agreed on the numbers and the decision was thus final.[173]

---

[171] *Supra* note 168, at ¶ 153.

[172] *Id.*, ¶ 126.

[173] IAN ROXAN, TRANSFER PRICING DISPUTES IN THE UNITED KINGDOM 194–195 (Cambrdige University Press 2017).

3. The Collapse of the Second Era (2010–2015)

*Stage 45 – The OECD Guidelines and Business Restructuring (2010).*[174] On 22 July 2010, not even a year after the 2009 update to the OECD Guidelines, the OECD decided on a further update. This pace for OECD Guidelines reforms (two updates in less than a year) was unprecedented to date and it is another element suggesting that the ALP is in an unstable equilibrium.[175]

The OECD Guidelines (2010) crystallise the first time the OECD recognises the difficulties of applying the ALP in the context of a business restructuring. The OECD Guidelines (2010) added a new chapter entitled *Transfer Pricing Aspects of Business Restructuring*.[176] A crucial paragraph was added on the meaning of the ALP in the context of business restructuring. It states the following:

> Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement.[177] The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.[178]

---

[174] *See supra* Figure 2.

[175] Org. for Econ. Co-operation & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (July 22, 2010). *See also* Richard Vann, *Reflections on Business Profits and the Arm's-Length Principle*, The Taxation of Business Profits under Tax Treaties 133, 133–169 (2003).

[176] Org. for Econ. Co-operation & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* at ch. IX (July 22, 2010).

[177] *Id*., ¶ 9.8 states the following:

> Domestic anti-abuse rules and CFC legislation are not within the scope of this chapter. The domestic tax treatment of an arm's length payment, including rules regarding the deductibility of such a payment and how domestic capital gains tax provisions may apply to an arm's length capital payment, are also not within the scope of this chapter. Moreover, while they raise important issues in the context of business restructurings, VAT and indirect taxes are not covered in this chapter.

[178] *Id*., ¶ 9.181. Interestingly, this paragraph has been re-worded in para. 9.38 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations to encapsulate a specific anti-avoidance test for the business restructuring area as follows:

> Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement. However, tax benefits at a group level do not determine whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the

This paragraph is crucial as it substantially limits the role of the ALP as an anti-avoidance regulation in the business restructuring arena. Indeed, according to the OECD Guidelines (2010), in principle, a business restructuring that is only driven by a tax purpose is not necessarily inconsistent with the ALP and the tax authorities in principle cannot recharacterise the arrangement.

In sum, the original anti-avoidance purpose of the ALP, crystallised, for example, in the France-US Tax Treaty (Stage 11: 1932) and the Carroll Report (Stage 12: 1933), has shrunk in the area of business restructurings less than eighty years later, according to the OECD Guidelines (2010). Strikingly, the OECD offered no justification for this fundamental amendment to the mission of the ALP.

The OECD Guidelines (2010) probably reinforced a tax atmosphere prone to aggressive tax planning regarding TP (see Stage 49 *infra*). As mentioned, the number of treaty disputes won by the taxpayer had steadily increased since the 1940s and was consistently greater than fifty percent from the 1980s until the emergence of the BEPS Reports in 2015.[179]

*Stage 46 – The UN Model (2011).*[180] The UN updated the UN Model and Commentary in 2011.[181] There seems to have been a substantial change in the opinion of the experts overseeing the development of the Commentary on Article 9 of the UN Model. Its wording is not clear regarding the 2011 Committee of Experts' support for the OECD Commentary on Article 9, given that, as they note, they have not fully considered its scope or application.[182] Interestingly, there is some mention of whether 'may' or 'shall' is more appropriate in the context of article 9(2) and whether an obligation to make corresponding adjustments is necessary. The UN decided not to introduce changes in this regard, due to the lack of internal consensus.[183] This lack of consensus was unprecedented since the first publication of the UN Model in 1980.

---

> restructuring […]. Moreover, as indicated in paragraph 1.122, the fact that a MNE group as a whole is left worse off on a pre-tax basis may be a relevant pointer in determining the commercial rationality of the restructuring'.

Org. For Econ. Co-operation & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, ¶ 9.38 (July 2017) http://dx.doi.org/10.1787/tpg-2017-en.

[179] *See* § 1.2.; *see also* Baistrocchi & Hearson, *supra* note 159.

[180] *See supra* Figure 2.

[181] U.N. DEP'T OF ECON. AND SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (January 1, 2011).

[182] *Id*. Commentary on art. 9 para. 3 states that "[t]he views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the Records of its annual sessions."

[183] *Id*. Commentary on art. 9(2) para. 7 states the following:

> The view has been expressed that a correlative adjustment under paragraph 2 could be very costly to a developing country which may consider not including paragraph 2 in its treaties. However, paragraph 2 is an essential aspect of Article 9 and failure to provide a correlative

*Stage 47 – The OECD on the TP Aspects of Intangibles (2012).*[184] The OECD considers that there are three fundamental aspects to the ALP: (i) comparability and profit methods; (ii) the TP aspects of business restructurings; and (iii) the TP aspects of intangibles. [185]

In 2012, the OECD decided to launch a project on the third issue, the TP aspects of intangibles. The first two issues were already part of specific projects. Three points were considered central on the intangibles front: (i) the definition; (ii) the identification; and (iii) the valuation of intangibles for TP purposes.

This OECD project on intangibles, in which the BRICS countries took no part, was eventually superseded by the 2015 OECD/G20 BEPS Reports.

As seen in cases such as GlaxoSmithKline, *Amazon* and *Veritas* (*see* Stages 40 and 42), intangibles continually present new challenges for valuation in the TP context, whether considered alone or in the context of a broader series of transactions, which the OECD projects to date have failed to address. Chapter VI of the OECD Guidelines and the BEPS Action Plan (particularly the work on Action 8) continue the work of the OECD on intangibles in the TP context. There have been consistent problems in applying the ALP to transactions involving intangibles.

*Stage 48 – Business Restructuring and Litigation: Alberta Printed Circuits Ltd. (Canada) (2011).*[186] *Alberta Printed Circuits Ltd.* (2011) illustrates the difficulties encountered in applying the ALP in the context of business restructurings. Again, this is a dispute decided largely for the taxpayer.

Alberta Printed Circuits Ltd., the taxpayer, was a private Canadian corporation that manufactured custom circuit boards for designers. Although the taxpayer was originally owned exclusively by its founders, Wayne and Geraldine Bamber, shares were subsequently issued to Daniel McMuldroch, an employee and later company director, who performed various services including network administration, web development, software development and the preparation of customer data for use in manufacturing (set-up).

---

> adjustment will result in double taxation, which is contrary to the purpose of the Convention. A country should closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment is appropriate to reflect the primary adjustment. Some countries take the view that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. This approach can be achieved by changing the word 'shall' to 'may'. Contracting States may, during bilateral negotiations, use the word that is convenient. However, there is no consensus on this point and the language of paragraph 2 remains unchanged.

[184] *See supra* Figure 2.

[185] *See also* Duff & Beswick, *supra* note 50.

[186] Alberta Printed Circuits Ltd. v. Her Majesty The Queen, [2011] T.C.C. 232 (Can.). *See supra* Figure 2.

In 1995, after attending a seminar about doing business in Barbados, Mr McMuldroch and the Bambers decided to move the set-up operations to Barbados, where they would be carried on by a Barbados corporation. To this end, Mr McMuldroch resigned as director of the taxpayer, sold his shares to a private enterprise owned by Mr and Mrs Bamber, incorporated a Barbados International Business Company (APCI), severed his ties with Canada and became a resident of Barbados. Pursuant to annual contracts that continued from February 1997 to January 2001, APCI performed three kinds of services for the taxpayer: (i) database software development and maintenance; (ii) website development and maintenance; and (iii) setup operations.

On the grounds that the taxpayer and APCI did not deal at arm's length, that the set-up fees that the taxpayer paid to APCI were the same or more than the set-up fees invoiced to its own customers and that the Canadian enterprise continued to perform some set-up operations itself, the tax authorities reassessed the taxpayer under domestic Canadian law, reducing the deductible amount of service payments to APCI. The taxpayer appealed, arguing that they dealt with APCI at arm's length and that the fees paid under the contracts were reasonable amounts that would be agreed to by parties dealing at arm's length.

Beginning with the first of these arguments, the Tax Court held that Mr Bamber exercised de facto control over APCI by virtue of an arrangement whereby he and Mrs Bamber received two thirds of its profits, that this arrangement demonstrated that the two enterprises acted in concert without separate interests and that Mr Bamber and Mr McMuldroch directed the negotiations between the enterprises according to a common plan. For these reasons, it concluded that the taxpayer and APCI did not deal with each other at arm's length as a factual matter, even though they were not related under the relevant statutory definition.

On the question of the reasonableness of the fees, however, the Tax Court found largely for the taxpayer and reduced the amount of the TP adjustment assessed by the tax authorities. Although the court's decision turned mostly on its factual findings that the taxpayer did not continue to perform set-up operations and that the set-up fees paid to APCI did not exceed amounts that the taxpayer charged its customers, the judgment also considered different TP methodologies and the comparability of uncontrolled transactions.

With respect to TP methodologies, the court adopted the hierarchy of methods set out in the OECD Guidelines (1995), favouring traditional transaction methods over transactional profit methods and the CUP method as the preferred method for determining a reasonable arm's length price. Since the taxpayer relied on the CUP method, whereas the tax authorities' argument was based on the TNMM, it is not surprising that the court preferred the taxpayer's argument. Indeed, the court found it 'perplexing to say the least' that the tax authorities sought 'comparables for the lowest ranking method of establishing an arm's length price, and not for the highest method' and criticised counsel for the tax authorities for 'a fundamental abdication of her duties under the transfer pricing rules' for making 'no

attempt to analyse either the applicability of the CUP or differences in the factors for determining what, if any, adjustments to the prices used could be justified'.

Regarding the comparability of transactions, the court also referred to the OECD Guidelines, listing five 'comparability factors' identified by the OECD and emphasising that this list 'is not intended to be exhaustive, as consideration of all relevant factors is mandated'. Rejecting the tax authorities' argument that there were no comparable transactions since APCI provided set-up services only for the taxpayer and, in turn, the taxpayer did not purchase set-up services from an arm's length party during the years at issue, the court held that it was reasonable to compare the set-up fees that the taxpayer charged its customers with the set-up fees that APCI charged the taxpayer on the grounds that 'it makes perfect business sense to treat services provided to a client through outsourcing in the same market as if they were supplied directly to the customer'. In addition to this 'internal CUP', the court also accepted evidence of comparable uncontrolled prices between other parties, suggesting that the set-up fees charged by APCI were not unreasonable. On this basis, the court concluded that amounts paid under the contracts for set-up services represented arm's length prices, though it upheld a portion of the overall TP adjustment on the grounds that the taxpayer did not meet the onus of establishing that it had not overpaid for the development and maintenance of its website and database software.

*Alberta Printed Circuit* suggests that the SEA and the ALP were giving substantial room for tax planning in the area of cross-border business restructuring and that the ALP's role as an anti-avoidance regulation had substantially eroded over time. This case law dynamic, largely in favour of the interests of MNEs, created the context for the emergence of the BEPS reports.

*Stage 49 – Public Outrage over Aggressive Corporate Tax Planning (2012).*[187] The tax planning schemes of the largest technology corporations—such as Apple, Microsoft and Google—began to be exposed, particularly as of 2012.[188] This dynamic has created increasing tension between globalisation and democracy, as represented in unexpected electoral results such as BREXIT and Trump.[189] This has triggered a strained environment among the US, the EU and the BRICS countries regarding international taxation and the ways in which MNEs should be taxed.

*Stage 50 – The UN Transfer Pricing Manual (2013).*[190] China and India now seem to be willing to use the UN Transfer Pricing Manual to export Chinese and Indian domestic law on TP to the UN Model and beyond as of

---

187 *See supra* Figure 2.

188 *See supra* Stage 49.

189 DANI RODRIK, THE GLOBALIZATION PARADOX: WHY GLOBAL MARKETS, STATES AND DEMOCRACY CAN'T COEXIST (Oxford University Press, 2011).

190 *See supra* Figure 2.

2012.[191] LSAs appear to be the major innovation proposed by China and India.[192]

The UN released its Transfer Pricing Manual in 2013. Interestingly, certain developing countries conveyed a credible threat to deviate from the OECD Model legal technology in TP.[193] There are many examples peculiar to specific jurisdictions, including the aforementioned Indian treatment of marketing intangibles and Brazilian safe harbour rules.

China is a case in point. Indeed, China openly challenged the SEA and the traditional ALS. It suggested that the different entities of an MNE should be considered as members of a family, rather than as orphans.[194] Hence, according to China, profit allocation should be grounded on a contribution analysis, rather than a transactional or profit-based approach.[195] For instance, China strongly advocated for the use of LSAs as a fundamental concept in the UN Transfer Pricing Manual (2013). China concluded as follows: 'a global formulary approach should be a realistic and appropriate option'.[196]

---

[191] *See* Michael Lennard, *The New United Nations Practical Manual on Transfer Pricing for Developing Countries*, 19 ASIA-PAC. TAX BULL. 1, 3–4 (2013).

[192] The stages in which the evolution of the allocation norm in the UN Model, China and India has been mapped are the following: 24, 25, 37, 46, 50, 54, 59 and 61.

[193] U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. TRANSFER PRICING MANUAL FOR DEVELOPING COUNTRIES, U.N. DOC. ST/ESA/347, *¶¶ 10.3.6.3.–10.3.6.4 (2013). See, infra, note 194.*

[194] Jinyan Li & Stephen Ji, *Location-Specific Advantages: A Rising Disruptive Factor in Transfer Pricing,* 71 BULL. FOR INT'L TAX. 5 (Mar. 22, 2017), https://www.ibfd.org/IBFD-Products/Journal-Articles/Bulletin-for-International-Taxation/collections/bit/html/bit_2017_05_cn_1.html.

[195] U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. TRANSFER PRICING MANUAL FOR DEVELOPING COUNTRIES*, U.N. Doc. ST/ESA/347*, ¶¶ 10.3.6.3.–10.3.6.4 (2013) arguing:

> China takes the view that a risk-based approach may have insufficient regard for the fact that there are sizeable assets located in China (i.e. the work force and factory plants). In many cases, the majority of the headcount of the electronic manufacturing services group are based in China, with only a few management personnel residing outside of China. Rather than a transactional or profits-based approach, a contribution analysis approach may be more suitable. This means that remuneration to each party involved would be commensurate with its role and contribution to the value chain in the group. In this case, the assets and the people should largely dictate where the group's profits should stay, and a global formulary approach should be a realistic and appropriate option.
>
> Alternatively, the Chinese tax administration may determine the property return for the headquarters, with the Chinese manufacturer earning the residual profits. Another potential alternative may be to evaluate the Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer.

[196] *Id*., ¶ 10.3.3.1. The U.N. states the following:

> The globalisation of trade and economies has given rise to concepts such as 'location savings', 'market premium' and more generally, 'location-specific advantages' (LSAs). LSAs are advantages for production arising from assets, resource endowments,

*Stage 51 – The BEPS Reports: Kick Off (2013).*[197] The BEPS Project is designed, in part, to try to bring the BRICS countries into the OECD tent and, perhaps, to reconcile a potential divergence between the EU and the US On the other hand, however, the BEPS Project is quite divorced from the priorities of the BRICS countries. Source/residence have been removed from the agenda, the digital PE has been killed off and there is a big focus on arbitration, which is an area none of the BRICS countries support. BEPS also serves a political purpose for certain countries (as in the case of the UK), which is to respond to the growing detachment of OECD legal technology from popular consent (*see* Stage 55).

The meaning of the ALP, as encapsulated in both articles 7 and 9 of the OECD Model, has implicitly evolved over time along five different and successive stages.[198] It was first considered a self-enforcing, rule-based norm in the Carroll Report (1933). [199]A few decades after the publication of the Carroll Report, the context had changed substantially, given the emergence of technological innovation such as the international trade of intangibles.[200] As of 2010, the OECD Guidelines have consequently acknowledged the increasingly non-self-enforcing character of the ALP.[201] For example, the OECD Guidelines now state that 'applying the arm's length principle can be a fact-intensive and often judgmental process that present uncertainty and may impose a heavy administrative burden on taxpayers and tax administrations that can be exacerbated by both legislative and compliance

> government industry policies and incentives, etc, which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers. Likewise, global automotive companies set up joint ventures (JVs) in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs. Limited guidance is available on these concepts in the OECD Guidelines; it has been seen that certain issues such as location savings and market premium arise more frequently in China and other developing economies, rather than in established and developed economies (which comprise the bulk of the membership of the OECD). China outlines its solutions to reconcile the arm's length principle with the lack of reliable comparables in developing countries in the following paragraphs.

[197] *See supra* Figure 2.

[198] *See generally* BAISTROCCHI & ROXAN, *supra* note 135 (showing the evolutionary path of TP dispute resolution in 20 countries on five continents since 1799. It consists of six core stages that encapsulate how the ALP has gradually evolved from being a rule-based regulation to a procedural, standard-based regulation over the last century. The main driving force of this transformation is probably the ALP adaptation to two central technological innovations: (i) the emergence of MNEs over the first globalisation (1850-1914) and (ii) the emergence of the international trade in intangibles during the second globalisation (1945-present)).

[199] *See supra* Stage 12.

[200] *See* BAISTROCCHI & ROXAN, *supra* note 135.

[201] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Aug. 16, 2010). *See also* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* ¶ ¶ 4.7, 4.60 (July 10, 2017).

complexity'.[202] This uncertainty is in part triggered by the OECD Model's failure to provide a precise ex ante meaning for fundamental elements of article 9 such as an 'associated enterprise' or an 'arm's length standard'.

A number of elements, including technological innovation, the financial crisis of 2008, the Great Recession that followed and high profile TP disputes such as the 2009 *Starbucks* case in the UK, have ultimately triggered the first structural crisis of the international tax regime since the 1920s.[203]

The G20 and OECD decided in 2013 to work together for the first time to search for solutions to this structural crisis of the international tax regime.[204] This unprecedented global effort has produced the 2015 OECD/G20 BEPS Final Reports, 'the first substantial renovation of the international tax standards in almost a century'.[205]

*Stage 52 – The Commentary on Article 9 of the OECD Model (2014).*[206] The OECD decided to update the OECD Model in 2014, that is, during the production process of the BEPS Reports. The Commentary on Article 9 of the OECD Model (2014) explicitly refers to the OECD Guidelines (2010) as follows:

> The Committee has spent considerable time and effort (and continues to do so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement.[207]

---

[202] Org. for Econ. Co-operation & Dev. [OECD], *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, ¶ 4.95 (July 10, 2017).

[203] As to the European Commission decision on State aid involving Apple, *see* European Commission, *State Aid: Ireland Gave Illegal Tax Benefits to Apple Worth Up to €13 billion*, U.N. Press Release (Aug. 30,2016), http://europa.eu/rapid/press-release_IP-16-2923_en.htm.

[204] *See* Pascal Saint-Amans and Raffaele Russo, *What the BEPS are we talking about?*, OECD Forum (June 2017), www.oecd.org/forum/what-the-beps-are-we-talking-about.htm.

[205] *See* OECD & G20, OECD/G20 Base Erosion and Profit Shifting Project (2015); *See also* R. Vann, *The Policy Underpinnings of the BEPS Project: Preserving the International Corporate Income Tax?*, 62 CAN. TAX J., 433–41 (2014); Reuven S. Avi-Yonah & Haiyan Xu*, Evaluating BEPS*, Univ. Mich. Pub. L. Res. Paper No. 493 (2016), http://ssrn.com/abstract=2716125; R. S. COLLIER & J. L. ANDRUS, TRANSFER PRICING AND THE ARM'S LENGTH PRINCIPLE AFTER BEPS, (Oxford University Press, 2017).

[206] *See supra* Figure 2.

[207] Org. for Econ. Co-operation & Dev. [OECD], Model Tax Convention on Income and on Capital, C(9)-*1* (July 15, 2014).

This reference in the Commentary on Article 9 of the OECD Model to the OECD Guidelines (2010) is particularly relevant. It substantially shrinks the anti-avoidance purpose of the ALP, as encapsulated in article 9, in the area of business restructurings (*see* Stage 45).

*Stage 53 – Cross-Border Related-Party Loans: Chevron (Australia) (2015).*[208] The Australian case *Chevron Australia Holding Pty Ltd. v. Commissioner of Taxation* (2017) illustrates the problem of applying the ALP to cross-border related-party loans.[209] The interesting upshot of this case is that the SEA appears to be breaking down in the context of financing within multinational groups (which also appears to be a theme present in the philosophy of BEPS Action 4, see Stage 55 ).[210]

Chevron is an oil and gas exploration and production multinational, the parent company of which is listed and a US resident. After Chevron's acquisition of the Texaco Group in 2000, there was a restructuring of its Australian business unit to refinance existing debt and increase the debt level of the Australian operations to a forty-seven percent debt-to-equity ratio.

As a result, in mid-2003, a Credit Facility Agreement was entered into between the parent of the Australian group, CAHPL (resident in Australia and also formed as part of the restructuring), and its wholly owned subsidiary, CFC, which was a US resident and was formed to enable the raising of USD 2.5 billion in the US commercial paper market. Financing was done in a way that qualified for an interest withholding tax exemption in Australia (for which the Australian Taxation Office, ATO, provided a private binding ruling).

The funds were raised by CFC in USD and advanced for 5 years to CAHPL in return for a promise to repay the equivalent amount of AUD with interest payable at Australian LIBOR plus 4.14%. No security or financial/operational covenants were provided by CAHPL and the advance to CAHPL was not guaranteed by the US parent company, though the parent did guarantee the USD borrowing by CFC. CFC did not hedge the AUD/USD currency risk. CAHPL could, at its option, repay the loan at any time. The USD funds were raised by CFC at approximately 2% interest and on-lent to CAHPL in AUD at approximately 9% interest.

---

[208] *See supra* Figure 2; *See also* Richard J. Vann and Graeme S. Cooper, *Transfer Pricing Money – The Chevron Case* (Sydney Law School Research Paper No. 16/72, 2016) https://ssrn.com/abstract=2823220*;* Greenwoods and H. Smith Freehills, *The Chevron Transfer Pricing Case: The Story So Far* (Nov. 5, 2015).

[209] *Chevron Australia Holding Pty. Ltd. v Commissioner of Taxation (2017), 62 FCAFC (Austl.),*
http://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2017/2017fcafc0062.

[210] Org. for Econ. Co-operation & Dev. [OECD], *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: 2015 Final Report* (2015) [hereinafter *Action 4 Final Report* (2015)]. *See also* LA Sheppard, *Chevron Australia: We Built This Intragroup Loan*, TAX NOTES INT'L 177 (17 July, 2017) (arguing that *Chevron* involved income stripping via interest deductions — a prima facie example of base erosion — combined with a circular flow of funds that Australians refer to as round-robin financing. As contrived as the arrangement was, the case was about the correct transfer price for an intragroup loan — not the denial of an interest deduction).

The profit made by CFC was distributed as a dividend to CAHPL, tax-free under Australian domestic law, and CAHPL also made substantial dividend distributions to its US parent during the period of the loan. The Australian first instance judgment claimed that CFC was not taxable in the US on the interest received, although the reason (possibly a check-the-box election in respect of CFC, which made this interest and the loan to CAHPL disappear for US tax purposes) is not given. CAHPL claimed deductions for the interest paid to CFC over the five-year term of the loan.

By determinations and assessments issued in 2010 and 2012, relying on Australian domestic law and on the associated enterprises article of the Australia-US Income Tax Treaty (1982),[211] the ATO denied a significant proportion of the interest deductions claimed (the exact amounts are not made clear in the judgment). The ATO applied a twenty-five percent penalty, on the basis that CAHPL entered into the facility for the sole or dominant purpose of obtaining a 'scheme benefit'.

The Federal Court of Appeals[212] upheld the first instance decision. Consequently, the ATO determination and assessment were confirmed. The Court of Appeals stated as follows:

> '[I]n determining arm's length consideration in the context of this case, the matter should be approached from the perspective of what is the consideration that CAHPL or a borrower in its position might reasonably be expected to have given to an independent lender if it had sought to borrow AUD 2.5 billion for five years. The answer to this question is to be found in the evidence. If the evidence reveals (as it did here) that the borrower is part of a group that has a policy to borrow externally at the lowest cost and that it has a policy that the parent will generally provide a third party guarantee for a subsidiary that is borrowing externally, there is no reason to ignore those essential facts in order to assess the hypothetical consideration to be given.
>
> [. . .] The independence hypothesis does not necessarily require the detachment of the taxpayer, as one of the independent parties, from the group which it inhabits or the elimination of all the commercial and financial attributes of the taxpayer. The fundamental purpose of the hypothesis is to understand what the taxpayer, CAHPL, or a person in the position of the taxpayer and in its commercial context would have given by way of consideration in an arm's length transaction.

The Court of Appeals concluded as follows: '[T]here were conditions operating between CAHPL and another enterprise which operated between

[211] Double Taxation Taxes On Income Convention Between The United States Of America And Australia, *Austl.-U.S.,* Aug. 6, 1982.

[212] *Chevron, 62 FCAFC (Austl.)*.

them in their commercial or financial relations [within the wording of article 9 of the Australia-United States Income Tax Treaty (1982)] which differed from those which might be expected to operate between independent enterprises dealing wholly independently with one another'.[213]

As Richard Vann and Graeme Cooter argue*,* *Chevron* shows the ongoing failure of international tax law and TP to deal with the basic issue of pricing money, particularly in a fashion consistent with the SEA. Information for the apparently simple exercise of pricing an intra-group loan enough to satisfy a judge cannot be obtained and the OECD to date has refused to provide meaningful practical assistance. Developing countries in particular, for which the OECD now expresses much sympathy in dealing with international tax issues, have reason to be unhappy with international efforts.[214]

*Chevron* also shows that TP litigation is fundamentally a battle of experts, so TP case law is particularly fact-specific and, consequently, is not normally a public good.[215] Finally, Chevron shows an implicit erosion of the orphan theory and the emergence of the family theory, as suggested by China, at least in the cross border related-party loans.[216]

*Stage 54 – Location-Specific Advantages: Syngenta (India) (2015).[217]* The notion of LSAs was adopted out of emerging countries' frustrations over what they viewed as the unacceptable result of profit allocation when following the pre-BEPS OECD Guidelines. China is a case in point. Under the OECD approach, Chinese subsidiaries of MNEs were treated as single-function, limited-risk entities, which made routine profit margins but failed to receive any share of the residual profits, or the super profit or economic rent, of the MNE groups to which they had made significant contributions. What was particularly offensive was that these profits were often ultimately allocated to entities in low-tax jurisdictions.[218] In fact, this frustration has a long history: it first emerged in the context of the *Vestey* case II in 1932 (*see* Stage 10) and has now expanded to India (in cases such as *Syngenta*, Russia and South Africa.[219] As noted, this is not the only instance of developing countries adopting a heterodox interpretation of the ALP and article 9 of the OECD Model, but it is a paradigmatic case of how far countries are willing to stretch their interpretation of it.[220]

---

[213] *Id.,* ¶ 152.

[214] *See* Richard J. Vann and Graeme S. Cooper, *Transfer Pricing Money – The Chevron Case* (Sydney Law School Research Paper No. 16/72, 2016), pages 1-3 https://ssrn.com/abstract=2823220.

[215] *See supra* text accompanying note 38 of the main article.

[216] *See supra* text accompanying note 54 of the main article.

[217] *See supra* Figure 2.

[218] *See U.N. Dep't of Int'l Econ. & Soc. Affairs, U.N. Transfer Pricing Manual for Developing Countries, U.N. Doc. ST/ESA/347, ¶¶ 10.3.6.3.–10.3.6.4 (2013). See supra, note 193.*

[219] U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. TRANSFER PRICING MANUAL FOR DEVELOPING COUNTRIES, *U.N. Doc. ST/ESA/,* (2017).

[220] Eduardo Baistrocchi, *Tax Disputes Under Institutional Instability: Theory and Implications*, 75 MODERN L. REV. 547 (2012). It isavailable at SSRN: https://ssrn.com/abstract=2336276.

To date, 'location-specific advantages' is a new term in international taxation. It denotes the following two kinds of location-specific features that may be relevant to TP analysis: (i) location savings; and (ii) local market features. LSAs are inherent characteristics of, or arise from, a specific location. As such, LSAs are exogenous to a specific taxpayer, such as an MNE. Nevertheless, the value of LSAs can be unlocked by an MNE by way of firm-specific advantages (FSAs), such as intangibles, potentially contributing in this way to the profits of the MNE.[221]

The concept of an LSA is incompatible with a core principle of the international taxation of MNEs, namely, the SEA, which emerged in the early 1920s (*see* Stage 7) and was a building block of the international tax regime in the period spanning from the League of Nations Carroll Report (1933) (*see* Stage 12) to the OECD BEPS Reports (2015) (*see* Stage 55).

Moreover, the LSA concept has the potential to disrupt the basic assumptions underlying the OECD's dominant view of the ALP and, perhaps, of upsetting the legal technology concept encapsulated in both articles 7 and 9 of the OECD Model. For instance, under both the pre-BEPS and the post-BEPS OECD Guidelines, the subsidiary of an MNE group that is subject to TP scrutiny is regarded as a stand-alone entity (the so-called orphan approach).[222]

The Chinese view is that a subsidiary should be regarded as part of the MNE 'family', thus enjoying the benefits of that family. In addition, under the pre-BEPS OECD Guidelines, any residual profits derived by MNEs generally belong to the legal owner of the relevant intangibles, which can be referred to as the intangible-centric approach. This approach is more 'relaxed' under the post-BEPS OECD Guidelines, as it takes into account factors other than the legal ownership of intangibles, but its essence remains. By contrast, the Chinese view is that some of the residual profit arises from taking advantage of LSAs, which, while external in nature, contribute to the creation of value in MNEs in very much the same way as intangibles. Consequently, local Chinese subsidiaries should be allocated a share of the residual profits. In essence, Chinese authorities view the subsidiary as part of the MNE group when taking advantage of LSAs, as opposed to a stand-alone entity that only performs specific routine functions.[223]

---

[221] *UN Transfer Pricing Manual* (2017), *supra* note 218, at D.2.4.41. Defining LSAs as:

> The globalisation of trade and economies has given rise to concepts such as "location savings", "market premium", and more generally, LSAs. The LSAs are advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities. For example, household electronics manufacturers invest in China to take advantage of a large pool of well-educated low-cost labour and a well-developed network of suppliers, or global automotive companies set up joint ventures ("JVs") in China to assemble automobiles locally to be close to the market and the customers and to take advantage of lower costs.

[222] *See supra* text accompanying note 54 of the main article.

[223] Li and Ji, *supra* note 194.

The notion of LSAs has been recognised in TP analysis, especially in China as of 2015, but its scope and relevance remain uncertain. As Jinyan Li and Stephen Ji maintain, attributing value to LSAs is inconsistent with the SEA and the ALP. It also deviates from the existing OECD approach to interpreting and applying the principle. It is consistent, however, with the direction of the OECD/G20 BEPS initiative in allocating profit of an MNE on the basis of where value is created. Giving value to LSAs reflects a different way of thinking about what contributes to value creation. "In the absence of international consensus on what LSAs are and how or how much they contribute to value creation, the profits of MNEs may be allocated among countries in a way that results in over-taxation or under-taxation of MNEs."[224]

The *Syngenta* case (2015) is one of the first disputes decided by the Indian tax authorities based on the concept of LSAs.[225] Syngenta India is primarily engaged in the business of agrochemicals and, inter alia, has been involved in the processing of field crops. The crop protection segment has sub-segments, including contract manufacturing. Syngenta India has a plant that is 100% a captive unit for its associated enterprise based in Singapore. Syngenta India has been paying royalties on both domestic and export sales to its Singaporean associated enterprise.

The Indian TP adjustment here is based on the concept of location savings. The argument was worded by the tax authorities as follows:

> Location savings . . . can arise whenever factors of production are employed keeping in view the locational advantages of a particular location to give rise to savings with respect to one or many of the factors of production. Thus a cheap finance regime will offer locational advantages of cheap finance, populous country will offer locational advantages of cheap labour [. . .]. This view also finds support in the Indian position on this issue in various international discussion fora [including the UN Transfer Pricing Manual (2013)].[226] Syngenta operates in India where labour costs are less compared to Western countries. Accordingly, location savings does exist in this case of the Syngenta group.[227]

The Indian tax authorities calculated Syngenta's location savings on both contract manufacturing and licensed manufacturing. This was the central ground of the TP adjustment that triggered this dispute. The Court of Appeal accepted the LSA concept but reversed the tax authorities claim on

---

224 *Id.*

225 Letter of Deficiency, Office of the Joint Commissioner of Income Tax Transfer Pricing – 4(1), Mumbai, 400021, Syngenta Ltd, 27 Jan. 2015.

226 *Id.* at 7.

227 *Id.*

this point. The Court grounded its reversal on the lack of evidence supporting this LSA claim.[228]

The 2015 China regulation on LSAs and the *Syngenta* case, applying the LSA concept in an actual dispute, seem meaningful. They suggest that the challenge posed by China and India to the SEA and the ALP crystallised in the UN Transfer Pricing Manual (2013) has not been deterred by the OECD/G20 BEPS Reports (2015).

### *C. The Third Era: A Stage-by Stage Analysis (2015–2019)*

#### 1. Rise of the Third Era (2015–2019)

*Stage 55 – The BEPS Reports on TP (2015).*[229] During the 1920s and 1930s, the international financial system was in turmoil, because the UK was no longer powerful enough to support it, nor was the US ready to assume a leadership role (for example, the US never formally joined the League of Nations). The ascendency of the London Model/OECD Model came at the time of maximum US power. But in the early twenty-first century, the US is no longer the global centre of power and the status of the OECD Model is under threat, as shown by China's position in the UN Transfer Pricing Manual (*see* Stage 50).[230]

The tax planning schemes of the largest technology corporations — such as Apple, Microsoft and Google — began to be exposed, particularly as of 2012.[231] This dynamic has created increasing tension between globalisation and democracy, as represented in unexpected electoral results such as BREXIT and Trump.[232] This has triggered a strained environment among the US, the E.U. and the BRICS countries regarding international taxation and the ways in which MNEs should be taxed.

The BEPS Project is designed, in part, to try to bring the BRICS countries into the OECD tent and, perhaps, to reconcile a potential divergence between the E.U. and the US On the other hand, the BEPS Project is quite divorced from the priorities of the BRICS countries. Source/residence were removed from the agenda, the digital PE has been killed off and there is a big focus on arbitration, which is an area none of the BRICS countries support. BEPS also serves a political purpose for certain countries (as in the case of the UK), which is to respond to the growing detachment of OECD legal technology from popular consent (*see* Stage 49).

---

[228] *See* Income Tax Appellate Tribunal – Mumbai, Dcit 1(3), Mumbai vs Syngenta India Ltd, Pune (30 November, 2016). The Court of Appeal decided "[…] the Transfer Pricing adjustment cannot be on vague generalities. Accordingly, the adjustment made on account of location saving for sums amounting to Rs.54,69,43,636/- is directed to be deleted." *Id* at 24.

[229] *See supra* Figure 3.

[230] *U.N. Dep't of Int'l Econ. & Soc. Affairs, U.N. Transfer Pricing Manual for Developing Countries, U.N. Doc. ST/ESA/347, ¶¶ 10.3.6.3.–10.3.6.4 (2013). See supra,* note 193.

[231] *See supra* Stage 49.

[232] RODRIK, *supra* note 188.

Four out of fifteen Action Plans crystallised in the *BEPS Reports* are focused on TP, given its potential for facilitating profit shifting. The mission of the recommendations on TP (Action 8, Action 9, Action 10 and Action 13) is to ensure that TP outcomes are in line with a new principle: value creation (the value creation principle).[233] Hence, the BEPS Reports state that article 9 of the OECD Model should be enforced in the light of the value creation principle. Strikingly, it is not clear how the value creation principle, created by the BEPS Reports in 2015, should interact with the two principles created by the 1928 League of Nations Draft Model Convention. These two principles predicate that passive income should be primarily taxed by the country of residence, while active income by the country of source (see Stage 7).

An outline of the four BEPS Action Plans on TP follows. As misallocation of the profits generated by valuable intangibles has contributed heavily to BEPS concerns, Action 8 aims at developing rules to prevent BEPS by moving intangibles among group members. This involves: (i) adopting a broad definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; (iii) developing TP rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.[234] Action 8 looked at TP issues relating to

---

[233] On the value creation principle and BEPS, *see* Romero J. S. Tavares, *Multinational Firm Theory and International Tax Law: Seeking Coherence* , 8 WORLD TAX J 243, 243 (2016) (quotation altered).

> This study provides an interdisciplinary analysis of firm theory and international tax law, applied within a framework of hypothetical illustrations of prototypical multinational enterprises. The study finds that the construct and interpretation of different norms of international tax law correlate over time with different and partial views of the functioning of multinational enterprises and of their value drivers. Accordingly, international tax law is incoherent or ineffective in key aspects of its design, interpretation and enforcement, such as in the recognition of permanent establishments under articles 5(1), 5(5) and 5(7) of the OECD Model, the attribution of profits to permanent establishments under article 7, and the interpretation of the arm's length principle under article 9. The "value creation" approach promoted through the G20/OECD BEPS Project, as well as the "Authorised OECD Approach" for the attribution of profits to permanent establishments under article 7, seem to approximate the interpretation of treaty law to modern firm theories, albeit inconsistently and still requiring improvement. Other fundamental rules for the allocation of taxing rights, however, remain unaltered and dated, and/or incoherently interpreted. This study supports the consistent use of modern firm theories and the convergence of international tax norms to a common and coherent approach.

*See also* A. Christians and Laurens van Apeldoorn, *Taxing Income Where Value Is Created,* 2 FLA, TAX REV. 1 (Mar. 1, 2018).

[234] Yariv Brauner, *Cost Sharing and the Acrobatics of Arm's Length Taxation,* INTERTAX 1 (forthcoming), Univ. Fla. Legal Stud. Res. Paper No. 2010-19, 1, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1651334. This paper argues that:

controlled transactions involving intangibles, since intangibles are by definition mobile and are often hard to value. To ensure appropriate pricing of hard-to-value intangibles, Action 8 has devised an additional tool for states to address the use of information asymmetry between taxpayers and tax authorities in an attempt to undervalue intra-group transfers of intangibles.[235]

Action 9 aims at developing rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This involves adopting TP rules to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules need to require alignment of returns with value creation. Under Action 9, contractual allocations of risk are respected only when they are supported by actual decision making and, thus, control is exercised over these risks.[236]

Action 10 focuses on other high-risk transactions and aims at developing rules to prevent BEPS as a result of engaging in transactions that would not, or would only very rarely, occur between third parties. This Action adopted TP rules to: (i) clarify the circumstances in which transactions may be recharacterised; (ii) clarify the application of TP methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses. Action 10 deals with the scope for addressing profit allocations resulting from controlled transactions that are not commercially rational, the scope for targeting the use of TP methods in a way that results in diverting profits from the most economically important activities of the MNE group and the use of certain types of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value creation.

Finally, the Action 13 Report contains a three-tiered standardised approach to TP documentation, including a minimum standard on country-by-country (CbC) reporting. First, guidance on TP documentation requires MNEs to report high-level information regarding their global business operations and TP policies in a Master File that is to be made available to all relevant tax authorities. Second, it requires that detailed transactional TP documentation be provided in a Local File specific to each country, identifying material related-party transactions, the amounts involved in such transactions and the enterprise's analysis of the TP determinations they have made with regard to those transactions. Third, large MNEs are required to

---

> [T]he US cost sharing regime enables multinational enterprises to export US intangible property to low or no-tax jurisdictions, essentially tax-free. This is in stark contrast to long standing US policy and the explicit tax agenda of the Obama administration. Two recent cases have circumvented attempts by the IRS to mitigate cost sharing based tax avoidance. This article explains the regime, how the insistence of the IRS on arm's length based TP rules contributed to the current non taxation of foreign income of [US MNEs], and explores alternative reforms.

[235] Avi-Yonah & Xu, *supra* note 204, at 40.

[236] *Id.* at 41.

annually file a CbC report that should list the amount of revenue, profit before income tax, income tax paid and accrued and other indicators of economic activities for each tax jurisdiction in which they do business. A large MNE is an enterprise with annual consolidated group revenue equal to or exceeding EUR 750 million. CbC reports should be both filed in the ultimate parent entity's jurisdiction and shared automatically through the government-to-government exchange of information. In limited circumstances, secondary mechanisms, including local filing, may be used as a backup. An agreed implementation plan should ensure that information is provided to the tax authorities in a timely manner, confidentiality of the reported information is preserved and CbC reports are used appropriately. [237]

The combined Report contains revised guidance that aims to ensure that TP rules secure outcomes to better align operational profits with the economic activities generating them. The Report also contains guidance on transactions involving cross-border commodity transactions and on low value-adding intra-group services. As these two areas were identified as being of critical importance by developing countries, guidance will be supplemented with further work mandated by the G20 Development Working Group, with the aim of providing developing countries with knowledge, best practices and tools for pricing commodity transactions for TP purposes and preventing the erosion of their tax bases through common types of base-eroding payments.[238]

As the approach of Actions 8-10 is inevitably subjective (standard-based) rather than objective (rule-based), the net effect on attributing the tax base of MNEs will rely on how MNEs and tax authorities bargain and negotiate. Either under-taxation or over-taxation will likely arise from this strategic game. To avoid under-taxation, tax authorities may tend to maximise their discretionary power to recharacterize transactions, which may lead to strong opposition from MNE taxpayers. For similar reasons, to avoid over-taxation, MNEs may upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will probably increase and more tax disputes will likely be created.[239] Moreover, as subjective judgment will be made independently and separately by different national authorities, different jurisdictions might reach conflicting recharacterization conclusions for the same intra-group transaction.[240]

On the Action 13 front, the EUR 750 million threshold for annual consolidated group revenue is high for major MNEs in developing countries, although this threshold is tailor-made for the needs of developed countries. Such a threshold will exclude many large MNEs from the CbC reporting requirement and deprive developing countries of any access to the relevant information regarding MNEs below the threshold. In fact, many large MNEs

---

[237] *See* OECD & G20, OECD/G20 Base Erosion and Profit Shifting Project, *Explanatory Statement*: *2015 Final Reports,* 17 (2015).

[238] *Id.* at 15–16.

[239] EDUARDO BAISTROCCHI, A GLOBAL ANALYSIS OF TAX TREATY DISPUTES: OECD COUNTRIES (2017).

[240] Avi-Yonah & Xu*, supra* note 204, at 42.

have annual consolidated group revenue of less than EUR 750 million. Needless to say, some large MNEs will be motivated to manipulate their group revenue to a level of less than EUR 750 million.[241]

Actions 8, 9, 10 and 13 introduce the first structural amendments to the OECD Guidelines since their emergence in 1979. These changes can be classified in three categories: (i) revision; (ii) deletion and replacement; and (iii) addition. Under category (i), Actions 8-10 introduce revisions in chapters VI (on intangibles) and VII (on low value-adding intra-group services). Under category (ii), Actions 8-10 delete in their entirety and replace chapter I, section D (Guidance for applying the ALP) and chapter VIII (Cost Contribution Arrangements), and Action 13 deletes and replaces chapter V (Documentation). Under category (iii), Actions 8-10 add a new element to chapter II (on commodity transactions).[242]

The OECD Guidelines often form the basis for domestic TP law, particularly within the G20.[243] The BEPS Reports alter the OECD Guidelines to an extent but may not require further implementation in domestic law. They will primarily exercise their influence as an "interpretative tool or soft law."[244] This is primarily the case for developed countries.

The reach of the BEPS Reports is less certain in relation to developing countries. Perhaps rather cynically, academic critics in developing countries have expressed the opinion that the primary role of the BEPS Project has been to decrease state autonomy in tax matters and to consolidate the hegemony of the OECD (and other organizations) as the 'new centres of global fiscal power'. [245]It is the lack of distinction between developed and developing countries in the schema of the BEPS Reports that has generated this criticism. The focus on aligning TP outcomes and the locus of value creation would seem to benefit developing countries at least as much as developed countries.[246]

*Stage 56 – The OECD Guidelines after BEPS (2017).* In June 2016, the OECD Council approved the introduction of the BEPS amendments into the OECD Guidelines.[247] It also introduced a regulation for dealing with potential inconsistencies among the different versions of the Guidelines:

---

[241] *Id.* at 46.

[242] Milton Gonzalez Malla & Gabriela Fasola, *Transfer Pricing in Emerging Countries: New Rules and More Guidelines for Commodities*, Tax Management Transfer Pricing Report (May 18, 2017); and Christian Rosso Alba*, Transfer Pricing in Argentina — Timing of Commodity Export Pricing*, TAX NOTES INT'L 289, 289–90 (Oct. 24, 2011). *See also* G. Gotlib, 'Impacto jurídico de los ajustes de precios de transferencia', in *DTE*, XXI (245), 434–45 (Buenos Aires: *Errepar*, August 2000).

[243] BAISTROCCHI, *supra* note 246.

[244] Sergio A. Rocha, *The Future of Transfer Pricing*, Cahiers de Droit Fiscal International, International Fiscal Association, Vol. 102 b, 2017. This is the case, for example, in Austria, Belgium, Canada, Finland, Italy, Norway, Spain, Sweden and Switzerland.

[245] *Id.* at 33.

[246] *Id.*

[247] Org. for Econ. Co-operative & Dev. [OECD], *Recommendation of the Council on Base Erosion and Profit Shifting Measures Related to Transfer Pricing* 3, OECD Doc. OECD/LEGAL/0424 (2020), https://legalinstruments.oecd.org/public/doc/339/339.en.pdf.

> [T]he provisions of the Transfer Pricing Guidelines should be interpreted to be consistent with those provisions of the Transfer Pricing Guidelines which have been amended by the 2015 BEPS Report on Actions 8-10 and 2015 BEPS Report on Action 13 and, in case of perceived inconsistencies, the modified provisions prevail.[248]

Interestingly, the OECD Guidelines (2017) now acknowledge the standard-based character of the ALP, as follows: "[TP] disputes may arise even though the guidance in these Guidelines is followed in a conscientious effort to apply the arm's length principle. It is possible that taxpayers and tax administrations may reach differing determinations of the arm's length conditions for the controlled transactions under examination given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases."[249]

Moreover, the OECD Guidelines (2017) recommend a range of six alternative methods for the prevention and resolution of disputes. These are: (i) TP compliance practise;[250] (ii) corresponding adjustment and the mutual agreement procedure;[251] (iii) simultaneous tax examinations;[252] (iv) safe harbours;[253] (v) advance pricing agreements;[254] and (vi) arbitration.[255]

The commensurate-with-income test for valuing intangibles was transplanted to the OECD Guidelines in 2016.[256] It shows the vitality of a standard-based regulation created by the US judiciary in 1968 (*see* Stage 63),

---

[248] Org. for Econ. Co-operative & Dev. [OECD], *OECD Council approves incorporation of BEPS amendments into the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* (June 15, 2016) http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm.

[249] Org. for Econ. Co-operative & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 171 (July 2017).

[250] *Id.* at 171–72.

[251] *Id.*

[252] *Id.* at 172.

[253] *Id.*

[254] *Id.*

[255] *Id.*

[256] OECD & G20, OECD/G20 Base Erosion and Profit Shifting Project, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10- 2015 Final Reports,* 111 (2015).

> In evaluating the *ex-ante* pricing arrangements, the tax administration is entitled to use the *ex post* evidence about financial outcomes to inform the determination of the arm's length pricing arrangements, including any contingent pricing arrangements, that would have been made between independent enterprises at the time of the transaction, considering the guidance in paragraph 6.185. Depending on the facts and circumstances of the case and considering the guidance in Section B.5 of Chapter III, a multi-year analysis of the information for the application of this approach may be appropriate.

then transplanted to US domestic law (Stage 27) and the OECD Guidelines in 1995 (Stage 35).

In sum, the OECD Guidelines (2017) now accept that 'transfer pricing issues are so complex' and prone to disputes and it recommends a range of six alternative dispute resolution methods for their prevention and resolution. The OECD Guidelines (2017) are yet another clear step towards transforming the ALP into a standard-based procedural regulation, indicating the spiral evolution of article 9 of the OECD Model (*see* Figure 4).

*Stage 57 – The OECD on Business Restructuring and TP (2016).* In 2016, the OECD also decided to update crucial chapter IX of the OECD Guidelines, which deals with business restructurings, in light of the BEPS Reports. It published a document entitled *Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines*.[257]

This document seems to be an attempt by the OECD to restore an anti-avoidance role to the ALP in the area of business restructuring. This restoration was implemented by strengthening the single tax principle in this area. The OECD revisited the issue of tax-driven business restructuring and offered two tests: (i) the entity-by-entity test (i.e., the ALP should be applied at the entity-by-entity level, rather than at the group level) and (ii) the commercial rationality test ('the fact that an MNE group as a whole is left worse off on a pre-tax basis may be a relevant pointer in determining the commercial rationality of the restructuring').[258]

---

[257] OECD, *Conforming Amendments to Chapter IX of the Transfer Pricing Guidelines,* Base Erosion and Profit Shifting (BEPS) Document for Public Review, (OECD 2016), www.oecd.org/tax/transfer-pricing/conforming-amendments-chapter-ix-transfer-pricing-guidelines.pdf. *See also* Vann, *supra* note 174.

[258] OECD Guidelines 2017, paras. 9.37-8, states the following:

> There can be group-level business reasons for an MNE group to restructure. However, it is worth re-emphasising that the arm's length principle treats the members of an MNE group as separate entities rather than as inseparable parts of a single unified business (see paragraph 1.6). As a consequence, it is not sufficient from a transfer pricing perspective that a restructuring arrangement makes commercial sense for the group as a whole: *the arrangement must be arm's length at the level of each individual taxpayer, taking account of its rights and other assets, expected benefits from the arrangement (i.e. consideration of the post-restructuring arrangement plus any compensation payments for the restructuring itself), and realistically available options.* Where a restructuring makes commercial sense for the group as a whole on a pre-tax basis, it is expected that an appropriate transfer price (that is, compensation for the post-restructuring arrangement plus any compensation payments for the restructuring itself) would generally be available to provide arm's length compensation for each accurately delineated transaction comprising the business restructuring for each individual group member participating in it (emphasis added).
>
> Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement. The presence of a tax motive or purpose does not of itself justify non-recognition of the parties'

These new tests are additional evidence of the emergence of the third era of the allocation norm, in which the ALP is grounded in a complex set of standard-based procedures (*see* Stage 55).

*Stage 58 –The Multilateral Convention for Implementing BEPS (2016).* The OECD MLI (2016) aims to create and/or expand a number of standard-based procedures in the area of TP in order to prevent or resolve TP disputes.[259] For example, it aims to expand the scope of article 9(2) of the OECD Model (the corresponding adjustment) to all covered tax treaties as a mechanism for solving economic double taxation regarding TP.[260]

---

> characterisation or structuring of the arrangement. However, tax benefits at a group level do not determine whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see previous paragraph). Moreover, as indicated in paragraph 1.122, the fact that a MNE group as a whole is left worse off on a pre-tax basis may be a relevant pointer in determining the commercial rationality of the restructuring.

OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* ¶¶ 9.37–9.38 (July, 2017) (emphasis added).

[259] OECD, *OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, Nov. 24, 2016 [hereinafter *OECD MLI* (2016)].

[260] *OECD MLI* (2016) at art. 17(1)–(3)(b) reads as follows:

> 1. *Where a Contracting Jurisdiction includes in the profits of an enterprise of that Contracting Jurisdiction – and taxes accordingly – profits on which an enterprise of the other Contracting Jurisdiction has been charged to tax in that other Contracting Jurisdiction and the profits so included are profits which would have accrued to the enterprise of the first-mentioned Contracting Jurisdiction if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other Contracting Jurisdiction 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 the Covered Tax Agreement and the competent authorities of the Contracting Jurisdictions shall if necessary consult each other.
>
> 2. *Paragraph 1 shall apply in place of or in the absence of a provision that requires a Contracting Jurisdiction to make an appropriate adjustment* to the amount of the tax charged therein on the profits of an enterprise of that Contracting Jurisdiction where the other Contracting Jurisdiction includes those profits in the profits of an enterprise of that other Contracting Jurisdiction and taxes those profits accordingly, and the profits so included are profits which would have accrued to the enterprise of that other Contracting Jurisdiction if the conditions made between the two enterprises had been those which would have been made between *independent enterprises.*
>
> 3. *A Party may reserve the right:*
>
> *a) for the entirety of this Article not to apply to its Covered Tax Agreements that already contain a provision described in paragraph 2;*
>
> *b) for the entirety of this Article not to apply to its Covered Tax Agreements on the basis that in the absence of a provision referred to in paragraph 2 in its Covered Tax Agreement:*

The OECD MLI also contemplates an expansive role for MAPs in the area of TP, as well as the introduction of optional tax arbitration for international TP disputes between states.

*Stage 59 – China and LSAs (2016).* The notion of LSAs was adopted out of emerging countries' frustrations over what they viewed as the unacceptable result of profit allocation when following the pre-BEPS OECD Guidelines. China is a case in point. Under the OECD approach, Chinese subsidiaries of MNEs were treated as single-function, limited-risk entities, which made routine profit margins but failed to receive any share of the residual profits, or the super profit or economic rent, of the MNE groups to which they had made significant contributions. What was particularly offensive was that these profits were often ultimately allocated to entities in low-tax jurisdictions.[261] In fact, this frustration has a long history: it first emerged in the context of the *Vestey* case II in 1932 (*see* Stage 10) and has now expanded to India (in cases such as *Syngenta* (*see* Stage 54), Russia and South Africa.[262] As noted, this is not the only instance of developing countries adopting a heterodox interpretation of the ALP and article 9 of the OECD Model, but it is a paradigmatic case of how far countries are willing to stretch their interpretation of it.[263]

The Chinese view is that a subsidiary should be regarded as part of the MNE 'family', thus enjoying the benefits of that family. In addition, under the pre-BEPS OECD Guidelines, any residual profits derived by MNEs generally belong to the legal owner of the relevant intangibles, which can be referred to as the intangible-centric approach. This approach is more 'relaxed' under the post-BEPS OECD Guidelines, as it takes into account factors other than the legal ownership of intangibles, but its essence remains. By contrast, the Chinese view is that some of the residual profit arises from taking advantage of LSAs, which, while external in nature, contribute to the creation of value in MNEs in very much the same way as intangibles. Consequently, local Chinese subsidiaries should be allocated a share of the residual profits. In essence, Chinese authorities view the subsidiary as part of the MNE group when taking advantage of LSAs, as opposed to a stand-alone entity that only performs specific routine functions.[264]

The notion of LSAs has been recognised in TP analysis, especially in China as of 2015, but its scope and relevance remain uncertain. Attributing value to LSAs is inconsistent with the SEA and the ALP. It also deviates from the existing OECD approach to interpreting and applying the principle. It is consistent, however, with the direction of the OECD/G20 BEPS initiative in

---

*i) it shall make the appropriate adjustment referred to in paragraph 1; or*

*ii) its competent authority shall endeavour to resolve the case under the provisions of a Covered Tax Agreement relating to mutual agreement procedure.* (emphasis added).

[261] *See*, *e.g.*, *Vestey* Case II, *supra* Stage 10; Press Release, *supra* note 203.

[262] *UN Transfer Pricing Manual* (2017), *supra* note 218, at ch. 10.

[263] Baistrocchi, *supra* note 220, at 547.

[264] Li & Ji, *supra* note 194.

allocating profit of an MNE on the basis of where value is created. Giving value to LSAs reflects a different way of thinking about what contributes to value creation. In the absence of international consensus on what LSAs are and how or how much they contribute to value creation, the profits of MNEs may be allocated among countries in a way that results in over-taxation or under-taxation of MNEs.[265]

*Stage 60 – US Reaction to the BEPS Reports on TP (2017).* The US reaction to the BEPS Reports on TP is noteworthy. The US position is encapsulated in a report entitled *International Taxation: Information on the Potential Impact on IRS and US Multinationals of Revised International Guidance on Transfer Pricing.*[266] It was submitted by the US Government Accountability Office (GAO) to the US Senate in January 2017.

As noted, the OECD Guidelines, particularly the 1979 and 1995 versions, have been a platform for exporting US IRC section 482 regulations to the OECD and beyond.[267] There is a novelty in the BEPS Reports, as the US is no longer an innovator in the area of international taxation. Despite this power shift, according to GAO report, the Internal Revenue Service (IRS) 'views the OECD revised guidance as consistent with but more detailed than its own regulations'.[268] The US has lost control of the OECD Guidelines as amended by the 2015 BEPS Reports. However, the 2015 version remains compatible with US law.[269]

In sum, article 9 of the OECD Model may now require interpretation in light of the 2015 BEPS Final Reports for those countries that implement their recommendations. What may be an open question is the extent to which the BEPS Reports will have an impact on the global taxonomy of treaty dispute patterns emerging in the pre-BEPS era (1923-2015).[270] The extent to which the BEPS recommendations are implemented remains to be seen, particularly in those countries that may not stand to gain much from implementation.

*Stage 61 – The UN Transfer Pricing Manual (2017).* The UN released the first post-BEPS version of the UN Model in 2017. Strikingly, the Commentary to Article 9 of the UN Model does not even quote the BEPS Reports on TP. The UN Model omission suggests the BRICS disagreement with the OECD-G20 work in the TP area. This disagreement was made visible in the first post-BEPS version of the UN Transfer Pricing Manual published in 2017.[271]

---

[265] *Id.*

[266] U.S. Gov't Accountability Office, GAO-17-103, Report to the Chairman, Committee on Finance, U.S. Senate: International Taxation: Information on the Potential Impact on IRS and US Multinationals of Revised International Guidance on Transfer Pricing (Jan. 2017), https://www.gao.gov/assets/690/682330.pdf.

[267] *See supra* Stage 19.

[268] *See supra* note 266, at 30.

[269] *Id.* at 2.

[270] Eduardo A. Baistrocchi, *Patterns of Tax Treaty Disputes: A Global Taxonomy,* A GLOBAL ANALYSIS OF TAX TREATY DISPUTES (forthcoming) (manuscript at 1351–52), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2811641.

[271] Thassiane Ayres Gossler, *Transfer Pricing Rules in the BRICS World: A Shifting Balance in Global Taxation Governance?* Electronic Thesis and Dissertation Repository.

The BEPS Reports seem to have encouraged the BRICS countries, under the leadership of China, to innovate and probably deviate from the OECD legal technology concept in the area of TP. The following paragraphs of the UN Transfer Pricing Manual (2017) suggest this new dynamic in the international tax arena:

> Having the right to speak does not necessarily mean being ready to speak. Getting involved is still a long way from being equipped to lead. It is therefore imperative that the developing countries continue to build capacity in tax administration to enable them to become more prepared to contribute and lead.[272]
>
> [...] China has overcome this challenge [emerging from the ALP application] by using some practical solutions that are sensitive to unique economic and geographical factors for companies operating in China. These solutions include concepts such as location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods.[273]

LSAs seem to be the first area in which China and India may deviate from the OECD legal technology concept in the TP arena (*see* Stage 54 on India and Stage 59 on China).

*Stage 61 – The Commentary on Article 9 of the OECD Model (2017).* With the 2017 version of the OECD Model, there were no changes made to article 9, but a new paragraph 6.1 was included in the Commentary and paragraph 10 was replaced. The full text of these new two new provisions are below, followed by an analysis of each of them.

> 6.1 Under the domestic laws of some countries, a taxpayer may be permitted under appropriate circumstances to amend a previously-filed tax return to adjust the price for a transaction between associated enterprises in order to report a price that is, in the taxpayer's opinion, an arm's length price. Where they are made in good faith, such adjustments may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle. However, economic double taxation may occur, for example, if such a taxpayer-initiated adjustment increases the profits of an enterprise of one Contracting State but there is no

4930.

(Sept. 12, 2017).

[272] Dep't Econ. & Soc. Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries*, sec. D.2.1.1, U.N. Doc. ST/ESA (2017) [hereinafter *UN Transfer Pricing Manual* (2017)], www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf. The size of the *UN Transfer Pricing Manual* has expanded substantially in just four years, from 499 pages in its (first) 2013 edition to 668 pages in its (second) 2017 edition.

[273] *Id.* at § D.2.5.3 (emphasis added).

> appropriate corresponding adjustment to the profits of the associated enterprise in the other Contracting State. The elimination of such double taxation is within the scope of paragraph 2. Indeed, to the extent that taxes have been levied on the increased profits in the first-mentioned State, that State may be considered to have included in the profits of an enterprise of that State, and to have taxed, profits on which an enterprise of the other State has been charged to tax. In these circumstances, Article 25 enables the competent authorities of the Contracting States to consult together to eliminate the double taxation; the competent authorities may accordingly, if necessary, use the mutual agreement procedure to determine whether the initial adjustment met the conditions of paragraph 1 and, if that is the case, to determine the amount of the appropriate adjustment to the amount of the tax charged in the other State on those profits so as to relieve the double taxation (paragraph 6.1).[274]

Paragraph 6.1 added in the Commentary to Article 9 aims to increase flexibility in the application of the arm's length standard. Indeed, article 9.1 now allows a taxpayer-initiated adjustment. Moreover, the scope of article 9.2 has been expanded to solve any potential economic double taxation triggered by the taxpayer-initiated adjustment. The mutual agreement procedure (MAP), within the wording of article 25, is the central procedural standard offered to solve this economic double taxation problem.

This innovation in article 9 is consistent with the net effect of the BEPS Reports of granting taxpayers an expanded role in the application of the OECD Model legal technology. Similar expansions have been implemented in other areas of the OECD Model. Article 25 is a case in point as the taxpayer now has the option of requesting a MAP in either contracting states, rather than in only the country of residence, as it was the case before the BEPS Reports era.

The 2017 version of paragraph 10 of the Commentary to Article 9 of the OECD Model provides the following (Paragraph 10):

> 10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words,

---

[274] OECD, *Model Tax Convention on Income and on Capital*, *Condensed Version*, ¶ 6.1 (Nov. 11, 2017), https://www-oecd-ilibrary-org.proxy01.its.virginia.edu/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017/commentary-on-article-9_mtc_cond-2017-12-en.

> that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25). Contracting States may also wish to address this issue through a provision limiting the length of time during which a primary adjustment may be made pursuant to paragraph 1; such a solution avoids the economic double taxation that may otherwise result where there is no corresponding adjustment following the primary adjustment. Contracting States that wish to achieve that result may agree bilaterally to add the following paragraph after paragraph 2:
>
> 3. A Contracting State shall not include in the profits of an enterprise, and tax accordingly, profits that would have accrued to the enterprise but by reason of the conditions referred to in paragraph 1 have not so accrued, after [bilaterally agreed period] from the end of the taxable year in which the profits would have accrued to the enterprise. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.[275]

The purpose of paragraph 10 is twofold. First, it deals with a potential tension between the ALP (crystallised in article 9. 1) and the avoidance of economic double taxation (encapsulated in article 9.2). Second, it suggests a way for solving this tension.

Paragraph 10 shows the increasing relevance of the avoidance of economic double taxation *vis a vis* the ALP in the BEPS era. So the OECD Model now offers contracting states the option of adding a third paragraph to article 9 to limit the length of time in which primary TP adjustments can be made on the basis of the ALP, as defined in article 9.1. The suggested article 9.3 limits its scope to cases not involving fraud, gross negligence or wilful default to limit the room for taxpayers' opportunistic behaviour.

---

[275] OECD, *Model Tax Convention on Income and on Capital, Condensed Version, Commentary on Article 9,* ¶ 10 (Nov. 11, 2017) https://www-oecd-ilibrary-org.proxy01.its.virginia.edu/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017/commentary-on-article-9_mtc_cond-2017-12-en.

*Stage 63 – The UN Model (2017).* The UN released the first post-BEPS version of the UN Model in 2017. Strikingly, the Commentary to Article 9 of the UN Model does not even quote the BEPS Reports on TP. The UN Model omission suggests the BRICS disagreement with the OECD-G20 work in the TP area. This disagreement was made visible in the first post-BEPS version of the UN Transfer Pricing Manual published in 2017.[276]

The BEPS Reports seem to have encouraged the BRICS countries, under the leadership of China, to innovate and probably deviate from the OECD legal technology concept in the area of TP. The following paragraphs of the UN Transfer Pricing Manual (2017) suggest this new dynamic in the international tax arena:

> Having the right to speak does not necessarily mean being ready to speak. Getting involved is still a long way from being *equipped to lead*. It is therefore imperative that the developing countries continue to build capacity in tax administration to enable them to become *more prepared to contribute and lead*.[277]
>
> China has overcome this challenge [emerging from the ALP application] by using some practical solutions that are sensitive to unique economic and geographical factors for companies operating in China. These solutions include concepts such as *location savings, market premium and alternative methods of analysis besides the traditional transactional and profit based methods*.[278]

[276] Thassiane, *supra* note 271.

[277] *UN Transfer Pricing Manual* (2017), *supra* note 272, at § D.2.1.1 (emphasis added)

[278] *Id.* at § D.2.5.3 (emphasis added).