Policy Forum: The End of Transfer Pricing?

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ABSTRACT
This article is based on a lecture delivered at the NYU School of Law in September 2012. It puts into question the viability of the prevailing model for the allocation of income within a multinational enterprise (MNE), the system of transfer pricing based on the arm’s-length principle. The author likens transfer pricing to a scientific “paradigm” as discussed by the historian of science Thomas Kuhn, suggesting that its perseverance is due especially to the entrenched interests of its practitioners in both government and the private sector. At the theoretical level, transfer pricing suffers from a conflict with the reality of the MNE; in practical terms, it is challenged in particular on the grounds of complexity and the attendant cost of administration and compliance. The author briefly canvasses possible solutions to the impasse, focusing on profit splits and formulary apportionment.

KEYWORDS: TRANSFER PRICING ■ POLICY ■ INTERNATIONAL TAXATION ■ MULTINATIONALS ■ ALLOCATION ■ APPORTIONMENT

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AN ALLEGORY

The Ptolemaic theory served humankind well for over a millennium, from antiquity to the Renaissance, providing accurate predictions of the motions of heavenly bodies around a fixed, centred earth. New observations were accommodated within an increasingly elaborate mathematical model under which planets traced paths in the form of complicated loops called epicycles (see figure 1). The model and its intellectual foundations survived by tweaking, bending, and adjusting the theory and its geometric elaboration.

The publication of a treatise on planetary motion by a Polish astronomer in 1543 ushered in the Copernican revolution. The significance of that event can be properly understood only in its full social, philosophical, religious, scientific, and historical context, but it is sufficient here to note a few purely practical aspects. Its impact was subjected to a creative reinterpretation by the historian of science Thomas Kuhn in 1957 and generalized in his 1962 classic, The Structure of Scientific Revolutions. Kuhn argued that scientific progress relied on the formulation and eventual abandonment of “paradigms,” associating famous names in the history of science with so-called paradigm shifts. Their contributions were not merely discoveries but reorientations in our understanding of the universe and its operation—like Lavoisier’s work on the interaction of substances or Newton’s optical theories.

At the risk of passing too abruptly from the sublime to the, let us say, less sublime, I invoke this notion of scientific revolution as a metaphor or allegory for the subject of this article—namely, the international tax regime for allocating profits within an associated group of companies, known as “transfer pricing.” It is often said that transfer pricing is not a science; Kuhn’s analysis does, nevertheless, offer some interesting lessons.

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2 The same term is used to refer to the managerial accounting task of determining intercompany prices, an important subject that has serious ramifications for economic efficiency (referred to briefly below). In this article, however, unless otherwise stated, “transfer pricing” refers to the eponymous tax regime.

3 Some prefer to say that it is not an “exact science”; see, for example, Organisation for Economic Co-operation and Development, OECD Transfer Pricing Guidelines for Multinational Enterprises.
First, his paradigms have a sociological and economic component. The members of a scientific community have a similar education and similar experiences; they belong to the same organizations; they read the same technical literature in the same way; they employ common theories, metaphysical understandings; they share values and commitments. Personal and professional advancement depends upon adherence to and promotion of the paradigm. Similar observations may be made about transfer pricing. The inertia of that paradigm is not unrelated to its significant sunk costs—human, institutional, and financial. Writers and publishers, partners and employees of professional firms (accountants, lawyers, economists), corporate tax officers, government officials in treasury departments or revenue agencies, and the guardians of the system seconded to or employed by intergovernmental institutions (notably, the

Organisation for Economic Co-operation and Development (OECD)—all of these people are engaged in and dependent upon the continued existence of a particular system. We might call it an “establishment” or, recalling President Eisenhower’s famous reference to “the military-industrial complex,” a private-public fiscal complex. Careers, livelihoods, and personal self-worth are at stake.

A second similarity between transfer pricing and a scientific pursuit concerns the way in which each controls its own scope. What Kuhn called “normal science” solves puzzles, problems that arise and are susceptible of solution within the paradigm. When a crisis arises, a fact or conception that threatens to undermine the paradigm, scientists do not renounce it. To do so would be to abandon science itself as they know it. Similarly, transfer-pricing practitioners approach such practical difficulties as the crisis of intangibles by expanding or adjusting rather than replacing the paradigm. Like the ether in physics or phlogiston in chemistry, transfer pricing is no longer merely a technique or tool but has become a way of understanding reality—in this case, fiscal reality.

My thesis is that 21st century transfer pricing bears an eerie resemblance to a superseded scientific paradigm. An observation by Kuhn about Ptolemaic epicycles seems apt. By the 16th century, he observed, “astronomy’s complexity was increasing far more rapidly than its accuracy.” So too with transfer pricing. Paradigms do change, generally after a period of intense insecurity. Revolutions do occur.

AN ANALYTICAL FRAMEWORK

The transfer-pricing complex has commandeered not only the levers of international income allocation but also its vocabulary and conceptual apparatus, by equating transfer pricing with the equitable distribution of fiscal revenues. Under this heading, I would like to reposition the concepts, placing them within a hierarchy, illustrated in figure 2.

As a preliminary matter, it is useful to draw a distinction that is often lost (or buried) by many commentators, both defenders and critics of the international fiscal order, between transfer pricing and tax avoidance.

Profit Allocation, Profit Shifting, and Base Erosion

Multinational enterprises (MNEs) earn their income globally, but countries tax it locally by imposing techniques of geographical division or allocation. It is unhelpful to confuse that task with the equally important, sometimes overlapping, but none-theless distinct objective of protecting the domestic tax base against undue erosion through international tax-avoidance strategies. Those strategies are only tangentially

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4 Dwight D. Eisenhower, “Farewell Address to the Nation,” January 17, 1961: “In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex” (http://quod.lib.umich.edu/p/potpus/4728424.1960.001?view=toe).

5 Kuhn, supra note 1, at 68.
related to transfer pricing. The main problem lies elsewhere, in the effectiveness of controlled foreign corporation (CFC) taxation, tax credit and exemption systems, and the establishment and implementation of anti-avoidance and anti-evasion regimes. For example, transfer pricing does not address “fat capitalization” of tax haven subsidiaries (at least not yet). Nor does it have any impact on alchemical financing schemes that transmogrify principal into interest. Most important, the avoidance of residence-country taxation by investment in or through low- or no-tax jurisdictions, whether by clever corporate structures or crude personal tax evasion, is not readily amenable to correction through better transfer pricing.

This is not to say that “transfer mispricing,” as the Tax Justice Network cleverly calls it, has no role. A corporate group may engage in a parody of intercompany pricing that causes profits to pop up in a jurisdiction where little has been done to earn them. More insidious and less egregious is the almost inevitable profit shifting that is both the target and the inevitable effect of transfer pricing.7 Taxable income, like water, tends to flow downhill, from high- to low-tax jurisdictions, although (the viscosity of profits being higher than that of water) there are impediments to its free flow. In fact, many transfer-pricing disputes do not involve significant or perhaps

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any net tax reduction. Countries commonly seek to “repatriate” profits that they believe to be rightfully theirs without regard to whether the tax imposed by “the other side” is higher or lower. It is not unusual for each of two jurisdictions to contend that an MNE has shifted profits to the other.

The distinction between allocating “real” MNE profits and stemming abusive tax avoidance is fundamental. A system designed to achieve the former may not be best suited to address the latter, and the confusion of these objectives is inimical to the resolution of either one. A prime example is the transfer of valuable intangibles to low-tax subsidiaries, a strategy so well known and widespread that even the New York Times has found out about it. Global mandatory consolidation would resolve the issue, as might certain types of CFC or anti-avoidance legislation. Addressing it through sophisticated transfer-pricing methodologies demands the construction of rules that are appropriate not only to these types of transactions but also to everyday inter-unit licensing, a recipe for designing a legislative response that is inappropriate to both.

These remarks are generally restricted to the questions that arise because of the need to allocate real income among jurisdictions that have real fiscal claims to it, recognizing that their relative tax rates or other system attributes may well have been a factor in MNE pricing strategies.

**Allocation of Tax Revenues and Transfer Pricing**

States need to defray the costs of public goods like defence, health care, education, pensions, enforcing contracts, maintaining public order, and regulation, for which they rely mainly on captive, relatively immobile tax bases—property and payrolls, consumption, and the income of residents. Some lucky states collect economic rents in respect of natural resources. In addition, most of them tax profits of MNEs that they regard as allocable to their jurisdictions.

Transfer pricing—along with the system within which it is embedded, including the permanent establishment (PE) threshold, PE profit allocation methodology, and source rules—is a means, not an end. The premise underlying the paradigm is that if the price is right, the interstate allocation of tax revenue will also be right, that the simultaneous and harmonious application of transfer-pricing requirements by multiple jurisdictions will result in the fair and accurate distribution of MNE tax revenues among states. In the words of a recent OECD release, transfer pricing is supposed “to ensure that each country receives its fair share of tax.”

A great deal of effort has been directed to the first of these two “rights” (the right price) and rather less to the second (the right result). In the simplest of worlds—one

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far simpler than ours, even back when these notions were first elaborated—it may seem intuitive that total group profit will be fairly allocated if intercompany prices are correctly determined. This is not always true even in the simplest case, and it is highly suspect in more complex and realistic situations. For reasons that will be discussed below, correct transfer pricing, whatever is meant by that expression, is not logically identical to the correct allocation of fiscal revenues, whatever is meant by that expression.

Discussions of the fair allocation of taxing rights with respect to MNE profits presume that allocative fairness is to be judged by how well the system responds to the question “Are the profits being taxed where they are earned?” The transfer-pricing paradigm responds with a tautology by asserting an affirmative answer so long as its rules are followed. More subtly, considerations of this allocation question commonly equate “earned” with “produced,” assuming that profits should be situated where “productive activities” occur. But income tax, as Lord Macnaghten famously said, is a tax on income.\(^\text{10}\) It is not a tax on production. Some arguments about the localization of income, especially from services, are really about what we mean by “earned.”

The Arm’s-Length Principle

The arm’s-length principle\(^\text{11}\) is the chosen means for applying transfer pricing. It is premised on the determination of the hypothetical profits of a hypothetical separate entity under the conditions that would hypothetically prevail if there were no “association.”\(^\text{12}\)

Other principles could be and in some circumstances are applied. For example, the introduction of the comparable profits method (CPM) in the United States was vigorously resisted by some governments in the mid-1990s because they felt that it did not conform to the arm’s-length principle (or, indeed, was not a transfer-pricing method at all).\(^\text{13}\) I vividly recall heated discussions between business representatives

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10 Attorney General v. London County Council (1900), 4 TC 265, at 293.

11 Sometimes called the arm’s-length method or the arm’s-length standard. “Standard” implies a comparison with something that is measurable, while “method” is used in this article to refer to certain operational tools. My preference for the term “principle” serves to emphasize that we are dealing with something more conceptual than a standard or method.


13 The Canadian government expressed its concern in a joint press release by the ministers of finance and national revenue: “The Ministers noted that difficulties may arise where a foreign jurisdiction adopts another approach—such as the ‘comparable profits method’ (CPM) set out in the new U.S. regulations—which may generate transfer prices that do not conform to the arm’s length principle and, hence, would not be acceptable for Canadian tax purposes.” (Canada, Department of Finance, “Transfer Pricing Rules and Guidelines Clarified,” News Release 94-003, January 7, 1994.) At the 1993 annual conference of the Canadian Tax Foundation, the Canada Revenue Agency (CRA) was even more negative: “The CPM redetermines a taxpayer’s profit,
and the OECD that led to a creative compromise in the new transfer-pricing guidelines, including both the “last resort” language and the so-called transactional net margin method, which is only CPM in drag. It is difficult to argue (although the US government and others do) that CPM is an application of the arm’s-length principle.14

Of special interest is the rise of profit splits, particularly (although not exclusively) in the context of one-off negotiations within the mutual agreement procedure (MAP) and advance pricing agreements (APAs).15 The transfer-pricing establishment considers that these solutions fall within the arm’s-length principle, which is now being applied to dealings involving “unique contributions.” This is typical intra-paradigm jargon. If the contribution is “unique,” then arm’s-length parties would not have made it, so any arm’s-length price is fanciful. More generally, commercial actors do not seek to share the aggregate profit attributable to their dealings in an equitable fashion. Profit splits are attempts to divide the baby, generally made in good faith although of less than Solomonic simplicity.

Thus, the arm’s-length principle should be regarded not as a definition of transfer pricing but instead as a particular and not inevitable decision about how it may be controlled.

Methods

Within the arm’s-length principle, various “methods” have been constructed upon which practitioners, enterprises, and tax administrations principally focus their intensive—and expensive—attention. These methods are intended to provide a mechanical and objective means of implementing the arm’s-length principle. They all rely on an external comparison—with either a price or a margin—in order to determine what one part of an MNE would have charged another in the absence of association.

The difficulties in applying these methods and the multiple and compounding hypotheses upon which they rest are reflected in their increasing complexity. Just

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14 Clausing and Avi-Yonah support the US argument that CPM is consistent with the arm’s-length standard “even though no comparables can be found.” (Kimberley A. Clausing and Reuven S. Avi-Yonah, Reforming Corporate Taxation in a Global Economy: A Proposal To Adopt Formulary Apportionment, Hamilton Project Discussion Paper 2007-08 (Washington, DC: Brookings Institution, June 2007), at 23-24.) However the issue is not, or not only, the lack of comparables but rather whether the conditions made between the two associated enterprises differ from those that would be made between independent enterprises.

15 Kroppen et al., supra note 7, at 269-71.
look at the apparently simple notion of “comparability.”16 These matters have been the subject of considerable commentary, and I will not repeat the incisive and sometimes caustic observations of others.

Far from heralding the strength of the arm’s-length principle, the prevalence of profit splits in MAPs and APAs signals the failure of the traditional methods and, for the reasons already remarked, the principle itself. The expression “profits-based methods” is a paradigmatically Orwellian non sequitur: negotiated allocations are not a “method.” Profit splits are used in complex, integrated situations where meaningful comparable data are not available—that is to say, where there is no way to determine what arm’s-length parties would have done.

**CHALLENGES TO THE PARADIGM: PRACTICE AND THEORY**

There is an old joke about the economist who muses, “I know it works in practice, but does it work in theory?” Transfer pricing is challenged in both respects.

**Practice**

I limit my comments to three aspects: money, consistency, and potential for economic inefficiency.

**Cost and Revenue**

Transfer pricing is an expensive hobby. I have found no data specific to its administration and compliance, but we know that corporate income tax (CIT) in general is less efficiently imposed than personal income tax (PIT), and consumption tax is cheapest of all.17 Research confirms, as one would expect, that the relative costs of

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16 The incorporation of the 2012 comparability recommendations into the OECD transfer-pricing guidelines was the culmination of a seven-year project beginning with public consultations based on a 78-page discussion draft (www.oecd.org/ctp/transferpricing/36651642.pdf). The drafters are to be complimented on reducing the final product to only 27 paragraphs in the guidelines, compared with 20 in the 1995 version. The 1979 guidelines had no separate presentation of the issue, although a few paragraphs were devoted to it in the consideration of the comparable uncontrolled price method. (Organisation for Economic Co-operation and Development, Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979) and Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 1995.)

CIT compliance are higher for small and medium-sized businesses, but even with respect to the large, concentrated pools of income where transfer pricing is concentrated, efficiency is not impressive. Some US studies indicate that foreign-source income accounts for a disproportionately large share of compliance costs. This must reflect the complex foreign tax credit rules, but transfer pricing is also part of the equation.

The burden of transfer-pricing compliance is confirmed by anecdotal evidence. In surveys, corporate tax officers regard it as significant, excessive, and rising. They cite the cost of multi-country documentation requirements, unpredictable and unquantifiable audit risks, penalties, and controversy management. This is not paranoia. Documentation requirements, for example, began with one country in 1994 and spread to around 20 over the next 10 years. Today, they have infected as many as 60 (depending upon what one regards as a documentation requirement). These rules are often onerous and inevitably uncoordinated. As for audit and controversy, the ultimate risk of double taxation may be of less concern than the cost of preventing it. Finally, it should be noted that unlike domestic and even most international tax rules, transfer pricing demands double and sometimes multiple compliance and administration with respect to the same revenue.

The OECD concedes that “the time has come to simplify the rules and alleviate the compliance burden for both tax authorities and taxpayers” because “complicated rules can be a barrier to cross-border trade and investment and place a heavy burden on tax administrations and businesses.” The predictable, paradigm-protecting response is to “simplify and strengthen” the existing rules with a “how-to manual” of “good practices.”

The flip side of cost is revenue. If transfer-pricing administration and compliance costs are high relative to the revenue produced for governments, what about the absolute dollars? People like to think that what they do is important, and billion-dollar tax cases have undoubtedly swelled the heads of many practitioners. But how fiscally important is transfer pricing really?

18 See the references in Kroppen et al., supra note 7, at 282.
19 These survey results relate to compliance, and while there is nothing comparable on the government side, the costs of administration presumably follow suit.
21 According to Global Transfer Pricing Consulting, 58 countries have “at least some form of requirements to justify the application of the arm’s length principle,” but since this firm has a pecuniary interest in selling documentation services, the estimate may be generous. (Global Transfer Pricing Consulting, “Transfer Pricing Documentation” (www.globaltpconsulting.com/index.php/en/transfer-pricing-documentation).)
22 Supra note 9.
23 Ibid.
Yet again, direct evidence is difficult to produce, but we can begin with CIT as a whole. OECD-wide, CIT produced a relatively stable 8 percent to 10 percent contribution to total tax revenues between 1965 and 2009, although this masks some glaring national differences (in 2010, 4.2 percent in Germany and 23.5 percent in Norway). For Canada, the share contributed by CIT has fallen from 15 percent in the early years to around 10 percent in the last decade. Most of this CIT is undoubtedly attributable to garden-variety domestic activity unaffected by cross-border transactions or dealings. This is especially true in economies, such as the United States, that are less dependent on international trade.

Non-governmental organizations contend that CIT revenues would be far higher were it not for “transfer mispricing.” Large numbers are thrown about, but they often fail to disaggregate individual tax evasion, tax haven abuse, and transfer pricing. A more carefully targeted study estimated that total CIT revenues in the United States are reduced by 35 percent as a result of transfer-pricing profit shifting. This sounds significant, but it is actually rather modest, for two reasons. First, most of the “shifted profits” are taxed somewhere else, and not always at a much lower rate. For this reason, MAP negotiations are often a zero-sum game (or even a negative-sum game, taking into account the costs incurred on all sides). Thus, the global incremental tax revenues may be significantly lower than 35 percent. Second, even at that percentage, the gain would be about 3 percent of tax revenues across the OECD—hardly irrelevant, especially in these lean times, but as dramatic as one might expect.

I conclude that putting aside the problem of aggressive tax avoidance, tax evasion, and tax havens, the carving up of MNE profits now produces and can only produce a relatively modest proportion of the revenues that countries need to provide public goods.

**Consistency**

It would be disingenuous and ungracious to deny the tremendous strides in the coordination of transfer-pricing practice achieved in the last quarter-century. Yet consistency remains elusive. In the document already cited, the OECD expresses a

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25 Ibid., at 23 and 92, table 12. CIT in Canada was 15 percent of total tax revenue in 1965, fell to 8 percent by 1982, rose to 12 percent in 2000, and has hovered between 10 percent and 11 percent ever since. The figure in any single year is not necessarily meaningful since it is positively or negatively affected by the yield of other tax bases, the state of the economy, etc.


27 Clausing reached this figure by a regression analysis based on relative tax rates, a questionable methodology but perhaps the best available. (Kimberly A. Clausing, Multinational Firm Tax Avoidance and U.S. Government Revenue, working paper (Portland, OR: Reed College, 2007), cited by Clausing and Avi-Yonah, supra note 14, at 10, note 7.)
goal for the future: reaching an international consensus “to ensure that the rules will be applied in a globally consistent manner.” I infer that the transfer-pricing system is not currently being so applied.

International fiscal harmonization is not always necessary or even desirable, but transfer pricing is different. If its rules and practice are out of joint, what do they accomplish? The paradigmatic reaction, of course, is to encourage continuous geographical expansion and progressive national conformity—a quest for universal, or as Ptolemy might have said, celestial, harmony. One wonders how much further harmonization can go, or more to the point (or at least more to my point), why particular countries in particular circumstances would want to adopt a system that produces what they regard as inequitable results.

**Impact on “Real” Transfer Pricing**

If there were no taxes, MNEs would still have to price the internal transfer of goods and services with a view to maximizing economic efficiency. Enterprises often argue that they should be allowed to use their non-tax transfer pricing to determine local tax liabilities, avoiding a duplication of effort and cost. In some respects, this is a reprise of the old argument about conformity between financial or managerial and tax accounting. The advantage of using a single system is simplicity; the disadvantages arise out of the differential goals and practices of fiscal and commercial profit measurement. Of particular importance is the potential for income tax rules and requirements to skew measured and reported financial results.

The same conceptual issues apply with respect to transfer pricing, but there are also additional concerns. First, because transfer prices are inherently international, more than one jurisdiction is involved. Absent perfect consistency, it is impossible to conform tax and managerial prices. Second, the determination of internal prices is meant to optimize the allocation of resources on an after-tax basis, and a sophisticated consideration of fiscal transfer pricing does take tax rates into account.

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28 Supra note 9.

29 Hints of this pushback can be found in United Nations, UN Practical Manual on Transfer Pricing for Developing Countries (New York: United Nations, October 2012), in both the substantive discussions and the country appendixes.


wonders, however, whether tax administrations in real life are quick to accept the implications. For example, suppose that a unique service is provided by company B, resident in country B, to company A, resident in country A, and both companies are members of an associated group. Assuming that the service is being properly remunerated, the price paid by company A should rise if, all other things remaining the same, the tax rate in country B increases. Would the tax administration in country A agree?

More generally, the correct price signals within the MNE—that is, those that promote the highest level of economic efficiency—may not coincide with any internationally accepted determination of fiscal transfer pricing for a number of reasons that are unrelated to any arm’s-length principle. It seems that cost and simplicity are strong motivators leading most MNEs to conform their management and tax prices, but in doing so, they both run the risk of challenge by tax administrations and simultaneously create perverse internal incentives.

Theory

Others with the economic expertise I lack have already broached many of the theoretical challenges to the transfer-pricing paradigm.32 The central issue, to which the comments below are limited, concerns the inability of the arm’s-length principle, or transfer pricing in general, to contend with the inherent value of the firm.

In 1937, Coase provocatively asked, why do firms exist?33 The answer, he said, is that there is a cost to the use of the price mechanism. Firms are different from and sometimes superior to market exchange. Coase’s “transaction cost” theory has been further examined, its mechanisms have been reconsidered, and the model has been refined to include groups or networks, but the fundamental point is generally accepted. The arm’s-length principle nonetheless tries to hypothesize its way around the economic integration of the firm while taking its legal and financial structure at face value.34

32 The literature is extensive. For a recent example accessible to the lay reader, see Erik Röder, “Proposal for an Enhanced CCCTB as Alternative to a CCCTB with Formulary Apportionment” (2012) 4:2 World Tax Journal 125-50. The UN Practical Manual on Transfer Pricing for Developing Countries, supra note 29, at chapter 2, includes a useful discussion of the theory of the firm and the legal structure of MNEs without, however, raising the implicit issues for the application of the transfer-pricing paradigm.


This problem has no solution within the paradigm. The essence of the firm—its quiddity, as a philosopher might have called it—is not an intangible susceptible of being priced; nor may it be geographically localized. The paradigm rests uneasily on its counterfactual assumption that associated enterprises are not associated; in reality, integration is fundamental to the very existence of the firm and cannot readily be ignored. The tension caused by this contradiction is apparent in the transfer-pricing system and its application. Notwithstanding the supposed rigour of the arm’s-length, separate entity assumption, sometimes the appurtenance of a corporation to a multinational group creeps back into the analysis.\(^\text{35}\)

Treating the firm’s constituent and inextricable parts as if the composite entity were merely the sum of discrete transactions and dealings between independent actors is not a mere peccadillo. Ignoring the “firmness” of the firm has serious consequences. It not only fails to address directly the value of integration; equally important, it ignores the inescapable fact that many activities, relationships, and transactions occur within an MNE but never outside one. A symptom of this latter problem appears in the recognition of the occasional need to “recharacterize” a transaction, as is permitted under the OECD guidelines where the transaction differs from what independent enterprises would do and it cannot be priced according to the arm’s-length principle.\(^\text{36}\) In such a case, the tax administration may disregard the actual transaction and recast it as the one that arm’s-length parties would reasonably be expected to have done.\(^\text{37}\) In a simple comparison case (sale or lease, for example), this sounds almost plausible, but in most cases it is sophistry.\(^\text{38}\)

The peculiarity of MNE behaviour is nowhere more evident than in “business restructuring.” The transfer-pricing complex has expended considerable effort and been highly creative in grappling with the issues grouped under this rubric, but the fundamental difficulty remains because the system insists on seeing firms differently from how they see themselves. If tax administrations took the business restructuring argument to its logical conclusion, they would demand a toll charge on every change of risk, every reallocation of function—for that matter, every relocation of

\(^{35}\) Compare the acceptance by Canada’s Federal Court of Appeal of “implicit support” for subsidiary indebtedness within a group of companies in Canada v. General Electric Capital Canada Inc., 2010 FCA 344.

\(^{36}\) OECD Transfer Pricing Guidelines, supra note 3, at paragraph 1:65.

\(^{37}\) Paragraph 247(2)(b) of the Canadian Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended, enacts a slightly different rule, substituting a “dominant tax benefit” test for the OECD’s “unpriceability,” although whether these are really different is a good question. The OECD guidelines do not refer to tax avoidance in this context, but the text seems to suggest it. What about bona fide commercial transactions that have no equivalent outside the MNE? If tax authorities can neither recharacterize transactions nor apply the arm’s-length principle, what are they called upon to do?

\(^{38}\) H. David Rosenbloom, International Fiscal Association Transfer Pricing Seminar at the University of Melbourne Faculty of Law (August 2005).
an employee or adjustment to capital structure. Perhaps every cross-border conversation should be priced. Such a thoroughgoing system would be impossible to enforce, entail enormous efficiency losses to MNEs, and impose serious costs on the economy. The conundrum illustrates once again the theoretical weakness of transfer pricing. The allocation of taxing rights in respect of the profits of a firm should not depend on how or why that firm reorganizes its internal commercial structures and relationships.

A Historical Postscript

Before turning from problems to solutions, I pause briefly to reflect on how this paradigm-challenging situation arose, probably in the 1980s and accelerating in the 1990s, after a long period of relative tranquility. A full historical consideration must be left to another day, but I offer two brief observations. First, MNEs and their advisers discovered that transfer pricing offered opportunities for significant global tax rate reduction too lucrative to ignore. This epiphany was partly serendipitous, a by-product of the scramble to tighten the management of supply chains and transform business enterprises from collections of local network points into truly global institutions. Tax advisers presented management with temptations that would have challenged a Saint Anthony. Second, governments and governmental organizations—partly in response to taxpayer behaviour and partly as the natural result of more sophisticated thinking about transfer pricing—began to cogitate about problems they had previously ignored. These were puzzles that, unbeknownst to them, had no solutions within the paradigm. The prime example is “intangibles,” a protean and malignant growth on the transfer-pricing regime. The label “intangible” has been applied to whatever it is about the MNE that demands a reallocation of tax revenues, or even the establishment of taxing jurisdiction.39

THE SOLUTIONS ON OFFER

In evaluating solutions, one must keep in mind what they are meant to solve. The goal is neither to preserve transfer pricing nor to bury it. If the system can promote a fair allocation of tax revenues or taxing rights, then by all means fix it. But if it cannot accomplish this objective at a reasonable cost, it should be replaced. Keep in mind that fair allocation is itself a matter that requires considerable examination and candid international discussion.

Stay the Course

Like any entrenched paradigm, transfer pricing has responded to challenges the seriousness of which it readily admits by modifications and improvements. These

39 When the earlier version of this article was presented at the International Fiscal Association (Canadian branch) seminar in Ottawa in May 2012, one listener suggested that I could simply cite the OECD intangibles project and sit down, and that was before the release of the weighty discussion draft on June 6, 2012, supra note 31.
have been successful in the sense that transfer pricing has, indeed, become more effective at accomplishing its intra-paradigm task, although at ever-increasing cost, not only financially but also in terms of complexity and strains at the margins. Guidelines and regulations always get longer, never shorter.

These efforts have focused mainly on improving the traditional methods, embracing the previously leprous profit split, and bringing intangibles into the tent. So long as transfer pricing and the arm’s-length principle reign, such projects will continue. For the reasons already expressed, it seems unlikely that these endeavours will resolve the fundamental practical and conceptual challenges.

Even staying the course, however, could accommodate improvements apart from the methods, notably in dispute resolution, a piece of the puzzle dear to the hearts of lawyers. Too much time and money is spent on transfer-pricing controversies. Arbitration is making headway as an alternative to judicial remedies. It is still slow and expensive, and no panacea. As often remarked, arbitration is perhaps most useful in terrorem against governmental intransigence.

There are also a number of creative ideas floating around. Almost 10 years ago, Krister Andersson of the Confederation of Swedish Enterprise proposed a novel approach. Instead of duking it out with national taxing authorities and then hovering at the fringes of the intergovernmental MAP, the MNE would deposit with a financial intermediary an amount equal to the maximum tax that would be due if the transfer-pricing adjustment were upheld and double taxation fully eliminated. The governments would then work out their differences—or not—but the MNE’s exposure would be limited to its deposit. This could reduce the cost of dispute resolution and resolve the nagging problem of double taxation.

It is just an idea. There is obviously more thinking to be done.

Change the Tax Base

The relatively modest contribution of corporate and specifically MNE profits taxation to government coffers and the disproportionately high cost of enforcement/compliance could suggest a drastic solution: eliminate the CIT. Transfer pricing is not, of course, either a necessary or a sufficient reason to consider such a course. Another reason would be to avoid embedded and potentially dangerous policy decisions: CIT may not produce much revenue, but it is easy to get wrong, causing real damage to the economy.

The main challenges to eliminating corporate or business taxation would be

1. fiscal—replacing the forgone revenues; and
2. sociopolitical—avoiding even greater inequities, both vertical (exacerbating income inequality) and horizontal (between the taxation of income from labour and income from capital).

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The simplest conceptual solution would be a new corporate-level tax producing the same revenue but without attempting to measure income—for example, a tax based on a presumptive return on capital employed in a jurisdiction. There are many possibilities. Alternatively, one could decide not to bother taxing corporations and find some other way to capture the resulting benefit that would flow to the owners of capital (to the extent that this is where the corporate income tax lands).\(^{41}\)

While the *intra*-nation income inequality that would result from repealing CIT may be addressed by new approaches to taxing capital income, the owners of capital often do not live in the countries that bear the cost of educating, and otherwise providing public goods for, the consumers who sustain MNE profits. Eliminating business taxation could therefore shift global tax revenues from poor to rich nations. This would likely lead to an increase in other means to access MNE profits, like the crude gross withholding taxes so decried by many policy experts. If such taxes produce revenue, perhaps this suggests that the domestic market is a source of economic rent.

The future of corporate taxation is obviously a large and open question. Transfer pricing is an illustration of its fragility.

### Two-Sided and Non-Transactional Approaches

Assuming that MNE profits continue to be taxed, they must somehow be divided among jurisdictions. The two competitors most often discussed as potential replacements for traditional transfer pricing are profit splits and formulary apportionment. Humans are attracted by binary choices, but real life is more analogue than digital; these two approaches are better seen as fuzzy categories, each comprising a range of possibilities and even touching at certain points.

**Profit Splits and Principled Profit Splits**

Profit splits are hardly new. As already remarked, this “method” is often promoted as a solution commonly adopted in MAP and APA negotiations. A number of commentators have become interested in (not to say enamoured of or obsessed with) a transfer-pricing system based on an enhanced and “principled” profit-split methodology. This could be part of a hybrid system, with the arm’s-length principle being used in some cases and a formulary transaction-based profit split being reserved for the difficult cases.\(^{42}\) Or a profit-split approach could offer a more general replacement to transfer pricing as currently understood.

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\(^{41}\)There have long been debates about whether capital income should be taxed at all. If one believes it should not, that simplifies the discussion, but I am not prepared to make that leap. Some recent economic research suggesting the contrary view is discussed in “Economists Are Rethinking the View That Capital Should Not Be Taxed,” *The Economist*, May 5, 2012, 74 (www.economist.com/capitaltax12).

\(^{42}\)The hybrid system was proposed and defended by Reuven Avi-Yonah and Ilan Benshalom, “Formulary Apportionment—Myths and Prospects,” a paper delivered at the conference on transfer pricing: alternative methods of taxation of multinationals, Helsinki, June 13-14, 2012 (www.taxjustice.net/cms/upload/pdf/Ilan_Benshalom__Reuvan_Avi_Yonah_ppt_1206_Helsinki.pdf).
A significant difficulty relates back to the purpose of the exercise, which is getting the right allocation of profits. Judging the adequacy of a profit split, principled or otherwise, requires some standard for determining whether the result is reasonable. There is, however, no independent or objective criterion, other than the profit split itself. In the best case, the merit of the profit split is judged by what the negotiators think is the fair remuneration of relative contributions. That judgment contains many important embedded assumptions.

Consider innovation. In a capitalist economy, the creative person owns and benefits financially from the results of his or her efforts, but it does not inexorably follow that the jurisdiction in which that person lives and works should have first claim to the tax revenue attributable to profits from the global exploitation of successful research and development (R & D). This, however, is a premise of the transfer-pricing paradigm, including profit splits. It amounts to a force-of-attraction theory for rich countries. The jurisdiction where R & D occurs may provide some financial support, but the number of people involved in the activity is generally modest. Thus, the host country probably spends much less from the public purse than the market countries, which have to provide healthy and educated consumers. So what should be the standard for splitting profits? And what is the objective of doing so?

Another issue with the formulaic profit split goes beyond the four corners of fiscal policy. The MAP system, in which the profit split has made great strides, is often derided as opaque and unfair. MNEs worry that intergovernmental bargaining may displace objective determinations. Less developed tax administrations—often, but not always, located in less developed economies—worry about being outgunned by those with greater experience, resources, or chutzpah. Unlike the MAP, APAs are transparent for the taxpayers as well as the governments involved, but not for other taxpayers, including competitors. Under a principled but flexible profit split, each deal could be different. However, if the current system is to emerge from the windowless rooms of competent authority negotiations to become the standard for normal taxpayer compliance and administration, it must be rule-based, reasonably predictable, not reliant on discretionary decision making or one-off deals, and susceptible to effective judicial appeal. Otherwise it risks offending the rule of law. Secret arrangements spawn inconsistency, suspicion, and corruption.

Formulary Apportionment

Formulary apportionment is an old idea that has been adopted on a restricted basis, particularly within federal states. From my perspective, the experience has been both sobering (the United States) and potentially encouraging (Canada). The extension or adaptation of such a system to international taxation of MNEs poses a direct challenge to the transfer-pricing complex, which has, in consequence, neglected,

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disdained, or derided it. One polemical tactic is to append the adjective “global,” arguing that worldwide agreement is impossible, as it undoubtedly is.  

However, universal participation is unnecessary. A Canada-US water’s edge system, for example, would resolve the lion’s share of the Canadian cross-border allocation question. Add Europe, or the rest of the OECD, and the exclusions become fiscally marginal. An apportionment system also relies on some agreement regarding the tax base. This is not as utopian as it is sometimes made out to be. Business income tax bases are converging anyway.

A formulary agreement among these sorts of countries leaves out those states that are poorer in both income and administrative resources, many of which would have something to gain.  

I fear that they would be reluctant to sign on. To adapt a wise observation of Groucho Marx, poorer countries may not want to join any wealthy clubs that would be willing to have them as members. That would be unfortunate.

Formulary apportionment among rich countries—like the proposed common consolidated corporate tax base in the European Union—may make them even richer.

The use of language in the OECD Transfer Pricing Guidelines, supra note 3, is illustrative of the polemic. Not only is “global” added to “formulary apportionment,” but the text notes that the method “has been attempted by some local taxing jurisdictions” (ibid., at paragraph 1.16, emphasis added) and comments that it would be based on “a predetermined and mechanistic formula” (ibid., at paragraph 1.17). Agreement on apportionment “would be time-consuming and extremely difficult” (ibid., at paragraph 1.22). As if transfer pricing is not time-consuming and difficult. The ultimate defence of a paradigm is always inertia: the transition to apportionment would “present enormous political and administrative complexity” (ibid., at paragraph 1.24).

In deference to the concerns of a different constituency, the UN Practical Manual on Transfer Pricing for Developing Countries, supra note 29, is more nuanced in its comments. It accepts (or succumbs to) the arm’s-length standard as the approach required under article 9 of the UN model convention (ibid., at paragraph 1.4.3) but is agnostic about larger issues: “In recognising the practical reality of the widespread support for, and reliance on, the arm’s length standard among both developing and developed countries, the drafters of the Manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards” (ibid., foreword). See also ibid., at paragraph 1.4.13, where it is recognized that formulary apportionment (with the qualifier “global” again) “might be” an alternative, pointing to its use in some federal states and the proposed system in the European Union, without drawing any conclusions.

Clausing and Avi-Yonah, supra note 14, at 25-26, discuss the distributive issues of moving from transfer pricing to formulary apportionment using a single sales factor (see also their table 1). Comparing the share of sales and the share of income of US MNEs among a number of developed and developing countries, they estimate that such a change would be roughly neutral for most African countries, while Asian and Latin American countries would gain and European countries would lose. This summary is expressed by region, and individual countries within them fare differently. I do not know if the results for non-US-based MNEs would be different. Guttentag has argued in favour of better transfer-pricing enforcement for these countries, including enactment of general anti-avoidance rules. (Joseph H. Guttentag, “Tax Administration in Sub-Saharan Countries: Transfer Pricing Issues,” a paper delivered at the Helsinki conference on transfer pricing, supra note 42 (www.taxjustice.net/cms/upload/pdf/Joe_Guttentag_1206_Helsinki.pdf)). I find his assessment of the potential benefits very optimistic and paradigm-defensive.
through greater fiscal efficiency (although there are doubters in the case of Europe), but it would not alleviate inequities in the worldwide apportionment of tax revenues.

In addition to these difficulties of implementation, critics also raise theoretical objections. Formulaic factors, it is said, are crude and open to unanticipated and implausible results. Yet if the goal is to allocate receipts in a way that is commensurate with local public expenditures and reasonably related to MNE income or activity, factors like wages and sales are not so wacky. One could argue that they come closer to these objectives than the pretense that the MNE does not exist, the basis of the arm’s-length principle and transfer pricing. Formulas may also be criticized as susceptible to manipulation, but for the transfer-pricing complex to raise that argument is, as the saying goes, like the pot calling the kettle black.

To be practical, one must consider the fiscal implications of formulary apportionment for the important developed countries that would have to adopt it. Under a formulaic system, the share of the pie received by many of these rich countries would be less than they think they deserve (recall, for example, the discussion of innovation). However, the pie would be far larger. Entities in intermediate facilitating jurisdictions that administer intangibles or provide group financing would attract a minuscule portion of MNE revenue, leaving more for everyone else. As in any such dramatic shift, a revenue-neutral solution will result in winners and losers. One might argue that the extra efficiency could compensate, but that is unlikely to assuage conservative government officials, who naturally prefer the status quo. Fear of unknown and potentially adverse consequences reinforces their inclination to defend the paradigm.

If, however, that paradigm becomes impossible to maintain, whether through its inherent weaknesses or because of external challenges from countries that will not buy in, it would be helpful to have a thoughtful alternative. Formulary apportionment needs some creative re-examination in place of the usual adversarial debates among academics and defensive posturing by the transfer-pricing establishment. For example, apportionment could learn something important from the principled profit split: one size need not fit all. The Canadian income tax regulations governing interprovincial allocation recognize the special circumstances of a limited number of commercial and industrial sectors (reflecting the economy as it was many decades ago)—financial institutions, transportation, grain elevators, and pipelines. A far more sophisticated system is possible without negating the basic principle of allocation without transfer pricing.

Paradigm shifts are not always abrupt. Sometimes they can be recognized only with the benefit of hindsight. Gradualism, reform rather than revolution, is probably necessary in the politically charged field of taxation. Transparent and mandatory formulas could be devised with the resulting system described as a profit split. If I am permitted to switch metaphors at the end of these remarks from the history of science to the history of political institutions, I imagine that this fiscal revolution would be more in the English than the French style. Which is not to say it would be bloodless.