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Interaction of Transfer Pricing & Profit Attribution: Conceptual and Policy Issues for Developing Countries*

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1. Introduction

Last two decades have seen several significant developments in the area of profit attribution to permanent establishments (PE) and transfer pricing (TP), leading to two contradictory views. One view prefers analysis of functions, assets and risk (FAR) for TP as well as profit attribution, while the other does not. FAR based TP is still not applied universally, while FAR based attribution of profits is even more contentious. These developments pose significant challenges for developing countries and necessitate a detailed analysis of relevant issues.

2. Conceptual Issues related to Taxing Profits

Since TP and profit attribution are intricately linked to the issue of taxing profits of foreign enterprises, it is worthwhile revisiting the conceptual basis underlying the international taxation regime.

2.1 Factors that Contribute to Profits of Enterprises

In the corporate tax regime, the tax base consists of profits, which are a function of the quantum of sales, price and cost of goods, as depicted by the following equation:

Profits = Quantum of sales x [Price - Cost] = Sales Receipts (Turnover) - Cost

While cost is purely a function of supply, price and quantum of sales depend on the interaction of demand and supply, which apply independent of each other. Factors that affect supply include efficiencies of the enterprise, while demand depends primarily on the consumer's ability to pay, depending in turn on disposable income, which itself is a function of the state of the economy. In a given market, their respective contributions depend upon the elasticities of demand and supply. Both supply and demand are essential for giving rise to profits.

Interestingly, in a perfectly competitive market, reduction in costs of supply, resulting from improvement in efficiency of enterprises, is likely to result in higher sales but lower market price, with an ambiguous impact on sales revenue. Profits of enterprises rise in such cases primarily due to reduced costs. On the other hand, a higher demand, resulting from a higher ability to pay, is likely to result in more sales as well as higher market price, resulting in higher sales and increased profits for the enterprises, as apparent in Figure 1. In a monopoly market too, the sales revenue is governed primarily by the demand. Either way, the contribution of demand to sales revenue and profits cannot be ignored.

2.2 Justification of Taxation in a Globalized Economy: The Benefit Principle

Legitimacy of taxation of business profits is governed by the need for financing public goods, including protection of property rights and enforcement of contracts, essential prerequisites for functioning of markets. Public provisioning is also required for infrastructure, equity, addressing market failures and maintaining macro-economic stability, all of which facilitate markets and consumer demand, thereby contributing to profits derived by enterprises therein. This contribution of public resources to business profits constitutes primary justification for their taxation.[1]

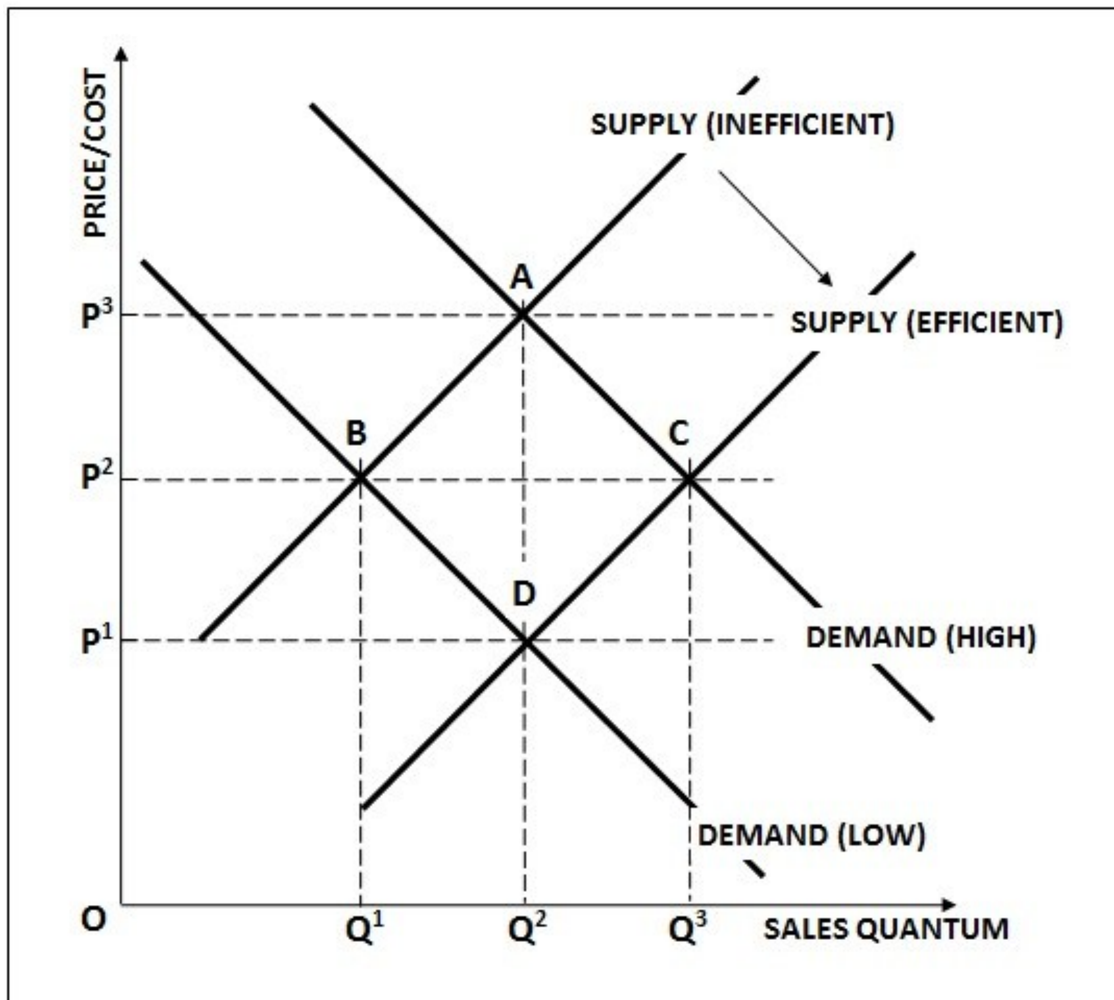
Use of tax revenue for facilitating markets and economic growth sets into motion a 'virtuous cycle' wherein tax supported economic growth augments business profits, lead-

Abstract

Till 2010, model tax conventions treated profit attribution to permanent establishments and transfer pricing under different articles, and profit attribution under Article 7 allowed sales to be taken into account both in the direct accounting method as well as the indirect apportionment method. However, the revised Article 7 in the 2010 update of the OECD Convention approximated profit attribution with transfer pricing and omitted the option of apportionment, thereby undermining sales and contributions made by market jurisdiction to business profits. When a tax treaty retains Article 7 based on the UN Convention or the earlier OECD Convention, Contracting States can take sales into account and also opt for apportionment. Developing countries need to fully understand these implications of Article 7 in their tax treaties, and opt for informed choices for transfer pricing and profit attribution to permanent establishments, including apportionment that takes sales into account.

* The views contained in the policy brief are personal to the author and do not represent the institutional views of the South Centre or its Member States.

Figure 1: Impact of Changes in Demand & Supply on Sales Revenue & Business Profits



In a welfare maximizing, perfectly competitive market, improvement in supply efficiency in the presence of low demand shifts sales revenue from OP^2BQ^1 to OP^1DQ^2. In the presence of high demand, the change is from OP^3AQ^2 to OP^2CQ^3. In either case, the resultant change in sales revenue and profit per unit sold is ambiguous, and profits rise only from higher quantum of sales. A shift from low to high demand in the presence of inefficient supply changes sales revenue from OP^2BQ^1 to OP^3AQ^2. In the presence of efficient supply, the change is from OP^1DQ^2 to OP^2CQ^3. In either case, sales revenue and business profits increase significantly from higher price as well as higher quantum of sales.

ing to a win-win situation. In the case of a multinational enterprise (MNE), the supply and demand may be spread over different tax jurisdictions. In such a case, the extent to which different tax jurisdictions contribute to the profits of that enterprise, by facilitating supply, facilitating demand or maintaining markets, provides a justification for them to tax such profits. The contributions made to the supply chain can be approximated by taking into account manpower, functions or assets, whereas the contributions by facilitating demand and maintaining markets are best approximated by sales revenue. When each jurisdiction taxes the profits to the extent of its contribution, while avoiding double taxation, the "virtuous" cycle of taxation can operate in the globalized economy.

These basic principles governing taxing rights can be traced as far back as Adam Smith's First Canon of taxation, which provides the basis of both the benefit principle of taxation as well as the ability to pay principle, as quoted by Richard and Peggy Musgrave[2], in these words: "*The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.*"[3] It has also been recognized as the primary basis of allocation of taxing rights between the country of residence and the country of source by T. S. Adams, who acknowledged that, "*A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.... Business ought to be taxed because it costs money to maintain a*

market and those costs should in some way be distributed over all the beneficiaries of that market ..."[4]

The benefit principle was also resorted to by the four economists[5] invited by the Financial Committee of the League of Nations in 1921 to prepare a report[6] formulating the "general principles as the basis for an international convention to remove the evil consequences of double taxation."[7] Their report stated, "*A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each.*"[8] They recognized that the production of wealth focuses upon "*the community the economic life of which makes possible the yield.*"[9] Their report formed the basis of the 1927 Report of the Committee of Technical Experts on Double Taxation and Tax Evasion constituted by the League of Nations, which proposed the first comprehensive Draft Convention for the Prevention of Double Taxation.[10]

2.3 Recognition of Sales as an Activity that Creates Value for the Enterprise

These economists also recognized sales as the activity which creates value for the enterprise, by observing "*The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them.*"[11] Their conclusion reflects that the value of any good being offered for sale is only as much as the price that the consumers would be willing to pay for it. Profits are derived only when consumers pay a price that is higher than the cost of supply, making apparent the contribution of demand to business profits.

T. S. Adams also recognized the right of the market jurisdiction to tax part of the profits on the basis of sales by observing, "*Income must to some extent be taxed where it is earned, at rates and by methods determined by the conditions under which it is earned - not by the conditions under which it is spent....Corporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.*"[12]

Sales as the basis for taxation is also advocated by Richard and Peggy Musgrave, who write, "*In regard to income and profits taxes, it is generally agreed that the country in which the income originates (also referred as the 'country of source') is entitled to tax that income…*"[13]. They conclude that "*The profits base of multinational corporations might be allocated among countries not by location of subsidiaries but in line with the national origin of profits earned by the business group as a whole. Such origin might be approximated by a formula including both location of value added and sales in its base.*"[14] Different rationale for allocating taxing rights on the basis of sales have also been offered by Arthur Cockfield[15] and Richard L. Doernberg[16].

Sales as the basis of taxing rights also finds support in Klaus Vogel's Commentary on the basis of efficiency[17] as well as equitable division[18] of taxation. It even goes to the extent of supporting the right of taxation of the market jurisdiction on the basis of sales, even in the absence of PE:

> "*If an enterprise derives profits from say, supplying goods, such profits result not only from the goods having been produced in the enterprise's State of residence, but also from the opportunity offered in the recipient State for the sale of such goods. If the flows of goods between the two countries involved – or rather, more accurately, the profits resulting from those flows - are balanced, the question of what principle should be applied when distributing taxation is of relatively little significance, and in such a case adoption of the permanent establishment principle is recommendable because it is practicable. But if the flows are in imbalance, the recipient State is justified in requiring to be allowed to participate in the taxation of the proceeds of the sales of the goods – in the same way as it participates where interest and royalties are involved. The same applies to services rendered by the enterprise.*"[19]

2.4 TP as a Tool to Prevent Artificial Shifting of Profits

TP can be conceptually understood as the process of determining the arm's length price of intermediate goods in a cross-border, non-market transaction within a supply chain. Theoretically, it is based on the concept of the single market price. Where the market price of the transacted good is readily available, it can be easily identified from market price data (comparable uncontrolled price method). However, in cases where the market price in an uncontrolled transaction is not available, it needs to be estimated by using one of the indirect methods, relying upon data of other enterprises.

Avi-Yonah traces the origins of TP to the threat of "*tax avoidance opportunities afforded by possessions corporations, which were ineligible to file consolidated returns with their domestic affiliates*"[20], which led to the introduction of US domestic law provisions in 1921 that authorized the Commissioner to consolidate accounts of affiliated corporations for the purpose of accurate distribution of their profits. These provisions evolved into Section 45 of the Internal Revenue Code in 1928, the text of which formed the content of Section 482 subsequently, dealing with transfer pricing regulations. Jens Wittendorf[21] provides an account of the tax dispute between the United States and France in the early 1930s related to over-invoicing of French subsidiaries of US companies, resulting in imposition of tax by French tax authorities on US companies that was objected to by the United States on the grounds of being extra-territorial and a breach of international principles. The dispute was finally resolved by the introduction of a provision based on Section 45 of the Internal Revenue Code as Article IV of the 1932 tax treaty between the United States and France.

This new development, which was the first of its kind at that time, prompted the introduction of Article 5 in the

draft Convention for allocation of business income proposed in the League of Nations Fiscal Committee Report in 1933[22], which subsequently formed Article 9 of the Model Tax Conventions. Given the separate entity status accorded to domestic subsidiaries of foreign corporations in the laws of most countries, these provisions provide an anti-abuse measure for addressing artificial shifting of profits by mispricing the intermediate goods transacted between them.

3. Treaty Provisions & Changes in Article 7 in 2010 by the OECD

For optimizing the benefits of international trade and investment, countries often prefer to limit their sovereign right to tax by entering into tax treaties, based on model tax conventions (MTCs) developed by the OECD or the UN Committee of Experts.

3.1 TP Provisions in Tax Treaties

Article 9 of the MTCs provides for TP adjustment of profits by determining the arm's length price of goods in cross-border transactions between associated enterprises. The primary objective of this provision is to address manipulation of price and not to attribute profits to a PE, which is purely the subject matter of Article 7. A corrective action under Article 9 is triggered only if a particular transaction between associated enterprises is not at arm's length price. The MTCs neither define arm's length price nor specify methods for determining it. The Contracting States may adopt methods advocated by the Organisation for Economic Co-operation and Development (OECD) [23] or the United Nations (UN) Committee of Experts[24].

3.2 Treaty Provisions for Attributing Profits to PE

Article 7 of the MTCs provides the rules for attributing profits to PE. The UN Convention provides relatively greater taxation rights to the source country in the form of 'force of attraction' rules and restrictions on deduction on expenses.[25] Apart from these differences, this article in the two conventions was somewhat similar till 2008, and sought to tax only those profits of the PE that it would be expected to make if it was an independent and separate entity. This would normally be achieved by maintaining separate accounts for the permanent establishment (*separate accounting or direct method*).[26] However, in the absence of the same, both conventions provided for attribution of profits by way of apportionment as may be customary in that State (fractional apportionment or indirect method), in paragraph 4 of this article:

> *"In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article."*

3.3 OECD/UN Guidance on Methods for Apportionment for Attributing Profits

The OECD Commentary on Article 7, prior to 2010, when Article 7 was revised, provided detailed guidance on the possible methods for applying apportionment, which is still relied upon and quoted in the existing commentary of the UN MTC. It stated:

> *"The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. … criteria commonly used can be grouped into three main categories, namely those which are based on the receipt of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part."*[27]

Paragraph 24 in the Commentary on Article 7 in the 1963 OECD MTC containing this text was renumbered as 26 in 1977, 27 in 1992 and 54 in 2008, before being omitted in 2010. Till 2010, OECD recommended fractional apportionment of profits based on any one of the three criteria, i.e. receipts, expenses and working capital, for attributing profits to a PE. This paragraph is still relied upon and quoted in paragraph 19 of the Commentary on Article 7 of the UN Model MTC[28], thereby indicating its acceptance by the UN Committee of Experts. Significantly, no country documented any observation, reservation or position in respect of this paragraph in the OECD MTC, 2008, before it was omitted, indicating the existence of a broad international consensus.

3.4 Changes in Article 7 in the OECD MTC & Its Three Differing Versions

In the 2010 update of the OECD MTC, Article 7 was amended by taking away the option of fractional apportionment and inserting the condition that profits should be attributed taking FAR into account. Prior to 2010, Article 7 had remained largely unchanged since the introduction of the OECD MTC in 1963. A large number of treaties retain either the earlier version of this article in the OECD MTC or the UN MTC version, both of which allow fractional apportionment, and do not impose FAR.

Thus, three standard versions of this article exist in tax treaties today, i.e. the pre-2010 version and the 2010 version of Article 7 in the OECD MTC and the Article 7 of the UN MTC. Since the Contracting States are governed by the provisions in their treaties, an inevitable result is the widening of differences in profit attribution to PE under different tax treaties. Profit attribution by apportionment can be resorted to, if the same is permissible under the treaty. However, where the treaty has adopted the revised Article 7 of the OECD MTC, which does not provide an option for apportionment, this option will not be available.

3.5 Implications of Changes in Article 7 by OECD

The insertion of FAR in Article 7 in the 2010 update of the OECD MTC has major implications. It approximated the process of profit attribution with that of TP, thereby leading to an illusion that both of them are one and the same exercise, and can be undertaken in an integrated manner by a common FAR analysis. A more significant impact was to attribute profits solely on the basis of FAR, representing supply, which completely ignored the contributions made by the market jurisdiction to the profits of MNEs by maintaining markets and facilitating demand. Lastly, it omitted the option of fractional apportionment, which was permissible in the earlier provision and thereby also took away the option of taking sales into account.

The changes in Article 7 suddenly overturned a long lasting broad international consensus that was based on sound principles of economics and provided fair division of taxing rights between jurisdictions contributing to profits of an enterprise. It significantly widened the wedge between the two MTCs, and increased tax uncertainty for MNEs, by subjecting them to different tax regimes under different treaties. It also aggravated the challenges faced by developing countries in implementing these provisions.

The most important implication, however, was the omission of sales, which prior to these changes, constituted the most important factor in profit attribution. In both other versions of Article 7, the 'direct or accounting method' has sales as the beginning point, with profits computed after deducting expenses, while for 'indirect or fractional apportionment method', sales can be taken as a basis.

4. Limitation of FAR based Profit Attribution

The proposal for FAR based analysis for profit attribution suffers from significant conceptual and practical limitations. The foremost limitation is the omission of sales, which prevents the market jurisdiction to tax business profits derived from its territory on the basis of its contribution to them. Other limitations include conceptual problems in approximating TP with profit attribution, and the practical constraint arising from its complexities and costs, which can also create avenues for tax avoidance.

4.1 Incompatibility of Omitting Sales with Economic Theory and Country Practices

As highlighted above, economic theory provides a strong basis for taking sales into account for taxing profits derived by MNEs from the economy. Literature also supports the option of attributing profits by apportionment based on sales. In a 1991 paper, Langbein suggested fractional formulary apportionment based on sales and working capital, each given equal weight.[29] He explains that while sales represent the demand or market side contribution, working capital represents the inputs or the supply side[30]. According to him, *"… sales, if anything, are the more or most important factor in indicating the "relative contribution" of a component to an enterprises' group profit."*[31]

Avi-Yonah and Clausing recommend formulary apportionment exclusively on the basis of sales, noting that, *"In the case of a sales based definition, the measure of economic activity is sales, which focuses on the demand side of market value."*[32] Jinyan Li argues in favor of adopting a multi-factor apportionment formula based on sales, payroll and property.[33] The Tax Justice Network has also suggested apportionment based on a three-factor formula (property, payroll and sales) with a double weighted sales factor.[34]

Some countries have adopted practices for determining taxable profits by formulary apportionment that takes sales into account. These include the practice adopted by US States, based on a formula giving equal weight to sales, property and payroll. According to Nerudova, this practice dates back to the 1870s, and since the 1930s, almost all States of the Federation have been following formulary apportionment based on the '*Massachusetts formula*' that can be expressed as the following equation:

$$P_i = P_t\left(\frac{1}{3}\frac{C_i}{C_t} + \frac{1}{3}\frac{L_i}{L_t} + \frac{1}{3}\frac{S_i}{S_t}\right)$$

where P_i represents profits allocated to the state i, P_t profits of the enterprise, C stands for property, L for labor and S for sales.[35] Validation of these tax rules by the Iowa Supreme Court and the US Supreme Court[36] have attracted considerable attention in literature and also resulted in greater allocation to sales, that goes up from one-third in the Massachusetts formula to as much as 90-100%.[37] Nerudova has also documented the practices in Canada, apportioning profits on the basis of sales and payroll.[38] Some other countries have also practiced apportionment, including Switzerland[39], Germany[40], Argentina[41] and India[42].

A proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) in the European Union has been placed before the European Commission[43] in September 2016[44]. Article 28 of this proposal provides that the consolidated tax base shall be shared between group members in each tax year on the basis of following the *formula for apportionment … giving equal weight to the factors of sales, labour and assets:*

$$Share\ A = \left(\frac{1}{3}\frac{Sales^A}{Sales^{Group}} + \frac{1}{3}\left(\frac{1}{2}\frac{Payroll^A}{Payroll^{Group}} + \frac{1}{2}\frac{No.of\ Employees^A}{No.of\ Employees^{Group}}\right) + \frac{1}{3}\frac{Assets^A}{Assets^{Group}}\right)$$

These details suggest that the post 2010 approach of OECD, which excludes sales as a factor for attributing profits to PE, is not in conformity with the economic principles and literature. Country practices, for instance, in the United States and the proposal for CCCTB in Europe also contradict the OECD approach that excludes sales and omits the option of apportionment for attributing profits to PE.

4.2 Conceptual Problems in Applying TP Methods for Profit Attribution

One of the limitations of TP methods based on comparable data to determine the arm's length price by arriving at a 'standardized' profit margin is the lack of theoretical and conceptual support for such an exercise. While economic theory provides a basis for the arm's length price, in the form of a single price of an economic good in a competitive market, there is no such basis for the "arm's length profit". There is nothing in economic theory, whatsoever, to suggest that all enterprises in a competitive market are likely to have the same profit margin. On the contrary, economic theory explains the entry and exit of enterprises based on the difference between their respective efficiencies. Efficient enterprises are expected to dictate a more competitive price in the market which will make the less efficient enterprises non-competitive, leading to their exit.

There are other problems too. Schon pointed out, "*TP at marginal cost is generally not accepted by traditional TP tax rules.*"[45] This creates a stress with economic theory, which tells us that the decision of an enterprise to supply is governed by marginal costs[46]. Though profit attribution rules create a legal fiction by deeming the PE as a separate and independent enterprise, the actual decision making by an MNE is still based on the objective of maximizing its profits as a single unit, and is not a sum of decisions taken by its various units located in different tax jurisdictions to maximize their respective profits. It is this limitation of the legal fiction which necessitates the option of attributing profits by apportionment as provided in other versions of Article 7.

Another significant question mark on the accuracy of the TP approach for attributing profits is its inability to take into account the synergy rents or the additional profits that are derived by the MNE as a whole from the synergies created by carrying out different functions in different jurisdictions, in some instances, by utilizing the 'comparative advantage' of different economies.[47] Since an enterprise is a single economic unit and takes its business decisions with an objective of maximizing its overall profits, rather than maximizing the profits of its different units, determination of how the synergy rents derived by running a comprehensive business across several tax jurisdictions are to be taxed by each of those jurisdictions cannot be ignored. Schon notes, "*From a tax point of view, these rents should not only be allocated to the country where the "winning" business unit is located. These rents are due to the fact that the "losing" business unit provides a specific business opportunity to the other divisions of the firm. In other words: the "winning" business unit should be taxed not only in its location country but also in the jurisdiction where the other unit resides.*"[48] He further points out, "*Transfer prices should not be the final measuring rod for allocation of taxing rights between countries. They are meant to allocate profits between business units but not to define the framework of territorial source taxation. Therefore, synergy rents drawn by members of a corporate group should be allocated to the country where the synergy is located (e.g. from the use of specific investment in a country) not to the country where the corporation receiving the rent resides.*"[49] The same issue has been analyzed by Wittendorff from the perspective of '*Economics of integration*', which is characterized as "*benefits that are not available to market participants in uncontrolled transactions*"[50] to argue that they should be distributed among the participating units and not allocated solely to the head office.

4.3 Practical Constraints: Complexities, High Costs, Tax Disputes & Tax Avoidance

FAR based TP has also attracted criticism due to its complexities and high costs of compliance and administration. Rosen cited anecdotal evidence of an enterprise which was required to include in its return, "*computations for subsidiaries located in about 100 countries, exceeded 30,000 pages, and required the work of more than 200 tax professionals both in the United Stated and abroad (Herman, 1999).*"[51] According to Avi-Yonah and Clausing, "*the arm's length standard has become administratively unworkable in its complexity. As a result, the arm's length standard rarely provides useful guidance regarding economic value.*"[52] They also refer to similar criticism by other experts.[53]

The complexities of FAR based TP and its inherent inability to objectively allocate profits among related parties is one of its most significant limitations from the perspective of developing countries, since it can create potential avenues for subjective application by taxpayers and tax authorities according to their respective objectives of tax minimization and tax maximization, leading to frequent disputes and tax litigation.

There has also been a criticism that TP creates avenues for tax avoidance. According to Avi-Yonah and Clausing, it "*creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic activities in such countries and by shifting profits toward more lightly taxed locations.*"[54] The explanation for this unintended and ironical outcome may lie in the limitations of applying TP, essentially an anti-abuse measure, as a universal method for determining taxable profits. Unlike an anti-abuse measure, a universal mechanism for determining taxable profits must be objective, free of undue complexities, and impose limited costs of compliance and administration, to be effective.

These concerns may have played a role in the proposal for CCCTB. The paper issued by the European Commission providing its justification states "*…business models of multinational companies have become more complex, intra-group transactions have multiplied and multinationals' integrated value chains make it difficult to determine where profits are created. Governments struggle to determine within the current set of international tax rules which country should tax a multinational's income. Smaller businesses are put at a competitive disadvantage and citizens perceive tax systems as unfair since some corporate taxpayers might be able to avoid taxation by exploiting tax planning strategies.*"[55] It also documents the expected outcomes of this measure as "*making EU tax law simpler and reducing regulatory costs, it is expected to contribute to a clear,*

stable and predictable regulatory framework and improve tax certainty."[56]

4.4 Developing Country Perspective: Threat of Vicious Cycle from Tax Base Erosion

From the perspective of a developing country, the inability to tax MNEs to the extent of its contribution to their profits erodes its legitimate tax base. This tax would then need to be collected from domestic enterprises, leading to an increase in their tax burden and consequent loss of their competitiveness, which can adversely impact economic growth as also the '*ability to pay*' of the consumers therein. Once that happens, even the profits derived by the MNEs from that economy will suffer, resulting in adverse consequences for every stakeholder in the global economy. One can describe it as the '*vicious cycle*' of defective tax application. The potential harm for the global economy as a whole necessitates that all countries are able to collect tax from profits that are derived by MNEs from contributions made by their economies to those profits.

5. Options Available & Informed Choices

The options available to a developing country in respect of TP and profit attribution are limited primarily by its treaty obligations.[57] In addition, developing countries may also be constrained by limited capacity and lack of appropriate data, particularly local comparables.

Tax treaties provide independent provisions for TP and attribution of profits. Thus, the first option that every developing country can exercise is to take into account its preferences and constraints in respect of them separately.

5.1 Options for TP under Article 9 of Tax Treaties

The provisions for TP provide a significant tool to deter artificial profit shifting by manipulation of prices of intermediate goods. Their existence, per se, does not impose any obligation on the Contracting States to apply them in each case or use them for attributing profits. This provides them reasonable flexibility regarding the extent to which they wish to invoke this provision, and how they wish to utilize it. Thus, presuming that the standard TP provisions exist in the tax treaties entered by a developing country, one can identify the options for it in respect of TP in the following matrix:

- To apply or not to apply TP

  ◊ If applied,

  - to apply it in all / most cases, or
  - to apply it selectively with risk assessment, or
  - to apply rarely in cases of very high risk

  ◊ If applied,

  - to apply it completely in accordance with OECD/UN guidelines, or
  - to apply it largely in accordance with OECD/UN guidelines, but deviate from it where the domestic law position differs, or
  - to apply it completely in accordance with domestic law that may or may not be in line with the OECD/UN guidelines

Analysis of Options

While selecting its preferred option in respect of TP, a developing country should take into account the complexities of TP methods, their high cost of compliance and administration, the probability of tax disputes and the benefits expected by preventing profit shifting. The expected benefits would generally be proportional to the size of the economy and international trade. The first choice to be made could be whether to apply or not apply TP. For a very small economy lacking capacity or comparable data, the option of not applying it at all could be a viable option[58].

For any developing country wishing to apply TP, the most important decision may be to decide its extent. It can opt for a uniform compliance burden on all taxpayers, but it may be preferable to limit such compliance, particularly for smaller enterprises or for small transactions, by way of reasonable thresholds. Adopting a selective audit approach based on risk assessment can mitigate high costs of administration and can be another option worth considering.

One way in which the deterrence benefits of TP can be preserved while minimizing costs of compliance and administration, is by laying down 'safe harbors' or objective criteria on the satisfaction of which, taxpayers are excluded from the risk of TP audit or TP compliance.

5.2 Options for Profit Attribution to PE

In terms of profit attribution to PE, there are significant differences between the three main provisions, and the one that is part of a particular treaty will govern its application and dictate the possible options.

5.3 Options under Article 7 based on UN MTC/Pre-2010 OECD MTC

Article 7 in the UN MTC is the most favorable provision for developing countries, due to the '*force of attraction*' rule that allows the country of source to tax not only profits derived by the PE, but also income derived directly by the foreign enterprise from similar business. It also restricts the deduction of certain expenses made by the PE to the head office that are not linked directly with the operations of the PE. It provides the following options to a developing country regarding the application of the 'direct or separate accounting method':

- For Direct or Separate Accounting Method

  ◊ Apply or not apply Force of Attraction Rules

  ◊ Limit or not limit deduction of expenses not permissible under Article 7(3) of UN Model Tax Convention

As the 'indirect or fractional apportionment method' is the same under Article 7 in the UN Model and the pre-2010 OECD version of Article 7, the options available to a developing country under a treaty containing either of these provisions can be listed in the following matrix:

- For Indirect or Fractional Apportionment
  - ◊ Apportionment based on
    - ♦ Sales in all cases or
    - ♦ Expenses in all cases or
    - ♦ Working Capital in all cases or
    - ♦ Either Sales or Expenses or Working Capital depending upon the characteristics of business, as per OECD/UN commentary, e.g.
      - • Sale for business in services or proprietary goods with high profit margin
      - • Expenses for manufacturing or services involving raw material or high labor content
      - • Working Capital for banking and financial concerns, or
    - ♦ A combination of factors, e.g.
      - • Sales, Payroll and Property with equal weight or
      - • Sales, Payroll and Property with a higher weight for sales or
      - • Sales and Working Capital, or
    - ♦ Any other method under domestic laws or
    - ♦ facts and circumstances of the case

Analysis of Options

Both these versions of Article 7 provide two methods, the 'direct or separate accounting' method and the 'indirect or fractional apportionment' method. Where it is possible to determine the taxable profits of a PE based on separate accounts, it is preferred, provided that it reflects profits that the PE would derive if it was a separate and independent entity. This would be the case, for example, where a PE undertakes a business completely independent from the business of the head office. However, where the PE is a part of an integrated business, the condition of 'separate and independent entity' would necessitate that the PE is fully compensated on an arm's length basis for all explicit or implicit obligations imposed on it[59]. It would also be important to examine whether the terms and conditions of a contract between a PE and the head office are those that would have been acceptable to a separate and independent entity, and whether the PE has been fully compensated at arm's length for the opportunity cost imposed on it by an unfavorable obligation.

While the existence of provisions for force of attraction and restriction on deductible expenses in treaties based on the UN Model provides the Contracting States a right to apply them, they would apply them only if the domestic tax laws also provide for the same. This provides an option of applying or not applying these rules, even if the same are present in the treaty. The choice of a Contracting State not to apply them under its domestic law, of course, does not prevent or affect the right of the other Contracting State to apply them.

In cases where separate accounts are not maintained by the PE, or where they do not reflect the profits that would have been derived if the PE was a separate and independent entity, then the fractional apportionment as may be customary, can be applied. The treaty does not lay down any particular formula for apportionment, leaving it to that Contracting State to determine the factors on the basis of which such apportionment can be made.

The OECD and UN Commentary list three factors, i.e. sales, expenses and working capital, each of which can be the basis for fractional apportionment of profits. Following their recommendation, a developing country can opt for one of these in all cases, or adopt them depending upon the characteristics of business as recommended. It is also open for it to opt for other methods, to the extent they satisfy the condition of being part of the customary practices, such as a multi-factor apportionment similar to the Massachusetts Formula followed by US States or the one proposed in the CCCTB.

5.4 Options under Article 7 based on Revised OECD Model Tax Convention (2010)

Article 7 in the revised OECD Model Tax Convention does away with the requirement of attributing profits that a PE would have made had it been a separate and independent entity, and instead requires these profits to be determined in accordance with FAR. It also does away with the option of fractional apportionment, thereby leaving very few options to a developing country, which can be identified in accordance with the following matrix:

- To apply or not to apply FAR based TP methods for attributing profits
  - ◊ If standard methods are applied
    - • Apply them in accordance with the Authorized OECD Approach (AOA) or
    - • Apply them according to domestic laws where they differ from AOA
  - ◊ If standard methods are not applied
    - • Adjust the results in accordance with AOA or
    - • Not adjust the results in accordance with AOA

The provision allows very limited options to the Contracting States. Detailed guidance has been developed by the OECD for the application of this provision, and very little alternative guidance or literature exists that could be resorted to by the developing countries wishing to deviate from this guidance. This provision, in effect, makes profit attribution secondary to TP, thereby making it necessary for Contracting States to apply it in every case requiring attribution of profits. In the presence of this provision in the tax treaty, the country of source may find it difficult to protect its right to tax profits of the PE that have been contributed by its economy by way of demand and functioning markets.

6. Conclusions and Recommendations

Economic theory recognizes the legitimate right of a tax jurisdiction to tax profits derived by foreign enterprises from its economy, to the extent of its contributions to those profits, either by facilitating demand, maintaining markets or facilitating supply. The contributions by facilitating demand and maintaining markets are best approximated by sales, which is recognized as a valid basis for the taxing right of market jurisdiction in literature, country practices as well as new proposals like CCCTB. This right is also provided in Article 7 of the UN MTC and the Article 7 of OECD MTC, prior to its revision in 2010, where both methods for profit attribution enable sales to be taken into account. The OECD Commentary also recommends sales as one of the criteria that can be adopted for fractional apportionment under this provision.

The 2010 revision of Article 7 in the OECD MTC 2010 requires Contracting States to attribute profits to PE on the basis of FAR, which represent supply, and thereby negates the contribution made by the market jurisdiction by facilitating demand and maintaining markets. This provision does not appear to conform to the basic economic rationale on which the whole edifice of modern international taxation rules, maintaining a delicate balance between the rights of the country of source and the country of residence, had been in existence. The positions documented by various countries reflect the unlikelihood of its universal acceptance anytime in the near future.

This also poses complex challenges for developing countries in terms of TP and profit attribution practices. Where a treaty retains a provision based on the Article 7 of the UN MTC or the pre-2010 version of the OECD MTC, TP and profit attribution can be considered as independent processes, and a developing country may choose options in respect of them separately. Under such a provision, a developing country has a right to attribute profits to a PE by fractional apportionment, either by relying on sales, expenses or working capital, as recommended in the OECD and UN guidance, or by resorting to a combination of these factors, as advocated in literature. Where a treaty includes profit attribution provision based on the revised Article 7 introduced in the OECD MTC 2010, profits to a PE are required to be attributed on the basis of FAR analysis, making adoption of TP a *fait accompli*.

Based on this analysis, it can be recommended that where the treaty permits, as in Article 7 based on the UN MTC or pre-2010 Article 7 of the OECD MTC, a developing country should consider various options for TP and profit attribution, and opt for them independently, depending upon its economic interests and policy preferences. These options include selective application of TP and attributing profits by apportionment based on factors that include sales.

A developing country that wishes to secure its rights to tax profits of a PE that have been contributed by its economy may prefer to retain Article 7 based on the UN MTC or pre-2010 Article 7 of the OECD MTC in its tax treaties. Under this provision, wherever the direct or accounting method for determining profits attributable to PE is not applicable, it should consider opting for fractional apportionment as permitted in paragraph 4 of that article, and include sales as one of the factors for such apportionment. In addition, it can also opt for applying TP methods on a selective basis, for preventing artificial profit shifting, as permissible under Article 9 of MTCs.

Endnotes:

[1] While other alternatives, such as debt, sales of assets and foreign aid also exist, taxes remain central to funding of public resources in most countries.

[2] Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, 5th ed. (New Delhi, McGraw Hill Education, 2004), p. 219.

[3] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* vol. 2, Edwin Cannan, ed. (London, Methuen & Co., 1904), p.310. Available from http://oll.libertyfund.org/titles/smith-an-inquiry-into-the-nature-and-causes-of-the-wealth-of-nations-cannan-ed-vol-2.

[4] Thomas S. Adams, "The Taxation of Business", *Proceedings of the Annual Conference on Taxation under the Auspices of the National Tax Association*, vol. 11, November 13-16, 1917, p. 187. Available from http://www.jstor.org/stable/23400384.

[5] M. Bruins (Netherlands), M. Einaudi (Italy), E.R.A. Seligman (United States) and Josiah Stamp (United Kingdom).

[6] League of Nations Economic and Financial Commission: Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp, *Report on Double Taxation submitted to the Financial Committee — Economic and Financial Commission Report by the Experts on Double Taxation — Document E.F.S.73. F.19 (April 5th 1923) — Legislative History of United States Tax Conventions.* Available from http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;collection=;database=;query=;brand=default.

[7] Ibid., p. 5.

[8] Ibid., p. 20.

[9] Ibid., p. 23.

[10] League of Nations: Committee of Technical Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion: Report — Document C. 216. M. 85 (London, April 12th, 1927) — Legislative History of United States Tax Conventions*. Available from http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-3.xml.

[11] Ibid., p. 23.

[12] Thomas S. Adams, "Fundamental Problems of Federal Income Taxation", *The Quarterly Journal of Economics*, vol. 35, No. 4 (August 1921), pp. 542-543.

[13] See Musgrave and Musgrave, footnote 2, p. 571.

[14] Ibid., p. 573.

[15] Arthur J. Cockfield, "Designing Tax Policy for the Digital Biosphere: How the Internet is Changing Tax Laws", *Connecticut Law Review*, Vol. 34, 2002, p. 396.

[16] Richard L. Doernberg, "Electronic Commerce and International Tax Sharing", *Tax Notes International*, vol. 16 (1998), pp. 1013-1022.

[17] Klaus Vogel and others, *Klaus Vogel on Double Taxation Conventions*, 3rd ed. (New Delhi, Wolters Kluwer India, 2010), p. 14.

[18] Ibid., pp. 14-15.

[19] Ibid., p. 400. Vogel refers to the criticism by developing countries that the PE principle operates exclusively in favor of developed countries, and finds this criticism justified to some extent.

[20] Reuven S. Avi-Yonah,"The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", Law & Economics Working Papers (Ann Arbor, Michigan, University of Michigan Law School, 2007), p. 3. Available from http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1074&context=law_econ_archive.

[21] Jens Witterndorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (The Netherlands, Kluwer Law International, 2010), pp. 75-76.

[22] League of Nations Fiscal Committee, *Report to the Council on the Fourth Session of the Committee. — Document C.399.M.204. 1933.II.A. (Geneva, June 15th to 26th, 1933) - Legislative History of United States Tax Conventions*. Available from http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-8.xml;chunk.id=0;toc.id=item-8;database=;collection=;brand=default.

[23] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (Paris, 2017). Available from http://dx.doi.org/10.1787/tpg-2017-en.

[24] UN Economic & Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York, UN Publishing, 2017). Available from http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf.

[25] The UN Convention allocates relatively greater taxing rights to the country of source than are provided in the OECD Convention.

[26] See Vogel, footnote 17, p. 442.

[27] OECD, *Model Tax Convention on Income and on Capital 2010 (updated 2010), Full version* (Paris, OECD Publishing), pp. C(7)-103-104.

[28] UN Economic & Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York, UN Publishing, 2011), pp. 159-160.

[29] Stanley I. Langbein, "A Modified Fractional Apportionment Proposal for Tax Transfer Pricing", Working Paper 1990-17, September 30, 1991 (Ann Arbor, Michigan, Michigan Ross School of Business, 1991), p. 6. Available from http://www.bus.umich.edu/otpr/papers/1990-17.PDF.

[30] Ibid., p. 7.

[31] Ibid., p. 27.

[32] Reuven S. Avi-Yonah & Kimberly Clausing, "A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project", Law & Economics Working Papers (Ann Arbor, Michigan, University of Michigan Law School, 2007), p. 13. Available from http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1071&context=law_econ_archive.

[33] Jinyan Li "Global Profit Split: An Evolutionary Approach to International Income Allocation", *Canadian Tax Journal*, vol. 50, No. 3 (2002), pp. 823-883.

[34] Tax Justice Network, "TP in Developing Countries An Introduction", 2013, para. 9.3. Available from https://www.taxjustice.net/wp-content/uploads/2013/04/TP_in_developing_countries.pdf.

[35] Danuše Nerudová, "Common Consolidated Corporate Tax Base: Sharing the Tax Base under Formulary Apportionment", In *Proceedings of the 13th International Conference on Finance and Banking*, D. Stavárek and P. Vodová, eds. (Karviná, Czech Republic, Silesian University in Opava, 2012), p. 466. Available from http://www.opf.slu.cz/kfi/icfb/proc2011/pdf/40_Nerudova.pdf.

[36] In *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978), the Iowa Supreme Court held the validity of the State of Iowa to impose tax only on the basis of sales. The US Supreme Court confirmed the validity of the formulatory apportionment method in *Container Corp. v. Franchise Tax Bd., 463 U.S. 159 (1983)* and *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal. 512 U.S. 298 (1994).*

[37] See Nerudová, footnote 35, Table 3, p. 467.

[38] Ibid., p. 468.

[39] See Tax Justice Network, footnote 34, para. 10.3.

[40] Ibid., para. 10.4.

[41] Erika Dayle Siu *et al.*, *Unitary Taxation in Federal and Regional Integrated Markets* (Brighton, UK, International Centre for Tax and Development, 2014). Available from https://assets.publishing.service.gov.uk/media/57a089ec40f0b652dd000486/ICTD-RR3.pdf.

[42] Rule 10 of Income-tax Rules, 1962 permits use of apportionment in India.

[43] European Commission, Final Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) {SWD(2016) 341 final} {SWD(2016) 342 final} (Strasbourg, 25.10.2016). Available from https://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_685_en.pdf.

[44] The 2016 proposal is a modification of an earlier proposal for CCCTB that was initiated in 2011.

[45] Wolfgang Schon, "Transfer Pricing - Business Incentives, International Taxation and Corporate Law", Working Paper 2011-05, January 2011 (Munich, Max Planck Institute for Tax Law and Public Finance, 2011), p. 8. Available from http://www.tax.mpg.de/repec/mpi/wpaper/Tax-MPG-RPS-2011-05.pdf.

[46] Average cost includes sunk cost, which could be a factor in investing decisions.

[47] For instance, an MNE may decide to locate its manufacturing activities in an economy which is recognized for its efficiency in manufacturing, locate its service units in another economy efficient in services or having skilled labor available at lower wages and locate its research units in a third economy that is recognized for its innovation, while selling its products in different economies around the world.

[48] See Schon, footnote 45, pp. 8-9.

[49] Ibid., p. 15.

[50] Jens Wittendorff, "The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?", *Tax Notes International*, April 18, 2011, pp. 223-249. Available from http://corit-academic.org/wp-content/uploads/2011/12/62TI0223-4.pdf.

[51] Harvey S. Rosen, *Public Finance*, 6th ed. (New York, McGraw Hill, 2004), p. 415.

[52] See Avi-Yonah and Clausing, footnote 32.

[53] Ibid., p. 9.

[54] Ibid., pp. 8-9.

[55] European Commission, Commission Staff Working Document, Impact Assessment, Accompanying the document, Proposals for a Council Directive on a Common Corporate Tax Base and a Common Consolidated Corporate Tax Base (CCCTB) {COM(2016) 683 final} {SWD(2016) 342 final} (Strasbourg, 25.10.2016). Available from https://ec.europa.eu/taxation_customs/sites/taxation/files/swd_2016_341_en.pdf.

[56] Ibid.

[57] For instance, even though OECD guidance for determination of arm's length price may not be binding, most developing countries would find it difficult to avoid, since MNEs would be following it in accordance with their compliance obligations in developed countries.

[58] The choice for not applying TP does not take away the obligation to provide corresponding adjustment, wherever such provisions exist in their tax treaties.

[59] For instance, an independent agent that has the opportunity of maximizing its profits serving multiple clients, will agree to a condition restricting it to serve only a single client, only if it is adequately compensated for the loss of potential profits resulting from this condition.

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