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TITLE

Sharing the burden of self-enforcement of 'relational agreements' in the international transfer pricing regime

NOTE

This draft outlines the author's **work in progress**, only for discussion purposes at the conference. It is not yet completed for the purposes of publication. Therefore, please do not copy, cite, post, or distribute beyond the purposes of this conference.

CONTENTS

1 Introduction and objectives

In recent decades, countries have been facing social and economic challenges that required them to increasingly approach regulation through collective action. As explained in the Oxford Handbook of Governance, "shifts in the form of governance are, in part, a response to increased globalization. In today's economy, the nation-state is less capable to govern and regulate markets… Globalization has … meant that many large corporations from developed countries operate at a transnational or multinational level, whether through ownership of a foreign subsidiary or by subcontracting core functions of the firm…"[1] The Handbook goes on to note that these developments "require regulators to better coordinate the levels of regulations from the local to the transnational and focus on the most effective ways of addressing social and economic challenges."[2]

In addressing their common needs and objectives, countries may choose to form different types of regulatory legal regimes[3] through their coordinated collective action. For example, countries may form *supernational legal regimes* that govern member states, as exemplified by the legal regime of the European Union ("EU"). They may also use collective action to coordinate *domestic legal regimes*, as exemplified by the international transfer pricing regime, which uses different legal instruments to converge and coordinate domestic laws that regulate transfer prices in cross-border controlled transactions.

When forming legal regimes, countries can also choose to utilize different types of instruments (e.g. binding 'hard-law' and/or non-binding 'soft-law'), which may or may-not be enforceable. When seen from the perspective of game theory (i.e. game models involving the strategic interaction between people who presumably act rationally), these alternative forms of collective action can create either cooperative and non-cooperative agreements.

As Hirsch explains, "cooperative game theory assumes the existence of an institution capable of enforcing the agreements concluded between the players…"[4] This is exemplified by the legal regime of the EU. EU instruments consist of binding primary[5] and secondary[6] sources of binding law as well as other types of non-binding EU legal acts.[7] The correct implementation of binding

[1] David Levi-Faur, The Oxford Handbook of Governance (OUP Oxford: 2012), pg 73
[2] David Levi-Faur, The Oxford Handbook of Governance (OUP Oxford: 2012), pg 73
[3] A generally accepted definition of a regime is a set "of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations." (Lorraine Eden, Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America (University of Toronto Press: 1998), pg 64). As Keohane explains, international regimes are used as "devices to facilitate the making of substantive agreements in world politics, particularly among states. Regimes facilitate agreements by providing rules, norms, principles, and procedures that help actors to overcome barriers to agreement… that is, regimes make it easier for actors to realized their interests collectively." (Robert O. Keohane, The Demand for International Regimes, INTERNATIONAL ORGANIZATION Vol 35, No. 2, pg 354).
[4] Moshe Hirsch (1998-1999), Game Theory, International Law, and Future Environmental Cooperation in the Middle East,27 DENV. J. INT'L L. & POL'Y 75, pg 80.
[5] specifically, treaty agreements between EU member countries
[6] Secondary sources are based on the primary sources. These include, for example, regulations and decisions which are automatically binding on EU member states, as well as directives which must be incorporated by EU member states into their national legislation
[7] These include, for example, non-binding recommendations and opinions by EU institutions.

EU law must be ensured by national authorities, while the implementation and enforcement of EU law is monitored by the EU Commission. "If national authorities fail to properly implement EU laws, the Commission may start formal infringement proceedings against the country in question. If the issue is still not settled, the Commission may eventually refer the case to the European Court of Justice."[8] European Court of Justice ("ECJ") decisions are enforceable domestically within the EU member states.[9]

In contrast, "non-cooperative game theory assumes no such institution exists."[10] This is exemplified by the international transfer pricing regime. In this regime, over the past several decades the Organisation for Economic Co-operation and Development's ("OECD") has been producing 'relational agreements', which are set out in its Transfer Pricing Guidelines ("TPG"). These guidelines provide consensus-based recommendations on how issues relating to domestic transfer pricing laws could/should be approached. The application of this agreement is open ended in its timeframe. Overtime, the agreement has been repeated with substantive (re-negotiated) revisions. They have the status of non-binding 'soft-law' instruments, and *may be* followed domestically to the extent required and permitted by domestic 'hard-law'. Unless otherwise enforceable by domestic courts, there is no international institution, such as an International Tax Court ("ITC"), that has the authority to enforce the domestic application of these recommendations. Instead, at least in theory and to varying extents, countries retain sovereignty to decide if an how to follow this international consensus on how to approach the transfer pricing analysis as it is recommended in the TPG.

For the purposes of the presentation and discussion at the 2018 ATTA conference, the following is a synopsis of my research on the use of 'relational agreements' as instruments for coordinating domestic transfer pricing laws. In this research, my objectives, which are briefly elaborated on in this draft, are as follows:

1. To apply 'game theory' to identify, describe, and model:
    a. the use of 'relational agreements' in the international transfer pricing regime, and
    b. the *need to have regulators share the burden of self-enforcing such agreements*.
2. Using the experiences of the Australian transfer pricing regime, to *exemplify this need* to have countries (in this international regime) share the burden of self-enforcing their 'relational agreements'.
3. Using Canada's transfer pricing law as an example, to point out the *potential need to apply the lessons distilled* from the Australian experience to other domestic regimes, where and as necessary.
4. To identify and assess the issue of *tax sovereignty as a potential hurdle* to having domestic regulators share this burden of self-enforcement.

[8] European Commission, 'Applying EU law', Retrieved from: https://ec.europa.eu/info/law/law-making-process/applying-eu-law_en#eu-countries

[9] As stated in Article 280 of The Treaty on the Functioning of the European Union (2008/C 115/01), "judgments of the Court of Justice of the European Union shall be enforceable under the conditions laid down in Article 299." (See: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.C_.2008.115.01.0001.01.ENG&toc=OJ:C:2008:115:TOC#C_2008115EN.01020101)

[10] Moshe Hirsch (1998-1999), Game Theory, International Law, and Future Environmental Cooperation in the Middle East,27 DENV. J. INT'L L. & POL'Y 75, pg 80.

2 The international transfer pricing regime: in pursuit of a coordinated approach to the BEPS problem

2.1 The BEPS problem

Domestic transfer pricing laws apply to cross-border controlled transactions. These laws are concerned with regulating conditions[11] (in such transactions) that would/could affect the determination of the taxable income and expenses of the associated enterprises in the exchange. An example of such conditions is the 'transfer price' that the parties have agreed to in their exchange of property and/or services.[12]

Why is it necessary to regulate the conditions agreed to in controlled transactions? As the OECD explains, "when independent enterprises transact with each other the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces".[13] In contrast, "[w]hen associated enterprises transact with each other their commercial and financial relations may not be directly affected by external market forces in the same way…"[14] This is due to the relationship of control between the parties. That is, either one party in the transaction controls the other (e.g. a parent company controls its subsidiary), or both parties are controlled by the same entity (e.g. two subsidiaries with a common parent company). Conditions of control may give associated enterprises the ability, opportunity and incentive to enter into "a much greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent."[15] It can facilitate arrangements which are driven by the common goals of the MNE. It may also make it possible to alter, suspend, extend, or terminate their transaction "according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively."[16]

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[11] Conditions typically include, but are not limited to, the transfer price of the property and/or services exchanged, gross margin, net profit, and the division of profit between the entities.

[12] As explained by the OECD, "[t]ransfer pricing... determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions." (OECD, 2010 TP Guidelines, *supra* note, Preface, para. 12). For example, "New Zealand taxes all persons on their income sourced in New Zealand, which means exercising its jurisdiction to tax foreign-based multinationals on profits attributable to their New Zealand operations. These profits, in theory, are expected to be commensurate with the economic contribution made (including commercial risk borne) by those New Zealand operations." (New Zealand's Inland Revenue, 'Appendix: Transfer Pricing Guidelines' (October 2000) 12(10) *IRD Tax Information Bulletin* 9. Available at: https://www.ird.govt.nz/resources/2/b/2bd702004ba38793811bbd9ef8e4b077/apx12-10.pdf). As New Zealand's "Transfer price adopted by a multinational determines where the profits of that multinational are sourced. Consequently, it also determines whether tax is imposed on the amount of income truly attributable to each jurisdiction in which the multinational operates." (*Ibid*, pg. 10)

[13] OECD, 2010 TP Guidelines, *supra* note, para. 1.2

[14] OECD, 2010 TP Guidelines, *supra* note, para. 1.2

[15] The OECD also notes that "associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case." (OECD, 2010 TP Guidelines, *supra* note 5, para. 1.67)

[16] OECD, 2010 TP Guidelines, *supra* note 5, para. 1.67

How and why may associated enterprises manipulate the terms of their commercial or financial relations? Baistrocchi explains as follows a typical tax motive which may influence MNEs to engage in tax arbitrage[17] by mispricing the value of property and/or services exchanged between their associated enterprises:[18]

> [I]f the effective tax rate of the manufacturer's jurisdiction is higher than that of its subsidiary, then the manufacturer can charge the lowest possible transfer price to its subsidiary in order to channel the profits of the MNE to the lowest tax jurisdiction. Conversely, if the manufacturer's effective tax rate is lower than that of its subsidiary, the manufacturer can charge the highest possible price to its subsidiary. The net effect of this transfer pricing strategy is to increase the after-tax profit of the MNE.

It should be clarified, however, that "transfer pricing rules are not mainly rules to prevent tax avoidance or tax abuse, but rules to prevent tax base shifting (tax arbitrage)..."[19] The concern is that, unlike parties who are dealing at arm's length and whose pricing (of property and/or services exchanged) are expectedly influenced by market conditions, associated enterprises have the ability and opportunity to manipulate (misprice) the transfer prices in their commercial exchanges in order to shift profits from one country to another.

Why is profit shifting a problem? As New Zealand's Inland Revenue explains, mispricing is a problem because "[i]f a non-market value (inadequate or excessive consideration) is paid for the transfer of goods, services, intangible property or loans between those members, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will flow through to the tax revenues of their host countries."[20] Profit shifting, therefore, risks producing tax outcomes which do not reflect the contracting parties' true contribution to the value created by their exchange, and consequently it also risks eroding the tax base of affected countries by distorting the determination of where taxable value was created and should/could thus be taxed. This has been referred to as the base erosion and profit shifting ("BEPS") problem.[21]

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[17] As Reuven S. Avi-Yonah explains, tax arbitrage refers to "transactions that are designed to take advantage of differences between national tax systems to achieve double non-taxation." (Avi-Yonah (2007), *supra* note 22, pg. 137). David Rosenbloom describes international tax arbitrage as "the deliberate attempt to take advantage of the different tax charactrizations that countries may ascribe to a single set of facts." (David H. Rosenbloom (2000), 'Arbitrage and Transfer Pricing', Ch 35 in: Report of Proceedings of the First World Tax Conference: Taxes without Borders, 2000 World Tax Conference Report, Toronto Canadian Tax Foundation).

[18] Eduardo Baistrocchi, Ian Roxan (eds), *Resolving Transfer Pricing Disputes – A Global Analysis* (Cambridge University Press, 2012), pg. 11

[19] Violeta Ruiz Almendral, *Chaper 7: Transfer Pricing in Spain*, section 7.7, in: Eduardo Baistrocchi and Ian Roxan, Resolving Transfer Pricing Disputes: a Global Analysis, Cambridge Tax Law Series (Cambridge University Press: 2012)

[20] *Ibid*, pg. 9.

[21] The OECD explains the problem as follows: "BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers." Retrieved from: (http://www.oecd.org/tax/beps/beps-about.htm)

The regulation of transfer pricing is intended to ensure that allocated profits/losses [among the associated enterprises in the transaction] are commensurate with the economic contribution and risk born towards creating the profits/losses. And, consequently, it also aims to ensure that "tax is imposed on the amount of income truly attributable to each jurisdiction in which the multinational operates."[22]

2.2 Alternative approaches to regulating the allocation of income

In 1929, "a newly-constituted League Fiscal Committee began to consider how to deal with rules for income allocation, but it 'soon came to the conclusion that, in order to do any useful work, it would be essential to have a detailed knowledge of the present practice in various countries.'"[23] The Committee appointed Professor Thomas S. Adams to produce a report on the matter. The Adams report revealed different approaches to income allocation; most notable being the 'separate entity approach' and 'formulary apportionment' (also referred to as 'unitary taxation').[24]

The separate entity approach assumes that each member within the MNE is a separate entity that conducts trade with the other entities in the MNE under free-market conditions.[25] This is exemplified by Australia's transfer pricing rules, which state that the entity (i.e. the associated enterprises) "is treated for income tax and withholding tax purposes as if arm's length conditions had operated"[26] (i.e. as if the entities were dealing as separate entities, at arm's length). "[W]here an entity would otherwise get a tax advantage from actual conditions that differ from arm's length conditions, the arm's length conditions are taken to operate for income tax and withholding tax purposes..." The objective being "to ensure that the amount brought to tax in Australia from cross-border conditions between entities is not less than it would be if those conditions reflected: (a) the arm's length contribution made by Australian operations through functions performed, assets used and risks assumed; and (b) the conditions that might be expected to operate between entities dealing at arm's length."[27]

By imposing [on controlled transactions] the assumption that the parties were dealing with each other at arm's length (i.e. as separate entities), it would become possible to also assume that conditions, such as transfer prices, which would affect the allocation of taxable income and expenses between the parties, should reflect the conditions that were (or would have been) agreed to in a comparable uncontrolled transaction (i.e. transactions in which the parties were dealing at arm's length).

How would it be determined how the associated enterprises would have allocated the income (profits) and expenses from their exchange had they been dealing at arm's length? This would be

[22] New Zealand's Inland Revenue, 'Appendix: Transfer Pricing Guidelines' (October 2000) 12(10) *IRD Tax Information Bulletin* 9, pg10. Available at:
https://www.ird.govt.nz/resources/2/b/2bd702004ba38793811bbd9ef8e4b077/apx12-10.pdf

[23] Brian D. Lepard (1999-2000), Is the United States obligated to drive on the right? A multidisciplinary inquiry into the normative authority of contemporary international law using the arm's length standard as a case study, 10 *DUKE J. COMP. & INT'L. L.* 43, pg 61 ("Lepard")

[24] Lepard, pg 63

[25] K. Sadiq, 'The Fundamental Failing of the Traditional Transfer Pricing Regime – Applying the Arm's Length Standard to Multinational Banks based on a Comparability Analysis' (Feb 2004) *IBFD*, pg 67

[26] Section 815.101, ITAA 1997

[27] Section 815.105, ITAA 1997

achieved by comparing the non-arm's length conditions[28] in the controlled transaction (e.g. the transfer price) to the arm's length conditions (e.g. price) in an uncontrolled transaction under comparable commercial or financial circumstances.[29] If the *conditions* in the *controlled transaction* differ from those which were (or would have been) agreed to in an *uncontrolled transaction* then the *income and expenses* in the controlled transaction could be adjusted (for tax purposes) to reflect the allocation that was (or would have been) agreed to in the comparable uncontrolled transaction.

Note, therefore, that arm's length conditions are being treated as a standard (benchmark) by which to assess the acceptability (reasonableness) of conditions in uncontrolled transactions. The US Treasury Regulations[30] to §482 of the Internal Revenue Code ("IRC") refer to this as the Arm's Length Standard ("ALS"),[31] whereas the OECD's Transfer Pricing Guidelines refer to this as the Arm's Length Principle ("ALP").[32]

Postlewaite, Cameron, and Kittle-kamp provide the following helpful example of how the transfer pricing rule in §482 of the US Tax Code is applied to regulate transfer mis-pricing and address the BEPS problem:[33]

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[28] Conditions could be, for example, "the price of goods transferred or services provided and the conditions of the transfer or provision" (OECD, 2010 TP Guidelines, *supra* note 5, para 1.2). Additional examples of conditions may be "payment terms" or "allocation of risks" (OECD, 2010 TP Guidelines, *supra* note 5, para 9.165). Note that "where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises." (OECD, 2010 TP Guidelines, *supra* note 5, para 1.11).

[29] This could "be either a comparable transaction between one party to the controlled transaction and an independent party ('internal comparable') or between two independent enterprises, neither of which is a party to the controlled transaction ('external comparable')" (OECD, 2010 TP Guidelines, *supra* note 5, para. 3.24).

Note that the arm's length transaction should be comparable in character and circumstances, but should not share the special (non-arm's length) conditions that may have affected income allocation in the controlled transaction. The aim is to eliminate the effect of these special conditions on income allocation in the controlled transaction. (OECD, 2010 TP Guidelines, *supra* note 5, preface, para. 6). "OECD member countries consider that an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in comparable transactions under comparable circumstances." (OECD, 2010 TP Guidelines, *supra* note 5, para. 1.3)

[30] In the US, "Federal agencies issue several different types of guidance to explain and interpret the application of statutes to particular situations… Generally, the IRS issues eight different types of official guidance: final, temporary or proposed regulations; revenue rulings; revenue procedures; notices and announcements; publications; private letter rulings; general counsel's memoranda; and general information letters… *Final regulations* are interpretations of law that are binding. Although courts are not bound to follow the regulatory definition, it is common for courts to follow final regulations unless the regulation is clearly contrary to the law… *Temporary regulations* are also binding until the IRS issues final regulations on the subject… *Proposed regulations* technically are not binding precedent." (Martha Priddy Patterson, 'Appendix C Administrative Rulings,' in The 401(k) Handbook, Vol 11, 2006 WL 3437992).

Hence, the "treasury regulations form the primary source for guidance on the IRS's position regarding the interpretation of the IRC. The ultimate authority to promulgate regulations is vested in the secretary of the Treasury. *See* reg. section 601.601(a). *See also* Mitchell Rogovin and Donald L. Korb, 'The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View From Within,' 46 *Duq. L. Rev.* 323, 326." (Hui Ling Quek (Jan 24, 2011), 'Economic Substance in U.S. Transfer Pricing and The Regulation of Taxpayer Behavior,' 61 *Tax Notes International* 311, footnote 10)

[31] 26 C.F.R. § 1.482–1, Treasury Regulations, §1.482-1(b)(1). *Paccar, Inc. v. C.I.R.*, 85 T.C. 754, p. 787.

[32] OECD, 2010 TP Guidelines, *supra* note 5, p. 31

[33] Philip F. Postlewaite, David L. Cameron, and Thomas Kittle-kamp, Ch. 14: Intangible Assets and the Taxation of International Transactions,' in Federal Income Taxation of Intellectual Properties & Intangible Assets, ¶ 14.11[2]

> In the international context, § 482 is employed to police the movement of income out of the reach of the United States taxing authorities. For example, assume that *A*, a United States manufacturer, sells component parts to *B*, a manufacturing subsidiary located in a low-tax jurisdiction. *B* then uses the components to manufacture finished products and sell them worldwide. If *A* sold the components at arm's-length prices (i.e., the prices *A* would sell them to unrelated parties), the United States would have no cause for complaint. But if *A* sold the components for non-arm's-length prices (e.g., cost or near cost), *A*' s income will be depressed and a portion of its profit on the components will be diverted to *B*. Assume further that *B* needs to employ a patented manufacturing process owned by *A* to make its finished goods. If *A* licenses this patented manufacturing process to *B* at below an arm's-length rate, *A* could effectively shift yet additional income to *B*. Section 482 may be used to reallocate income, deductions, or credits in such transactions, even if the non–arm's-length results were purely unintentional.

Adams also found that some countries used alternative methods of allocating income and expenses where "separate accounts were inadequate or misleading."[34] Adam's report was followed by the 1933 Carroll Report, which was carried out by Mitchell B. Carroll at the request of a subcommittee of the Fiscal Committee. This report also identified that different approaches to income allocation existed, including the 'separate entity' approach and the 'unitary method'. According to the unitary method, as exemplified by the approach of some U.S. states,[35]

> a company's taxable income in a given state is calculated by multiplying payroll, and sales located within that state. The unitary system (also known as formula apportionment) is based on the idea of apportioning the taxable income by means of a formula reflecting the activity of the transnational company in a given jurisdiction. As such, it presents clear benefits to revenue authorities.

If applied to a MNE engaged in intragroup cross-border transactions, "the taxable income would be distributed among the different countries where it operates according to a given formula that would take several aspects into account, such as the sales or the number of employees that correspond to each jurisdiction."[36]

2.3 The risk of 'double taxation'

In theory, countries possess national sovereignty to tax based on their own policies and rules, without external influences and limitations.[37] Not surprisingly, therefore, it is possible to find countries taking different countermeasures in order to address the BEPS problem. As noted by the OECD, "the existing countermeasures are unilateral, individual country, antiavoidance rules…"[38]

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[34] Lepard, pg 63

[35] Claudio M. Radaelli (1998), Game Theory and Institutional Entrepreneurship: Transfer Pricing and the Search for Coordination in International Tax Policy, POLICY STUDIES JOURNAL, Vol. 26, No. 4, pages 603-619, pg 605 ("Radaelli")

[36] Vega, International Governance through soft law, pg 7

[37] Charles E. McLure Jr., 'National Tax Rules and Sovereignty,' in A.K. Vaidya (Ed.), *Globalization: Encyclopedia of Trade, Labor, and Politics* (Calif: ABC-CLIO, 2005), 212. Note that in reality, however, tax sovereignty may be subject to different types of limitations. McLure identified four types of limitations: market-induced voluntary limits; negotiated limits; externally imposed limits; and administrative limits." (Charles E. McLure Jr. (Aug 2001), 'Globalization, Tax Rules and National Sovereignty', 55(8) *Bulletin for International Taxation* 328-341)

[38] OECD (Measuring and Monitoring BEPS), pg 106

The OECD points out numerous studies that have analyzed the economic effects of BEPS behavior[39] as well as the incidence of unilateral measures which tax[40] and regulate[41] multinationals and cross-border transactions.[42] For example, "[s]everal academic studies find that anti-avoidance countermeasures have reduced profit shifting through transfer pricing documentation … and interest limitations. These studies show positive effects of current law unilateral measures, which could be shifting BEPS behaviours away from the countries with anti-avoidance rules to countries without the anti-avoidance rules."[43]

Yet, as the OECD cautions, unilateral measures can themselves induce the BEPS problem. As the OECD explains, without a unified and common countermeasure, under the current framework "if one country were to adopt tough BEPS countermeasures, then MNEs could move their activities to continue BEPS behaviours elsewhere."[44] Moreover, there are problems that cannot be effectively addressed solely by unilateral domestic measures. This includes, among other things, the risk of double taxation.

The OECD identifies two forms of double taxation which are addressed by countries through their collective action in the international tax treaty system: international 'juridical double taxation' and 'economic double taxation'.[45] Transfer pricing cases involve 'economic double taxation', which means "the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers… For example, a tax administration adjusts a price charged between related parties with a resulting tax charged on the additional income in the hands of one related party, where tax has already been charged in another country on that same income in the hands of the other related party."[46]

[39] BEPS effects government revenues, it can influence changes in corporate income taxes due to BEPS behaviours and countermeasures, it can influence tax competition between countries, among other economic effects. (OECD (Measuring and Monitoring BEPS), pg 106)

[40] For example, Clausing investigated "the effect of host country statutory and effective tax rates on inter-company trade in goods. Using data on intra-firm transactions from the United States Bureau of Labor Statistics…" [T]he analysis finds that low foreign statutory tax rates are correlated with lower export prices and higher import prices relative to third party transactions. The analysis finds a "tax rate 1% lower in the country of destination/origin is associated with intra-firm export prices that are 1.8% lower and intra-firm import prices that are 2.0% higher, relative to non-intra-firm goods." (Clausing, K. A. (2003), "Tax-motivated transfer pricing and US intrafirm trade", *Journal of Public Economics* 87(9-10), 2207-2223. Referred to in: OECD (Measuring and Monitoring BEPS), pg 106)

[41] For example, "[a] paper by Dyreng, Hoopes and Wilde (2014) finds empirical evidence suggesting that U.K. public companies decreased tax avoidance and reduced the use of subsidiaries in tax haven countries when there was increased public disclosure. Several studies (Lohse et al., 2012; Lohse and Riedel, 2012; Annex 3.A1) find empirical evidence of reduced profit shifting from tougher transfer pricing documentation rules. Increased transparency of government tax rules (Action 5) will reduce a non-tax rate competition, with greater disclosure of government rulings involving potential base erosion." (Dyreng, S., J. L. Hoopes and J. H. Wilde, (2014), "Public pressure and corporate tax behaviour", Working Paper available at SSRN: http://ssrn.com/abstract=2474346 or http://dx.doi.org/10.2139/ssrn.2474346. Referred to in: OECD (Measuring and Monitoring BEPS), pgs 110-111)

[42] OECD (Measuring and Monitoring BEPS), pg 106

[43] OECD (Measuring and Monitoring BEPS), pg 106

[44] OECD (Measuring and Monitoring BEPS), pg 111

[45] OECD, 2007, '*Manual On Effective Mutual Agreement Procedures (MEMAP) – February 2007 version'*, Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, pg 8

[46] Ibid, pg 8

In 1927, a report by the League of Nations warned that double taxation should be avoided because it tends to paralyse the activities of cross-border trade "and to discourage initiative and thus constitutes a serious obstacle to the development of international relations and world production."[47] Likewise, the OECD cautions that "[d]ouble taxation has a detrimental effect on the movement of capital, technology and persons and on the exchange of goods and services."[48]

2.4 Choosing a common approach: a 'battle of the sexes' scenario

To the extent that states can be presumed to be acting rationally,[49] 'game theory'[50] can be applied to describe, model, explain, suggest and predict how states approach (and should approach) dealing with these BEPS and 'double taxation' problems.

Game theory identifies that if a person[51] (P1) can achieve its goal(s) through a single strategy, then it can be expected that P1 will pursue that strategy. However, there may be circumstances in which P1depends on the behavior of others (P2) in order to achieve its objective(s).

> In the context of transfer pricing, for example, countries (that exercise their jurisdiction to tax an associated enterprise involved in a cross-border transaction) may decide that a particular approach to income allocation (e.g. unitary taxation) would best serve their interests, even though the other country taxing the same transaction may apply another inconsistent approach to income allocation. Yet, even if both states apply the same approach (e.g. the ALP), they may disagree on how that principle ought to be applied, and consequently they may refuse to make the necessary corresponding adjustments in order to avoid economic double taxation.[52] As the UN cautions:

[47] League of Nations, *Double Taxation and Tax Evasion* (Geneva, April 1927), pg 8. Retrieved from: http://faculty.law.wayne.edu/tad/Documents/League/League_Tech_Experts.pdf

[48] OECD (2007), MEMAP, pg 8

[49] For the purposes of game theory analysis, "decision-makers are assumed to be rational in the sense that they have certain goals, which they strive to attain through their actions." (Moshe Hirsch (1998-1999), Game Theory, International Law, and Future Environmental Cooperation in the Middle East,27 DENV. J. INT'L L. & POL'Y 75, pg 79) It should be acknowledged that these assumptions have been criticized and challenged by some, though the weight and relevance of this debate is beyond the scope of this article. For the purposes of this article's arguments, the general assumption of rationality are accepted as sufficiently adequate, relevant and thus helpful for establishing the author's general arguments.

[50] Game theories utilize different types of models to describe and explain situations in which a person's ability to achieve its goals depends on the behavior of others (Hirsch, pg 79). These models are widely used in different disciplines such as economics, political science, international relations, law, sociology, to name a few (Hirsch, pg 78)

[51] People refers to either "individuals or collective decision-making units like firms or states" (Hirsch, pg 79)

[52] As the OECD explains, "[t]o eliminate double taxation in transfer pricing cases, tax administrations may consider requests for corresponding adjustments as described in paragraph 2 of Article 9. A corresponding adjustment, which in practice may be undertaken as part of the mutual agreement procedure, can mitigate or eliminate double taxation in cases where one tax administration increases a company's taxable profits (i.e. makes a primary adjustment) as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction. The corresponding adjustment in such a case is a downward adjustment to the tax liability of that associated enterprise, made by the tax administration of the second jurisdiction, so that the allocation of profits between the two jurisdictions is consistent with the primary adjustment and no double taxation occurs. It is also possible that the first tax administration will agree to decrease (or eliminate) the primary adjustment as part of the consultative process with the second tax administration, in which case the corresponding adjustment would be smaller (or perhaps unnecessary). It

> "there remains substantial risk of double taxation even when two countries follow the same general arm's length principle approach. For example, such double taxation may occur where specific guidance on the implementation of the arm's length principle is different from one country to another, and countries do not bridge this gap with any specific understanding or interpretative guidance."[53]

Yet, to the extent that both countries share the same objective of avoiding double taxation, to achieve the dual objectives of regulating transfer prices (in order to adequately determine the amount of income and expenses which are attributable to each country that has jurisdiction to tax the transaction) and avoiding double taxation,[54] countries would need to agree on a coordinated approach to regulation. Accordingly, as the OECD explains, "[i]n order to minimize the risk of such double taxation, *an international consensus is required* on how to establish for tax purpose transfer prices on cross-border transactions."[55] Hence, as the OECD explains, "by its nature, BEPS requires co-ordinated responses. This is why countries are investing time and resources in developing shared solutions to common problems."[56] The importance of coordination in transfer pricing should not be underestimated. As noted by Pistone, Julien and Cannas: "a lack of coordination could ultimately be detrimental both to taxpayers (by contributing to legal uncertainty which could stifle the very cross-border investment that tax treaties hope to facilitate) and for tax administrations and policymakers (by allowing gaps and loopholes to persist which contribute to BEPS in the first place)."[57]

Radaelli identified this scenario as resembling a 'battle of the sexes' game in which "actors want to use a common standard, although they cannot agree on the standard to be employed (arm's length, unitary taxation, or profit methods). The main problem is standard setting, not free-riding (typical of cooperation games). This is what makes strategic interaction in this issue area similar to a coordination game such as battle of the sexes." [58]

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should be noted that a corresponding adjustment is not intended to provide a benefit to the MNE group greater than would have been the case if the controlled transactions had been undertaken at arm's length conditions in the first instance." (OECD TPG 2017, para 4.32)

[53] UN Manual 2017, para B.8.2.9

[54] These dual objectives were recently reiterated by the OECD through its BEPS project. It stated that its recommended actions aimed to "realign taxation with economic substance and value creation, while preventing double taxation." (OECD, 'BEPS – Frequently Asked Questions,' Retrieved from: http://www.oecd.org/tax/beps/beps-frequentlyaskedquestions.htm)

[55] TPG-2010, Preface, para 12

[56] OECD/G20 Base Erosion and Profit Shifting Project (2014), Action 8: Guidance on Transfer Pricing Aspects of Intangibles, pg 4. Through its recent revisions of its Transfer Pricing Guidelines, based on the BEPS Project, the OECD's stated an objective was to "prevent the existing consensus-based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever." (OECD-BEPS, pg 3) The OECD emphasizes that its current recommendations "reflect consensus, as of July 2014." (OECD-BEPS, pg 3)

[57] Pasquele Pistone, Rita Julien, and Francesco Cannas, '*Can the Derivative Benefits Provision and the Competent Authority Discretionary Relief Provision Render the OECD-Proposed Limitation on Benefits Clause Compatible with EU Fundamental Freedoms?*', in Michael Lang (eds), *Base Erosion and Profit Shifting (BEPS)* (Linde Verlag GmbH: 2016), pgs 212-213

[58] Radaelli, at pg 606

After reviewing the options, the Carroll Report recommended that states should coordinate by adopting the separate entity approach. Lepard reflected on the conclusions of the Carroll Report as follows:[59]

> In his conclusion, Carroll indicated as a matter of policy a strong preference for the separate accounting method of allocating income between branches of a single corporation, because he viewed it as more consistent with the principle that a state should only have authority to tax income from sources within its own territory. He also cited many of the practical difficulties with formulary apportionment previously discussed, including the problem that states would likely choose formulas that allocate more income to their tax jurisdiction. In addition, Carroll argued that the separate accounting method was "preferred by the great majority of Governments, and business enterprises represented in the International Chamber of Commerce, as well as by other authoritative groups."
>
> Presumably on similar grounds, Carroll recommended that corporations be treated as independent legal entities and that allocations between related corporations be based on an independent enterprise standard: "[I]f it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise." Carroll contended that "the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation."

Let us turn to examine how countries have approached the application of this shared regulatory approach (i.e. the ALP) through the formation of a pluralistic legal system that consists of 'hard' and 'soft' law instruments, which are executed both the domestic and international levels.

3 Constructing a pluralistic legal system to implement the coordinated approach taken

3.1 Choosing the 'form' and 'substance' of coordination based on the costs and benefits of their level of commitment: insights from Rational Choice Theory

Rational Choice Theory assumes that social agents "act rationally to satisfy preferences, or to maximize utility".[60] This understanding has been widely applied to explain the behavior of individuals, institutions, and states. Guzman applied this theory to explain the behavior of States in the contexts of international law.[61] His basic rational choice assumption is that States may be willing to cooperate or coordinate with other States when doing so serves a common interest that

[59] Brian D. Lepard (1999-2000), Is the United States obligated to drive on the right? A multidisciplinary inquiry into the normative authority of contemporary international law using the arm's length standard as a case study, 10 *DUKE J. COMP. & INT'L. L.* 43, pgs 65-66

[60] M. Zafirovski, 'Unification of Sociological Theory by the Rational Choice Model: Conceiving the Relationship between Economics and Sociology' (1999) 33 *Sociology*, pg 496

[61] A.T. Guzman, *How International Law Works A Rational Choice Theory* (2008) Oxford University Press: Oxford ("Guzman")

is of value to each State.[62] Arthur Stein, a political scientist, similarly explains that when states engage in inter-state relations they are guided by "independent, self-interested decision making."[63]

When faced with common problems and/or objectives, states have choices. As Guzman explains, they could choose to "refrain from any international agreement, enter into a 'soft law' agreement (defined as an agreement that is neither a formal treaty nor customary international law), or enter into a formal treaty."[64]

If they choose to enter into an international agreement, it would expectedly have the effect of circumscribing national behavior to some extent.[65] Accordingly, as Jinyan Li explains, "any tax reform that requires a high level of international coordination or cooperation must deal with the sovereignty hurdle."[66]

The extent to which an international agreement limits national sovereignty would depend on the form of the agreement. For example, an international regime could be based on a 'soft law' agreement, such as the coordination of principles, norms,[67] and decision-making procedures. Such an agreement is unlike a binding contract that is enforceable within centralized governmental institutions. A binding contract sets fixed terms, precludes continual renegotiation, and is automatically enforceable by the courts. In contrast, a soft-law agreement is used by states:[68]

> to establish stable mutual expectations about others' patterns of behavior and to develop working relationships that will allow the parties to adapt their practices to new situations. Rules of international regimes are frequently changed, bent, or broken to meet the exigencies of the moment. They are rarely enforced automatically, and they are not self-executing. Indeed, they are often matters for negotiation and renegotiation…

States could also choose to enter into more binding forms of agreement, such as formal treaties. They could also form centralized institutions that have the authority to make binding rules, enforce those rules, and adjudicate disputes with respect to those rules.

As Guzman explains, the choice of states with respect to the form of their international agreement reflects their level of commitment to their arrangements. A binding arrangement, such as a formal treaty, represents a higher level of commitment since the treaty is binding. This gives the promise(s) exchanged by the states credibility.[69] Conversely, a soft law agreement represents a

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[62] Guzman, at 121. Guzman notes that a criticism of this approach has been that "there is no workable set of assumptions that can satisfy all relevant concerns. It is, therefore, possible for reasonable people to disagree with respect to their preferred set of assumptions. There should be no disagreement, however, with the fact that progress requires some set of assumptions be made, and that the rational choice assumptions used here offer a reasonable starting point..." (Guzman, at 17)

[63] Arthur A. Stein, Coordination and Collaboration: Regimes in an Anarchic World, in International Regimes 115 (Stephen D. Krasner ed. 1983), pg 117. Cited in Lepard, pg 97.

[64] Guzman, at 59

[65] Arthur A. Stein, Coordination and Collaboration: Regimes in an Anarchic World, in International Regimes 115 (Stephen D. Krasner ed. 1983), pg 115. Cited in Lepard, pg 96.

[66] Jinyan Li (2004), 'Tax Sovereignty and International Tax Reform: The Author's Response,' 52(1) CTJ 141-148.

[67] As Keohane explains, norms consist of "standards of behavior defined in terms of rights and obligations" (Keohane, pg 341)

[68] Keohane, pg 331

[69] Guzman identifies at least three factors that may compel a state to comply with its international obligations: "First, and perhaps most important, is reciprocity. A violation by one side would likely provoke a violation by the other side. The one to violate initially would enjoy a one-period gain, but thereafter the treaty might collapse, in which case both

lower level of commitment since it does not bind the States, and thus the promise(s) exchanged have more limited credibility.

Commitment to an international agreement comes at a cost to each state. Guzman identifies various costs that may be taken into account when considering the level of commitment that the states are willing to agree to. First, "states sometimes prefer less binding or less credible commitments because they value the flexibility these less stringent obligations provide..."[70] This concern with flexibility has been used to "explain why international agreements so rarely provide for mandatory dispute resolution."[71] Second, "states prefer to avoid dispute resolution because they fear losing."[72] Third, there is the risk of "reputational loss in the event of a violation"[73] of the agreement (i.e. loss of credibility as a reliable party to international agreements).

An agreement will vary in its substance[74] and form[75] depending on the level of commitment that the parties are willing to agree to. The parties, acting rationally, will agree to a level of commitment that serves a common interest that is of value to the states, and that involves costs that they are willing to sustain. The costs they are willing so accept may change over time depending on different factors.

If value maximization is the objective, it would appear that "an exchange of promises is only valuable to the extent that it binds the parties and gives each state confidence that the other states will perform as promised. An agreement that constraints state behaviour more effectively, then, should have greater value."[76] Nevertheless, "states sometimes resist using formal elements to maximize the credibility of their agreements."[77] An explanation for this is that value, in terms of credibility, ends up being balanced against the cost factor. "Although increased credibility leads to higher compliance rates, which is good, it also increases the costs the parties face in the event of a violation. This cost is taken into account by the parties when they enter into the agreement and may discourage them from increasing the credibility of the agreement."[78]

Considering the cost of entering into formal international agreements, states may decide instead to enter into a soft law agreement.[79] "Because states make decisions about soft and hard law on the

parties would return to the noncooperative outcomes. Second, both parties wanted to be able to make credible commitments in the future. By complying with its promises, each country enhances its reputation as a state that honors its commitments and, therefore, its ability to make future promises. Third, a violation had the potential to trigger some form of retaliatory action, which might further increase the cost of the breach." (Guzman, at 32)

[70] Guzman, at 136

[71] Guzman, at 136

[72] Guzman, at 138

[73] Guzman, at 141

[74] Guzman identifies "the 'substance' of an agreement as the set of formal obligations, commitments, or promises that speak to the actions State say they will take in the future." (Guzman, at 131)

[75] "Form includes parts of the agreement that determine the degree to which states have pledged to comply with the obligation, that determine when obligations can be avoided, and that provide for enforcement. Examples of choices as to the form of the agreement include the decision to adopt a treaty rather than soft law, the provision or omission of dispute resolution and monitoring, and the inclusion or omission of reservations, escape clauses, and exist clauses." (Guzman, at 131)

[76] Guzman, at 135

[77] Guzman, at 135

[78] Guzman, at 135

[79] As Guzman explains, the "common use of the term refers to international promises, obligations, or commitments that are not 'binding' under international law. That is, they do not qualify as treaties, custom, or general principles of

basis of the costs and benefits of each, it is... productive to view this as one of the choices states make in the course of negotiating an agreement. In essence, they can choose to downgrade the level of commitment and the credibility of their promises by entering into a soft law agreement rather than a treaty."[80]

3.2 The international transfer pricing regime: a (partial) description of its form and substance

3.2.1 Coordination through a pluralistic legal system, with different levels of commitment

In pursuit of their common objectives for the purposes of regulating transfer pricing, countries could have chosen to *cooperate* using legal institutions and instruments that create a high level of commitment to this regime, albeit with higher costs. This would involve establishing international institutions for creating rules and principles that would bind member states, as well as an international court for enforcing this law and settling disputes. Such a cooperative game (regime), however, would come at the cost of significantly relinquishing national sovereignty (among other potential costs).

A notable example is the supernational legal regime of the EU. Through binding treaties, members of this union have formed formal institutions (e.g. a European Parliament) for making binding primary legislation (e.g. treaties, and general principles) and secondary legislation (e.g. Regulations and Directives) to govern the scope of areas covered by their agreements. They have also established a European Court of Justice ("ECJ") that gives, as required and/or requested by national courts, binding preliminary rulings to ensure the effective and uniform application of EU legislation (which consequently also establishes binding case-law based on those rulings) and reviews the legality of EU law.[81] This *cooperative game*, played out by the EU member states, is intended to achieve their common values and objectives, as set out in their treaties. For example, Article 2 of the Treaty on European Union ("TEU") identifies shared values such as: respect for human dignity, freedom, democracy, equality, the rule of law, respect for human rights, among other things. Article 3 of the TEU sets out numerous objectives such as: ensuring (for EU citizens) core freedoms within the EU, establishing a common market for the union, among other things.

Likewise, for the purposes of the achieving their objectives of regulating transfer prices without the risk of double taxation, countries could have engaged in a cooperative game. They could have formed a centralized international body, such as an International Tax Organization ("ITO").[82] Instead of having varying (and potentially inconsistent) domestic transfer pricing laws, an ITO

law." Guzman suggests, however, that "there is no reason to view soft law agreements as different in kind from treaties. The decision to enter into an agreement is motivated in both cases by a desire to address some sort of cooperative problem. The exchange of commitments allows each party to anticipate and rely on the behaviour of other parties. Though soft law agreements will normally represent a weaker form of commitment, they should be analyzed and understood in essentially the same way as treaties." (Guzman, at 142-143).

[80] Guzman, at 144

[81] Gundega Mikelsone. 2013. *The binding force of the case law of the Court of Justice of the European Union*, 20(2) JURISPRUDENCE 469-495

[82] This idea was proposed by a UN panel in its Report of the High Level on Financing for Development, available at http://www.un.org/esa/ffd/a55-1000.pdf .

could develop uniform binding transfer pricing rules, principles, and guidelines.[83] Also, an International Tax Court ("ITC") could have been formed to settle transfer pricing disputes and establish coherent interpretation and application of ITO based rules and guidelines.[84] However, such proposals, which were previously raised in other contexts of international tax, were not sufficiently embraced; mainly, as it appears, because of the associated cost (risk) of limiting the tax sovereignty of States.[85]

Instead, countries have continually chosen to coordinate their collective action by forming and preserving a pluralistic legal system that would also facilitate maintaining, albeit to varying extents, their fiscal sovereignty. As the OECD comments, "BEPS requires co-ordinated responses… At the same time, countries retain their sovereignty over tax matters and measures may be implemented in different countries in different ways, as long as they do not conflict with countries' international commitments."[86]

This pluralistic system consists of a mix of international and domestic forms of: binding 'hard-law' instruments (treaties and domestic tax legislation); domestic case-law; binding customary international law; internationally coordinated non-binding 'soft-law' instruments (e.g. the OECD's TPG and the UN Manual on Transfer Pricing for Developing Countries[87]); and, domestic administrative guidelines on transfer pricing, which may follow the OECD's guidelines.

3.2.2 Legal convergence of the ALS through international and domestic 'hard law' instruments

3.2.2.1.1 Treaties

As Brandstetter explains, "OECD Model Conventions were drafted to facilitate "common solutions to identical cases of double taxation."[88]

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[83] Report of the High Level on Financing for Development, pg 28. available at http://www.un.org/esa/ffd/a55-1000.pdf

[84] See, for example: Patricia Brandstetter, "Taxes Covered": a Study of Article 2 of the OECD Model Tax Conventions (IBFD: 2011). See also: (1998) 'Tackling Tax Treaty Tensions: Time To Think about an International Tax Court", 52 (8/9) BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, pgs 344-357.

[85] With regards to an ITO, McLure explains that it is unlikely that countries will "engage in the massive surrender of national sovereignty over tax policy implied by this option (C. E. McLure, 'National Tax Rules and Sovereignty', in A.K. Vaidya, *Globalization: Encyclopedia of Trade, Labor, and Politics* (2005) ABC-CLIO, at 227). Similarly, Kragen has noted that "this suggestion has received very little support from tax authorities and the difficulty of constituting such a court makes adoption improbable." (A.A. Kragon, 'Avoidance of International Double Taxation Arising from Section 482 Reallocation' (1972) 60:6 *California Law Review*, pg 1516). As for the proposal of an ITC, Michael Lang notes that "the creation of an international tax court has been frustrated so far by the States' refusal to relinquish their fiscal sovereignty in an attempt to stay in control in appeal procedures as well." (M. Lang (ed.), *Multilateral tax treaties: new developments in international law* (1998) Kluwer Law International: London, Boston, pg. 168)

[86] OECD-BEPS, pg 4

[87] UN Department of Economics & Social Affairs (2013), *United Nations Practical Manual on Transfer Pricing for Developing Countries* (ST/ESA/347), available at http://www.itatonline.org/info/wp-content/files/United_Nations_Transfer_Pricing_Manual.pdf.

[88] Brandstetter, pg 10. See also the Commentary on the 2003 OECD Income and Capital Model Convention, at m.no.2 of the Introduction: "[It is] most desirable to clarify, standardize and guarantee the fiscal situation of taxpayers in each

A treaty is an international agreement (similar to a contract, rather than a legislative Act) between sovereign nations. It sets out rules, rights and obligations that relate to and affect the contracting states' jurisdiction to tax beyond their national borders. The agreement is legally binding on the contracting states and its terms must be performed by them in good faith.[89]

While most tax treaties are bilateral, there are a few multilateral income tax treaties.[90] The Carroll Report produced a draft convention that could be used as the basis for forming a *multilateral convention* on double taxation (the "1933 Draft Convention"). Subsequently, the Fiscal Committee proposed to the League Council the adoption of the 1933 Draft Convention.[91] Such a convention was, according to the committee, to "materially encourage the movement to reduce double taxation *by uniform law* - a method which in important respects is obviously superior to the method of reducing double taxation through the instrumentality of bilateral conventions."[92] The allocation of income arising from a cross-border controlled transaction was dealt with by Article 5 of the Draft Convention, which expressed the ALS as follows:

> When an enterprise of one contracting State has a dominant participation in the management or capital of an enterprise of another contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists [sic], *in their commercial or financial relations*, conditions different from those which would have been made between *independent enterprises*, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, *shall be* entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.

While states were willing to adopt the Draft Convention's approach to income allocation – i.e. the ALS - they were not inclined to do so by entering into a multilateral convention.[93] Accordingly, the Fiscal Committee concluded that "progress is more likely to be achieved by means of bilateral agreements… Governments consider… that bilateral agreements are likely to prove more appropriate."[94] As Lepard notes, the Committee went on to endorse the multinational coordination of the ALS by having states incorporate the standard into their bilateral tax treaties. The Committee believed that "the promulgation of the model convention as the basis for bilateral treaties would 'automatically [create] a uniformity of practice and legislation,' while remaining 'sufficiently

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Member country… through the application by all Member countries of common solutions to identical cases of double taxation."

[89] Article 26, Vienna Convention. See also: Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, pgs 1-2. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html

[90] An example is the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. (Brian Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, pg 2. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html)

[91] Lepard, pg 66

[92] Report to the Council on the Work of the First Session of the Committee, Held in Geneva from October 17h to 26th, 1929, League of Nations Doc. C.516.M.175.1929.II. (1929), reprinted in 4 Joint Committee on Internal Revenue Taxation, Legislative History of United States Tax Conventions ("Conventions Legislative History"). Cited by Lepard, pg 64.

[93] Lepard, pg 68.

[94] Report to the Council on the Fifth Session of the Committee, Held at Geneva from June 12th to 17th, 1935, League of Nations Doc. C.252.M.124.1935.II.A. (1935), reprinted in Conventions Legislative History, at 4249, 4251. Cited by Lepard, pg 68.

elastic to be adapted to the different conditions obtaining in different countries or pairs of countries,' since it could be modified in particular bilateral agreements."[95]

The first bilateral treaty that incorporated the ALS as the basis for allocating income arising from cross-border controlled transactions appears to have been the 1932 treaty between the U.S. and France.[96] The language in this treaty is said to have been "modeled on" s.45 of the American Revenue Act 1928,[97] which was subsequently replaced by s.482 of the IRC. Ever since the adoption of the 1933 Draft Convention, and the ratification of the 1932 U.S.-France treaty, other countries around the world began to incorporate the ALS in their bilateral tax treaties. Today, the ALS can be found in more than 3000 bilateral tax treaties world-wide.[98]

At the present time, the ALP tends to be based on one of several model tax treaties that have been coordinated in the aftermath of the Second World War. These include: the OECD's Model Convention on Income and on Capital, which focuses on treaties between developed countries; the UN's Model Double Taxation Convention between Developed and Developing Countries; and, the US's Model Income Tax Convention. Each of these models contains an Article 9, which deals with associated enterprises and sets out the ALS. As the American Internal Revenue Service ("IRS") noted in its *Notice 88-123,* the OECD, UN, and US Models are essentially the same with respect to Article 9.[99] Considering this widespread adoption of the ALS into bilateral tax treaties, in its 1979 Report the OECD stated that "[m]odern bilateral double taxation conventions between OECD Member States and between OECD Members and other States have accordingly adopted this principle."[100]

What are the effects and implications of a treaty?

Brian J. Arnold explains that "[i]n some States, treaties are self-executing: that is, once the treaty is concluded, it confers rights on the residents of the contracting States. In other States, some

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[95] Lepard, pg 68.
[96] Lepard, pg 69
[97] S.45 stated as follows: "In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses." (Lowell and Briger, 1999 WL 257434, 3)

As explained in the Act's regulations, the purpose of s.45 was "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer .... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." (Reg. 86, § 45, art. 45-1(b) (1935), as cited in: Edward B. Dix. (Fall, 2010), *From general to specific: the arm's-length standard's evolution and its relevancy in determining costs to be shared in cost-sharing agreements*, 64 TAX LAWYER 197, pg 200)
[98] OECD (2014), *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, p.11.
Retrieved from: *http://dx.doi.org/10.1787/9789264219250-en*
[99] U.S. Department of the Treasury, "A Study of Intercompany Pricing" (Oct. 19, 1988), Notice 88-123, 1988-2 CB 458, 475.
[100] OECD 1979 Report, para 3, pg 8-9.

additional action is necessary (for example, the provisions of the treaty must be enacted into domestic law) before benefits under a treaty can be given to residents of the contracting States."[101]

In the US, for example, the Supreme Court of the US explained that "while treaties "may comprise international commitments ... they are not domestic law unless Congress has either enacted implementing statutes or the treaty itself conveys an intention that it be 'self-executing' and is ratified on these terms."[102] Therefore, "the domestic legal status of a ratified treaty thus largely depends on whether judges interpret its provisions as self-executing."[103] "The enforceability of treaties by individual citizens and taxpayers depends on whether or not the treaty is self-executing; individuals in court may enforce only treaties that are self-executing."[104]

As explained in the United Nations Practical Manual on Transfer Pricing ("UN Manual"), "… Article 9 is not 'self-executing' as to domestic application - it does not create a transfer pricing regime in a country where such a regime does not already exist."[105] The Supreme Court of the US explained that "a non-self-executing treaty, by definition, is one that was ratified with the understanding that it is not to have domestic effect of its own force."[106]

"In general, tax treaties apply to all income and capital taxes imposed by the contracting States, including taxes imposed by provincial (state), local, and other subnational governments. In some federal States, however, the central government is constrained by constitutional mandate or established tradition from entering into tax treaties that limit the taxing powers of their subnational governments."[107]

Treaties can have numerous objectives. As Arnold explains, "originally, the focus of tax treaties was almost exclusively on solving the problem of double taxation. Multinational enterprises were facing risks of substantial double taxation, few countries provided unilateral relief for double taxation and treaty networks were just being developed. Treaty solutions to most of the major double tax problems were worked out in the mid-twentieth century, however, and they are now routinely accepted by States when they enter into tax treaties." Yet, as Arnold goes on to explain, "the one major exception is the double tax problem arising from inconsistent applications by countries of the arm's length method for establishing transfer prices in transactions between related persons."

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[101] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, pg 1. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html

[102] *Medellin v. Texas*, 552 U.S. 491, 505, 128 S. Ct. 1346, 1356, 170 L. Ed. 2d 190 (2008)

[103] Milena Sterio, 'Incorporating International Law to Establish Jurisdiction over Piracy Offences: A Comparative Examination of the Laws of the Netherlands, South Korea, Tanzania, India, and Kenya,' in Michael P. Scharf (eds.), *Prosecuting Maitime Piracy: Domestic Solutions to International Crimes* (Cambridge University Press, 2015), pg 77.

[104] Stephen R. Faivre, 'An Imprudent Proposal: The Case Against Restricting the Comparable Uncontrolled Transaction Method for U.S. Transfer Pricing,' *Fed. Law*., June 2011, at 31, 33

[105] UN Department of Economics & Social Affairs (2013), *United Nations Practical Manual on Transfer Pricing for Developing Countries* (ST/ESA/347), para. 1.7.1., p. 21, available at http://www.itatonline.org/info/wp-content/files/United_Nations_Transfer_Pricing_Manual.pdf.

[106] *Medellin v. Texas*, 552 U.S. 491, 128 S. Ct. 1346, 1351, 170 L. Ed. 2d 190 (2008)

[107] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 36, pg 8. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html

Treaties also help prevent "tax evasion and avoidance or double non-taxation," though the terms of the treaty will typically not specifically address this objective.[108] "The exchange of information in the typical tax treaty can be an important tool in combating tax evasion and avoidance and to ensure that taxpayers receive treaty benefits."[109]

There are also ancillary objectives. For example, they help eliminate "discrimination against foreign nationals and non-nationals."[110] "[F]acilitate administrative cooperation between the contracting parties,"[111] to assist with "exchange of information, assistance in the collection of taxes and dispute resolution."[112] And, "provide a mechanism in their treaties – the mutual agreement procedure – for resolving disputes concerning the application of the treaty."[113]

Chrysler Canada Inc. v. Canada[114] provides an example of a case in which a taxpayer relied on its rights, under a tax treaty between Canada and the US, to avoid being subject to double taxation as a result of a transfer pricing adjustment of a cross-border controlled transaction. As Canada's Federal Court ("FC") explained, "Transfer Pricing Transactions give rise to Transfer Pricing Adjustments as permitted under the Treaty,"[115] though the taxpayer is entitled to require the tax authority to provide relief from double taxation, as contemplated by the applicable treaty.[116] The tax authority needs to give the taxpayer notice of the transfer pricing adjustment "within six years of the taxation year. In 2002 and 2004 CRA issued letters to the Applicant regarding proposed Transfer Pricing Adjustments to the income it earned from the Transfer Pricing Transactions for its 1996 – 1998 taxation years (the "Prior Letters"). The Prior Letters indicated that their purpose was to enable the parties to the Transfer Pricing Transactions to avail themselves of rights available under the Treaty. The Applicant did so and notified the Internal Revenue Service ("IRS") of the Prior Letters. Rights available to the Applicant under the Treaty enable the Applicant to avoid the imposition of double taxation on the Transfer Pricing Transactions."[117]

3.2.2.1.2 Domestic legislation

The UN Manual also recognizes that "transfer pricing regimes are creatures of domestic law and each country is required to formulate detailed domestic legislation to implement transfer pricing rules. Many countries have passed such domestic transfer pricing legislation which typically tends

[108] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 46, pg 10. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[109] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 48, pg 11. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[110] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 47, pg 10. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[111] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 47, pg 10. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[112] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 47, pg 10. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[113] Brian J. Arnold, 'An Introduction to tax treaties', UN Primer on Double Tax Treaties, para 48, pg 11. Retrieved from: http://www.un.org/esa/ffd////capacity-development-tax/primer-dtt.html
[114] *Chrysler Canada Inc. v. Canada*, 2008 FC 727 (CanLII)
[115] *Chrysler Canada Inc. v. Canada*, 2008 FC 727 (CanLII), para 12
[116] *Chrysler Canada Inc. v. Canada*, 2008 FC 727 (CanLII), para 14
[117] *Chrysler Canada Inc. v. Canada*, 2008 FC 727 (CanLII), para 14

to limit the application of transfer pricing rules to cross-border related party transactions only."[118] It notes that "[b]y the end of 2012, there were around 100 countries with some form of specific transfer pricing legislation."[119]

Notably, there are variations in how countries have gone about doing so.[120] As noted by the OECD:[121]

> Countries that have adopted transfer pricing legislation based on the arm's length principle follow different legislative drafting approaches. Some countries have adopted very brief language setting out basic principles in "primary legislation" (*i.e.* mainly in the law), often elaborating on those principles in "secondary legislation" (including regulations, circulars, decrees or similar administrative pronouncements). Other countries have adopted more elaborate and extensive language in primary legislation. The choice of a particular drafting approach will depend on the legal system of the country concerned, and in particular on whether it is a civil law or common law system.

3.2.3 The ALS as part of Customary International Law

As Allison Christians explains, "unlike treaty law, customary law emerges not from formal documentation but from state practice, pronouncements made by international bodies, and other informal processes".[122] She goes on to explain that "customary law is characterized by two fundamental elements: states uniformly comply with it…, and they do so out of a sense of legal obligation…"[123]

Recently, Reuven S. Avi-Yonah reiterated the argument that the ALS has become part of Customary International Law, and as such it is binding even in those situations where it has not been formally and expressly incorporated into 'hard-law' instruments such as treaties. In his words:[124]

> Customary international law is accepted by the US as a binding part of international law.[6] In order for customary international law to exist, three elements must be fulfilled: (a) the widespread repetition by States of similar international acts over time (State practice); (b) the requirement that the acts must occur out of a sense of obligation (*opinio juris*); [7] and (c) that the acts are taken by a significant number of States and not rejected by a significant number of States.[8]

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[118] UN Department of Economics & Social Affairs (2013), *United Nations Practical Manual on Transfer Pricing for Developing Countries* (ST/ESA/347), para 1.7.2., p. 21, available at http://www.itatonline.org/info/wp-content/files/United_Nations_Transfer_Pricing_Manual.pdf.

[119] UN Manual, pg 31

[120] OECD (June 2011), Transfer Pricing Legislation – A Suggested Approach, p. 4. Available at http://www.oecd.org/ctp/tax-global/3.%20TP_Legislation_Suggested_Aproach.pdf.

[121] OECD (June 2011), Transfer Pricing Legislation – A Suggested Approach, pg 4

[122] Allison Christians, 'Hard Law, Soft Law, and International Taxation' (Summer 2007) 25(2) *Wisconsin International Law Journal*, fn. 18

[123] *Ibid*, p. 329

[124] Reuven S. Avi-Yonah, *Altera, the Arm's Length Standard, and Customary International Tax Law,* 38 MJILOpinioJuris 1 (2017), http://www.mjilonline.org/altera; Avi-Yonah, Reuven S., 'Tax Competition, Tax Arbitrage, and the International Tax Regime' (2007) 61(4) *Bulletin for International Taxation* 130; Brian Lepard, 'Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study' (1999-2000) 10 *Duke Journal of Comparative & International Law* 43, pgs. 167-175

> In the case of tax law, the first and third elements are relatively easy to prove. There are over 3,000 bilateral tax treaties covering almost every nation on earth, and they all follow similar models (the OECD, UN, and US model treaties). As Ash and Marian have shown recently, about 80% of the words of each tax treaty are identical.[9] Moreover, of all the articles in the treaty, Article 9 (Associated Enterprises), which mandates the ALS, shows the greatest level of identity across treaties.[10]
>
> The harder part is to prove *opinio juris*, i.e., do states follow the treaties even when they are not legally bound to do so (e.g., in a non-treaty case)? I have previously argued that the behavior of the US in certain cases indicates that it believed itself bound by certain international tax norms even when not legally bound by treaty or otherwise.[11] …
>
> *Altera* provides an interesting case study that further shows that at least in the US the ALS is considered binding even in a non-treaty situation, i.e., that it is part of CITL.[13]

3.2.4 Coordination of how to apply the ALS using soft-law instruments

3.2.4.1 The OECD's TPG

The UN Manual goes on to explain that "Article 9 ('Associated Enterprises') … advises the application of the arm's length principle but does not go into the particulars of transfer pricing rules".[125] Similarly, the standard in domestic legislation may not provide such information.[126] Further guidance on the application of the standard is therefore required.

By and large, countries around the world appear to follow the OECD's guidelines, which were first set out in the OECD's 1979 Report and were subsequently and periodically revised in the TP Guidelines of 1995, 2009, and 2010. These guidelines represent the OECD's multinational consensus on how to apply the ALP. As stated in the Commentary on Article 9 of the *United Nations Model Double Taxation Convention*:[127]

> With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been on other than arm's length terms, the Contracting States will follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions *represent internationally agreed principles and the Group of Experts recommends that the Guidelines should be followed for the application of the arm's length principle which underlies the article*.

Importantly, the guidelines are passed with the unanimous consensus of the OECD Council.[128] As noted by Kiyotaka Akasaka, Deputy Secretary-General of the OECD, such "consensus is a powerful instrument when building shared guidelines and recommendations with which all participating countries are expected to comply".[129] In light of this consensus, it is not surprising

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[125] UN, Manual on Transfer Pricing, *supra* note 51, p. 21, para. 1.7.1

[126] *Canada v. GlaxoSmithKline Inc.*, 2012 SCC 52, para. 21

[127] United Nations (2011), Model Double Taxation Convention between Developed and Developing Countries, Page 171 (Paragraph 3). Retrieved from: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

[128] The OECD explains that "decision-making power is vested in the OECD's Council. It is made up of one representative per member country plus a representative of the European Commission... decisions are taken by consensus." (OECD, 'The OECD Brochure' (2008), pages 7-8. Retrieved on May 24, 2008 from http://www.oecd.org/dataoecd/15/33/34011915.pdf, at 11)

[129] K. Akasaka, 'Challenges, Reforms and the OECD' (2004) *OECD Focus*, page 8. Retrieved on March 7 2008 from http://dspace.kiep.go.kr:8080/dspace/retrieve/6797/Documents1.pdf

that the UK's Special Commissioners referred to the guidelines as "the best evidence of international thinking on the topic."[130]

In its recent revision of the guidelines, based on the BEPS project, one of the OECD's stated objectives was to "prevent the existing consensus-based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever."[131] "The BEPS package represents the first substantial renovation of the international tax rules in almost a century. This renovation is necessary not only to tackle BEPS, but also to ensure the sustainability of a consensus-based system aimed at eliminating double taxation."[132]

A notable exception is the U.S., which has been relying instead on its own Treasury Regulations to the Code.[133] Initially, these were regulations on §45 of the Revenue Act of 1928, and currently it is the regulations on §482. Nevertheless, the significance of coordinate has not gone unrecognized in the US. As was acknowledged by Leslie B. Samuels, assistant secretary for tax policy at the U.S. Department of the Treasury, the OECD's TP Guidelines are "so important" because "they represent broad acceptance by all our major trading partners…"[134] Efforts appear to have been taken to coordinate the regulations with that of the OECD.[135] As Lepard notes:[136]

> the US Treasury Department began an international campaign to persuade other countries to adopt similar allocation principles. In a 1965 speech before the Tax Institute of America, Assistant Secretary of the Treasury Stanley Surrey explained why the United States sought worldwide acceptance of its version of the arm's length standard. Emphasizing that "a unilateral approach by the United States, or any country, is not sufficient," and that "the ultimate goal [must be] an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions," assistant Secretary Surrey suggested that the new U.S. section 482 regulations "may prove helpful as a starting point [for the OECD's efforts to establish allocation standards] and as a way of focusing attention on a wide range of issues.

Technical Explanation of Article 9 emphasizes the harmony in which the OECD's Transfer Pricing Guidelines and § 482 were meant to operate: "This article incorporates in the Convention the arm's

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[130] *DSG Retail Ltd and others v. Revenue and Customs Commissioners* [2009] STC (SCD) 397, para 77

[131] OECD-BEPS, pg 3.

[132] OECD, 'BEPS – Frequently Asked Questions,' Retrieved from: http://www.oecd.org/tax/beps/beps-frequentlyaskedquestions.htm

[133] 26 C.F.R. § 1.482–1, Treasury Regulations.

[134] Radaelli, pg 613.

[135] Radaelli identified and traced the coordination game between the regulations and the OECD's guidelines (C.M. Radaelli, 'Game Theory and Institutional Entrepreneurship: Transfer Pricing and the Search for Coordination in International Tax Policy' (1998) 26(4) *Policy Studies Journal* 603, 613-615). In the years following the publication of Radaelli's analysis, the coordination between the TP Guidelines and the US Regulations has become even closer. Most notably, the 2010 version of the TP Guidelines applied a "most appropriate method" principle which is similar to the "best method rule" in the 1994 US Regulations. Also, the OECD abandoned its prior focus on comparing prices, and shifted the focus instead to comparing the arm's length "outcome", which is similar to the US approach of comparing the arm's "result". Consequently, now both the US Regulations and the TP Guidelines do not impose any strict priority of transfer pricing methods, so long as the method used provides the most reliable indication of the arm's length result/outcome.

[136] Lepard, pg 74

length principle reflected in U.S. domestic transfer pricing provision, particularly code section 482."[137]

Notably, as the OECD explains, its "recommendations are not legally binding, but practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation. Thus, Member countries which do not intend to implement a Recommendation usually abstain when it is adopted."[138] Accordingly, with regards to its TP Guidelines, the OECD has stated that these "are soft law legal instruments. They are not legally binding but there is an expectation that they will be implemented accordingly by countries that are part of the consensus."[139]

3.2.4.2 The UN Manual on Transfer Pricing

For developing countries, the UN has produced a Practical Manual on Transfer Pricing ("UN Manual").[140] In producing this manual, "consistency with the OECD Transfer Pricing Guidelines has been sought, as provided for in the Subcommittee's mandate and in accordance with the widespread reliance on those Guidelines by developing as well as developed countries."[141]

4 Mechanisms for resolving transfer pricing disputes

While the mechanisms for resolving transfer pricing disputes are not the focus of this paper, a brief mention of the regime's approach to dispute resolution is necessary in order to more fully understand how countries have approached their level of commitment in this coordination game.

As was already mentioned, unlike the EU's supernational regime which has a ECJ, there is currently no international court with the authority to settle disputes over the application of the ALP, when it is applied as the basis for making a transfer pricing adjustment under domestic tax law. Yet, taxpayers can challenge transfer pricing adjustments by pursuing litigation within the appropriate domestic court system.

If the countries affected and involved [in the cross-border transaction] have entered into a tax treaty, the treaty will typically also provide the taxpayer with the option of pursuing a Mutual Agreement Procedure ("MAP") in order to avoid double taxation. Tax treaties generally provide for a MAP in cases where:

1) the tax payer believes that the actions of one, or both of the contracting states has resulted or will result in "taxation not in accordance with the provisions of the Convention";

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[137] Stephen R. Faivre, 'An Imprudent Proposal: The Case Against Restricting the Comparable Uncontrolled Transaction Method for U.S. Transfer Pricing,' *Fed. Law*., June 2011, at 31, 33

[138] OECD, ''OECD Legal Instruments," Retrieved from: https://www.oecd.org/legal/legal-instruments.htm

[139] OECD, 'BEPS – Frequently Asked Questions,' Retrieved from: http://www.oecd.org/tax/beps/beps-frequentlyaskedquestions.htm

[140] UN Department of Economics and Social Affairs, *United National Practical Manual on Transfer Pricing for Developing Countries*, 2nd Edition (UN New York: 2017), para B.1.3.2, pg 30 . The Manual cautions its users to "consider the level of guidance available in their countries, and determine if further detail is needed." (UN Manual 2017, para B.8.2.8.)

[141] UN Manual 2017, Forward, pg xi

2) there is doubt regarding the "interpretation or application of the Convention"; or
3) where the elimination of double taxation is not otherwise provided for in the Convention.

In Australia, for example, most of Australia's Conventions permit a tax payer to present a case within three years of first receiving notification of the actions giving rise to the taxation not being in accordance with the Convention. The tax payer is then required to make a 'justified' case to the Australian competent authority. In order for a case to be considered 'justified', the Australian competent authority must consider whether the "taxpayer has reasonable ground upon which to seek competent authority consideration."[142] If the objective appears to be justified and the competent authority is unable to arrive at a satisfactory solution itself, then Article 25, of the 2014 OECD Model Tax Convention states that the competent authority "shall endeavour… to resolve the case by mutual agreement with the competent authority of the other Contracting State." This means that competent authorities are only obliged to use their best endeavours to come to an agreement. However, they are not required to reach an agreement.[143]

Herein lies the biggest risk of the MAP. Competent authorities are only obliged to use their "best endeavours" to come to an agreement – they are not mandated to reach an agreement. If no arbitration clause exists, the taxpayer has no alternative but to seek resolution through litigation with each Contracting State. Leaving the tax payer open to not only an expensive, but drawn out litigation process, but the real possibility they may still be required to pay tax to each Contracting State.

The key advantage of the MAP is that it provides a dispute resolution channel between organisations that are investing in or doing business internationally. It has the potential to eliminate the need for lengthy litigation proceedings and discussions are undertaken by the competent authority of each Contracting State, who are experienced professionals and familiar with MAP procedures. It generally provides a bilateral resolution (not just domestic recourse) and if a taxpayer is not satisfied with the proposed agreement they may be entitled to withdraw from the MAP process and pursue other domestic mechanisms (provided they have taken appropriate steps to protect their rights under applicable domestic law).

The most well-known case of a MAP gone wrong is the 2006 GlaxoSmithKlein ('GSK') Holdings case - which resulted in the largest tax settlement payment in the history of the United States ('U.S.') Internal Revenue Service.[144] GSK Holdings were a U.S. based affiliate, of a United Kingdom ('U.K.') based parent company. With the US and the UK government unable to agree on a MAP resolution, GSK were forced to go to litigation with the U.S Internal Revenue Service.[145] According to the IRS, the primary value of income earned by GSK Holdings was derived in the

[142] ATO, 2002, 'Taxation Ruling: Income tax: international transfer pricing transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure', Australian Taxation Office, TR 2000/16, downloaded 8 August 2017

[143] OECD, 2007, '*Manual On Effective Mutual Agreement Procedures (MEMAP) – February 2007 version',* Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, downloaded 8 August 2017

[144] Shaw, H, 2006, '*GlaxoSmithKline Settles Largest IRS Tax Dispute',* CFO.com, retrieved 12 August 2017, http://ww2.cfo.com/accounting-tax/2006/09/glaxosmithkline-settles-largest-irs-tax-dispute/

[145] Vollebregt H, Thomas, R & Pieschel, W, 2011, 'Arbitration Under the New Japan-Netherlands Tax Treaty', *Bulletin for International Taxation,* April/May 2011, pp. 223-226, downloaded 21 August 2017

U.S. rather than in the U.K. The IRS found that the rate for marketing services charged by GSK Holdings to its UK parent company was too low. After over a decade in litigation, GSK agreed to settle and pay the U.S. IRS $3.4 billion.[146]

With over 3000 bilateral tax treaties in existence, each varying differently due to either the long period of time in which they had been negotiated or the specificities of economic relations between the two contracting states – opportunities for exploitation by tax payers were created. With an agreed political objective to end BEPS, the OECD identified the need to develop a mechanism that could be implemented to ensure issues could be swiftly addressed. Action 15, which is called for by the BEPS project, aimed "to streamline the implementation of the tax treaty-related BEPS measures" through development of a *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*,[147] also referred to as the Multilateral Instrument ('MLI').[148]

In May 2015, an Adhoc Group of interested countries began working on the MLI. Participation was voluntary, with all countries on equal footing. The aim was to develop an MLI that would have the same effect as a "simultaneous renegotiation of thousands of bilateral tax treaties" (OECD, 2015, p. 9). Following completion of negotiations, the OECD MLI was signed by over 70 jurisdictions on 7 June 2017. Marking a new chapter in the history of tax treaties, the OECD Secretary-General, Angel Gurria, stated that the MLI would not only save signatories the burden of re-negotiating tax treaties, but would result in "more certainty and predictability for businesses, and a better functioning international tax system for the benefit of our citizens."[149]

The MLI further enhanced the dispute resolution mechanisms identified in the OECD BEPS Action Plan. Aiming to strengthen the efficiency and effectiveness of the MAP process, Action 14 introduced the establishment of an independent and robust peer-based monitoring system to ensure the effective and timely resolution of disputes through the MAP (OECD, 2015). With countries agreeing to report regularly to the G20 through the Committee on Fiscal Affairs and commit to minimum standards to ensure:

- all eligible tax payers can access the MAP;
- administrative processes are implemented that promote the resolution of disputes; and
- that MAPs are implemented not only in good faith, but are resolved in a timely manner.

In addition, to provide further tax payer certainty, 26 jurisdictions, including Australia, committed to providing *mandatory binding MAP arbitration* to ensure that cases are resolved. Under the new mandatory binding provision a cut-off date will be established for each case. If the case is not

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[146] PwC, 2015, '*International Transfer Pricing 2015/16',* PricewaterhouseCoopers, Belgium, downloaded 8 August 2017, http://www.pwc.com/internationaltp

[147] OECD, 2017, '*Multilateral Instrument Information Brochure - Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting',* OECD Publishing, retrieved 1 September 2017, http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf

[148] http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm

[149] OECD, 2017, '*Multilateral Instrument Information Brochure - Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting',* OECD Publishing, retrieved 1 September 2017, http://www.oecd.org/tax/treaties/multilateral-instrument-BEPS-tax-treaty-information-brochure.pdf

resolved within the defined period, then the case will be referred to an arbitration panel "composed of three independent individual members."[150]

Each Contracting State is required to submit a proposed resolution, for each issue under review, with the arbitration panel selecting one of the proposed resolutions as its final offer. The arbitration decision is final and binding. However, circumstances exist where the decision may be annulled, including but not limited to the tax payer not accepting the result or the competent authorities agreeing on a different resolution on all unresolved issues within three months.[151]

5 The article's objectives going forward: the research questions to be addressed

5.1 Objective 1: model, describe and explain the regime and its needs using game theory

If described and analyzed from the perspective of rational choice theory, in choosing how to coordinate their collective action, countries have been willing to give a high level of commitment to the ALP by incorporating it into binding 'hard-law' instruments, which includes treaties and domestic tax legislations. Arguably, the principle has also become part of Customary International Law, which would make it binding even in non-treaty situations. The widespread adoption of the principle in these ways has facilitated the legal convergence and international acceptance of the principle.

As for the mechanisms for transfer pricing dispute resolution, litigation remains within the authority of domestic courts, rather then an international court. This facilitates the concern with preserving tax sovereignty by having domestic courts, rather then an international court, determine the interpretation and application of the ALP, as required by domestic law. As for the alternative option of pursuing a MAP to prevent double taxation, initially countries have demonstrated limited will to be bound by such a procedure unless they could reach a mutual agreement. Yet, the current adoption of a mandatory binding arbitration procedure in the MLI signals a significant shift in countries' level of commitment to resolving disputes in this regime. Notably, this reveals and exemplifies how the choices of the players in legal regimes can change over time as they reassess their objectives and needs.

Thus far, the article has set out a foundation for analyzing the international transfer pricing regime using game theory models, as may be relevant and helpful. It identified that countries have been sharing common objectives that required them to undertake collective action through coordination (i.e. their objective of regulating transfer prices in order to address the BEPS problem, as well as the need to do so in a way that will minimize the risk of double taxation, which in turn requires a

[150] Ernst & Young, 2016, '*Global Tax Alert, Mandatory Binding Treaty Arbitration under OECD's Multilateral Instrument',* EYGM Limited, New York, accessed 11 September 2017, pg 2. Available at: http://www.ey.com/Publication/vwLUAssets/Mandatory_Binding_Treaty_Arbitration_under_OECDs_Multilateral_Instrument/$FILE/2016G_04148-161Gbl_Mandatory%20Binding%20Treaty%20Arbitration%20under%20OECD%E2%80%99s%20MLI.pdf

[151] Ernst & Young, 2016, '*Global Tax Alert, Mandatory Binding Treaty Arbitration under OECD's Multilateral Instrument',* EYGM Limited, New York, accessed 11 September 2017, pg 2. Available at: http://www.ey.com/Publication/vwLUAssets/Mandatory_Binding_Treaty_Arbitration_under_OECDs_Multilateral_Instrument/$FILE/2016G_04148-161Gbl_Mandatory%20Binding%20Treaty%20Arbitration%20under%20OECD%E2%80%99s%20MLI.pdf

coordinated approach to regulation). It was also identified that countries have chosen to coordinate using a pluralistic legal system, which includes the use of consensus-based 'soft-law' agreements (i.e. the OECD's TPG).

The next objective is to identify a model that can help describe the nature of this soft-law agreement, and can help explain what such an agreement requires. It will be explained that the TPG can be described as a 'relational agreement' (also referred to as 'relational contract'). Using insights game theory, it will be explained that such agreements, while not legally enforceable, can have a valuable role for the purposes of coordination. Based on the circumstances and needs of the coordination game, a relational agreement can provide benefits and opportunities which are not available when using traditional binding and legally enforceable agreements. Yet, as revealed by insights from game theory, to be effective relational agreements also require and depend on having parties share the burden of self-enforcing such agreements. Otherwise, their shared objectives, which are to be accomplished through their agreement, may be undermined by defecting courts.

5.2 Objective 2: distilling lessons about self-enforcement from Australia's transfer pricing regime

Having described the TPG as a 'relational agreement', and identified the necessary role of self-enforcement mechanism(s) when using such an agreement for the purposes of coordination in a legal regime, the article will proceed to provide an example of the necessary role of self-enforcement by making reference to experiences in the Australian transfer pricing regime. The *SNF* case[152] will be referred to as an example of the risk that domestic, unless they are required to do so by binding 'hard-law', may choose not to consider and follow the TPG since there is no legal requirement for doing so. The court's analysis in this case revealed an Achilles' Heel of this type of agreement, and it prompted the Australian government to respond by explicitly requiring consideration of the guidelines for the purposes of applying the domestic transfer pricing rules, with the aim of applying the rules in a manner that could best achieve consistency with the OECD's recommendations. This legislative requirement essentially made it possible for the Australian government to self-enforce the application of the TPG, to which it agreed to as a member of the OECD. The effectiveness of this self-enforcement measure proved itself in the recent *Chevron* case,[153] where the court referred to and considered the relevant parts of the OECD's TPG without question.

5.3 Objective 3: exemplify the ongoing (potential relevance) of sharing this burden of self-regulation: applying the lessons to Canada

The Australian experience reveals the risk that domestic courts may choose to defect from the application of a 'relational agreement' such as the OECD's TPG, unless necessary and effective self-enforcement mechanisms exist to prevent defection. It is important to show that this risk was not necessarily confined to the Australian experience, and could potentially also arise within other transfer pricing jurisdictions. The third objective, therefore, is to show that the same risk currently exists in Canada, and may potentially also arise in other countries. Focusing on Canada, where the

[152] *SNF (AUSTRALIA) PTY LTD v FC of T*, Federal Court of Australia, 25 June 2010, [2010] FCA 635
[153] *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation* [2017] FCAFC 62

risk actually exists, the article will review recent relevant case law, and call on the Canadian Government to take necessary legislative measures to achieve self-reinforcement, similar to those taken by Australia.

5.4 Objective 4: assessing the prospects of legislative reform

The call for legislative reform, in order to implement necessary measures for self-enforcement, require acknowledging and considering a key hurdle to such reform: the concern over having to relinquish tax sovereignty. The fourth objective, therefore, is to address and assess this concern. The analysis will reflect on the international transfer pricing regime's evolution thus far, focusing on two issues as examples: (i) the regime's evolving approach to the coordinated arm's length standard, as well as (ii) the regime's evolving approach to dispute resolution. The analysis will call on regulators to learn from these noted experiences of the international transfer pricing regime, and to properly address the issue of self-enforcement in order to pre-empt regime failures. This necessary learning regulator approach will be exemplified by recent legislative reforms in Hong Kong SAR and in India, where similar issues where identified and addressed by regulators.