CHAPTER X

TAX POLICY

In designing a tax system, a Government needs to ensure that it maintains its revenue base while providing a favourable climate for business and investment. That principle also applies to international investment and the taxation of transnational corporations (TNCs), which is the subject of the present chapter. The adoption of different tax systems by Governments may result in the imposition of conflicting tax assessments on TNCs for the same transactions. Ultimately, it can result in double taxation. Both Governments and enterprises therefore have a common interest in devising workable solutions to these issues.

Because of the growth of foreign direct investment (FDI) and the activities of TNCs, an increasing number of transactions in the value-added chain takes place within groups of associated companies in different countries. This raises complex questions about *where* taxable income is *earned* by groups of associated enterprises, *how* it is *distributed* among entities located in different countries, and *how* the revenue from taxes imposed on such income is *allocated* among countries.

Those problems are not new, but they matter more and they have become more complex. As long as intra-firm transactions took place in a domestic context only, they could be handled by the same tax authority. When firms acquired control of value-adding activities abroad, more than one tax jurisdiction was affected. But as long as foreign affiliates were stand-alone facilities, it was still relatively simple to judge the tax liability of a TNC and where it arose.

The picture is becoming considerably more complicated with the rise of integrated international production and the growing share of international activities in the total output of firms. The stand-alone nature of foreign affiliates is giving way to an intricate division of labour where a foreign affiliate might not be viable on its own, precisely because it is a specialized unit in a larger transnational system. In addition, linkages are becoming stronger not only between parents and foreign affiliates, but also among affiliates, and the range of linkages has expanded significantly to include various service functions (including research and development).

All these changes make it increasingly difficult to apply the traditional methods of determining where income has been generated and how it should be allocated among the various parts of a corporate system. As in any team effort, the precise contribution of each member is often hard to pin down.

A. Problems of allocating business income

1. The traditional approach

The development of conventional approaches, standards and methods to deal with the international allocation of business income (both by individual States and in international model conventions) began in the 1920s (Langbein, 1986). Since then, successive model conventions for the avoidance of double taxation of income and capital have embodied the conventional approach (United Nations, 1979). At present, the conventions most followed by States are the United Nations Model Double Taxation Convention Between Developed and Developing Countries of 1979 (United Nations, 1980) and the OECD Model Tax Convention on Income and Capital, revised in 1992 (OECD, 1992b). Model conventions deal with the allocation of all types of income[1] and, more generally, with the question of the jurisdictional rights of States to tax (a) income originating within their territories (source or *situs* income) and (b) income of corporations domiciled within their territorial jurisdiction (residence income). The State of residence is generally considered to have jurisdiction to tax the world-wide business income of resident corporations; the source State is normally allowed to tax investment income and income from business conducted in that State through a permanent establishment (e.g., a branch). Consequently, on the basis of the residence principle, the business profits of a foreign affiliate are taxed by the State in which that affiliate is resident (e.g., has its main place of effective management), while, on the basis of the source principle, the profits of a foreign branch are taxed by the country where the branch is located.

In both cases, the conventional approach has been the same: to treat the parent firm and its foreign affiliates or branches as separate and independent enterprises. Accordingly, when a TNC carries out business through a foreign affiliate or branch, the profits attributed to that affiliate or branch are those that it might be expected to make if it were a separate enterprise engaged in the same or similar activities under similar conditions and dealing with the parent on a wholly independent basis. In determining the net taxable profits of such a foreign affiliate or branch, expenses incurred for its benefit (wherever they arise) are frequently allowed as deductions.[2] In the case of a branch, in so far as it has been customary for States to determine its attributable profits by apportioning the total profits of the enterprise, the model conventions uphold that practice, provided that the results are consistent with the overall arm's-length approach.[3]

The arm's-length standard was applied to transactions between related or associated enterprises: for tax purposes, they were to be treated in the same way as similar transactions between independent parties.[4] Indeed, that standard was generally considered to be appropriate for determining the allocation of taxable income for any transaction involving related or unrelated parties (Langbein, 1986; United Nations, 1979; OECD, 1979, 1984, 1992b).

This approach was complemented by measures to protect a corporation from being taxed twice for the same income. This could arise when, for example, an allocation of income made by a TNC or by the tax authority in one country was not recognized for foreign tax purposes. Governments therefore concluded bilateral treaties for the avoidance of double taxation. Those treaties were intended to balance the resulting distribution of revenue between the source country and the residence country. They prescribe common definitions and standards, as well as foreign tax credits, withholding taxes on investment income (i.e., dividends, interest, royalties), tax exemptions, tax sparing and other adjustments. They also provide mutual agreement procedures for resolving discrepancies between tax authorities (see below).

All these standards were introduced at a time when cross-border trade between unrelated parties was the main form of international economic activity, and TNCs were hierarchical organizations firmly rooted in particular countries. The standards were devised for a classic organizational and operational structure and strategy used by TNCs, in which a single parent controlled some largely autonomous foreign affiliates in two or more countries. Most of the elements of the value-added chain of its output were the responsibility of the stand-alone affiliate. For tax purposes, those activities would normally be treated as its production costs, which could be deducted from gross earnings to arrive at its income-tax base.

2. Methods for allocating income under the arm's-length standard[5]

In practice, units of the same TNC have more flexibility than their independent counterparts to enter into arrangements that differ from those that would have prevailed between independent parties. They share a common interest, are part of a common governance structure, and their arrangements may be changed according to the overall strategy of the TNC. As a result, tax authorities have had to develop some tests to establish whether related-party transactions conform with arm's-length standards.

One obvious test is to compare transactions between related parties with similar transactions between unrelated parties. Where direct comparisons are not feasible, other tests were developed (OECD, 1979):[6]

- The *resale price method.* This can be useful for transactions that do not involve substantial value added. The costs and appropriate profit margins are subtracted from the final selling price to arrive at the appropriate allocation of income.
- The *cost plus method.* This is favoured for certain assembly or other value-added production. An appropriate profit margin is added to the initial cost of the goods and services involved.

In addition, a method has been developed known as "*safe harbour*". This is appropriate in situations where the use of a range of arm's-length prices is indicated. It permits tax authorities to establish in advance a methodology for determining a range of profits and costs that would be considered within acceptable arm's-length limits. They then agree to accept allocations made by the taxpayer which fall within the set range. That method can significantly reduce administrative burdens and can give the corporation a higher degree of predictability about its tax liability.[7]

(a) Transfer-of-technology transactions

In principle, the arm's-length standard is applied to transactions involving tangibles, intangibles and services, and the methods described above to varying degrees might be used for all three types. However, those transactions involving a transfer of technology—patents, know-how, industrial designs, trade marks, copyrights etc.—have presented particular difficulties (OECD, 1979, ch. III). They are often the result of research-and-development activities undertaken by one, some or all of the associated corporations within a group, in a process that may require heavy spending over a long period, with uncertain results and considerable risks. If and when research-and-development projects become commercially profitable, there are various ways in which a TNC may seek to recover those costs.

One way is to make the technology available to related parties by intra-firm licensing arrangements. The research-and-development costs of producing an intangible asset can then be offset against the profits of making the patent or know-how available. For tax purposes, these transactions are usually treated in the same way as similar transactions between independent enterprises operating at arm's length. To allow a deduction, the tax authorities normally require that the transaction confers a real benefit to the paying company. They may accept the payment of a fee or royalty based on the output, sales or profits (or similar variables) of the user, provided such arrangements are usual among independent parties. Sometimes a TNC might want to include a technology charge in the price of the sale of unfinished products. In those cases, if it can be assumed that a payment for an unfinished product includes a licensing charge, additional payments for royalties would normally be disallowed by the licensee's jurisdiction. In arriving at the appropriate allocation of costs/profits, the tax authorities will take various factors and special circumstances into account, such as the nature of the patent and the length of time it is likely to maintain its value.

Another form of financing research and development is for the parent TNC to make cost-contribution arrangements with its foreign affiliates. In some cases, the members of the group undertake to share the actual costs and the risks involved. In return, each is entitled to a share of any results. In another type of arrangement, the participants simply pay a fee, the costs are borne by the enterprise doing the research work, and the results are made available to all the contributors. The fees they pay might be related to sales turnover, or to the use of the product developed. Following observations from the OECD (OECD, 1979, ch. III), some countries (e.g., Canada and the United States—see Tang, 1993) have adopted special rules for cost-sharing arrangements. Under certain conditions, enterprises involved in these arrangements are allowed to deduct the actual costs of research and development incurred. However, this approach requires the tax authorities to ensure that the party seeking the deduction has a real interest in, and potential benefit from, the results of the effort.

(b) Payments for intra-firm services

Additional difficulties arise in determining the value and allocation of costs for certain services performed within a group of companies for the benefit of the group as a whole. In some TNCs, technical services are provided to individual companies in connection with new processes or products, or the improvement of existing ones. In others, administrative services might be provided in connection with employment, training, payroll, accounting, auditing, sales control, cash management etc.. In addition, services relating to the role of the parent company as a shareholder, such as annual meetings, distribution of dividends, annual reports and so on, are typically performed by the parent company.

For certain types of services, members of a TNC would normally be charged a fee. The tax authorities would usually agree, provided a real benefit accrues to the paying company. The generally accepted standard is familiar: that prices for services performed between related parties should be those that would be paid between independent companies acting at arm's length (United Nations, 1979; OECD, 1979, 1984). When using cost methods, the arm's-length charge usually includes the direct cost to the supplier of the services, and at least a part of the indirect costs. In certain cases, a profit element may be added. But if the services rendered are an integral part of the business activity of either the supplier or the recipient, the arm's-length charge typically includes a profit element.[8] Services are normally considered an integral part of a firm's business activity if, for example, it performs similar services for unrelated parties, or the provider is peculiarly capable of supplying the services and they are a principal element in the operations of the recipient.

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In deciding how to allocate business income in transactions between associated enterprises, most countries use the arm's-length standard, although not all have developed it fully in statutory provisions. The most broadly used model conventions on income allocation also use the arm's-length standard, but do not endorse any particular method for achieving it. However, they may accept the use of a fractional apportionment method for expenses allocation[9] or, generally, if it is the "customary" method, in the context of the permanent establishment provisions.

As regards tax administration practice, "rectifications" are often made to the strict application of methods based on comparables, particularly when arm's-length comparators are not available. These rectifications often resort to apportionment methods, and they may be supplemented by any other method that produces acceptable results.[10] Case law [11] from some countries, where the arm's-length principle has been formally adopted, also tends to deviate from these regulations by relaxing the conditions imposed on the use of comparable uncontrolled transactions methods and/or using alternative methods, such as the profit split (see below).

Lastly, the tax regulations themselves are increasingly embracing *ad hoc* approaches to the allocation of income. This indicates how difficult it is to apply the traditional comparable methods (OECD, 1979). In broad terms, the tax authorities favour a separate-enterprises approach when comparable prices are available; otherwise they tend to use other methods, including apportionment, that look at two or more companies in the TNC system as an economic unit, at least as a cross-check to ensure that the comparable methods have produced the arm's length results.

The allocation of costs and profits between related parties across borders is an area particularly prone to double taxation. Model conventions and bilateral treaties provide that tax authorities make corresponding adjustments to correct their discrepancies. To resolve any potential disagreements between tax authorities relating to these adjustments, the conventions and the treaties have devised the "mutual agreement procedure" to help tax authorities reach satisfactory solutions.[12] Some of these aspects are further discussed in the next sections.

B. Income allocation in an integrated international production system

As corporate activities become more internationally integrated, some of the traditional approaches to taxing TNC profits become increasingly inadequate. It is harder to find comparable transactions taking place between unrelated parties, because a TNC's transactions are becoming more and more integrated. Similarly, when the transactions to be compared take place at different stages in the chain of production, or the volume of the transaction are drastically different, comparability with third-party transactions is seldom satisfactory.

Even where there is an open market for the products and services in question, factors such as the different locations where production takes place may influence the cost-profit ratio. Some activities might be more profitable in some countries than in others, because, for example, they are growing rapidly, whereas elsewhere they are mature; some industries may enjoy monopolistic or oligopolistic power in some countries, but are subject to open competition in others. Government interventions, in the form of subsidies, exchange controls, wage controls etc. will also affect profits and costs. In short, in an internationally integrated production network, it is very difficult to find true comparability.

Under those circumstances, the cost-plus method might be the most appropriate. However, even it must take account of some indirect costs that are not directly attributable to a particular transaction, but are part of intra-group activities. These, too, are increasingly difficult to allocate under conditions of integrated international production.

If it is hard to make all these judgements for the production of goods and services, the same is true for the allocation of research-and-development activities within TNC networks. Indeed, the difficulties are growing, because there is a trend towards decentralizing research and development while, at the same time, integrating it across affiliates and countries (chapter III). It is therefore far from certain which unit of the network has contributed what to the production of an intangible asset. Here again, the efforts of the group as a whole are more significant than any individual contributions. Under those conditions, for the costs of research and development to be allocated fairly, an additional test might be needed. It would look at the overall strategy of a TNC system rather than at individual transactions, and perhaps average some of the calculations in relation to the overall profile of the network.[13]

More and more TNCs are now providing certain functions, such as advisory, research and development, legal, accounting, financial management, and data-processing services, from one or a few international centres for the rest of the group. In other words, functions traditionally performed by the parent company can now be decentralized and spread over several countries. Thus, in order to reduce costs, a TNC might locate its data-processing activities in one country, its accounting in another, training for managers in a third, and group cash management in a fourth. In those circumstances, the challenge for corporate executives and tax authorities is how to value those services (which, as discussed in chapter V, account for a substantial share of a firm's value-added), and how to allocate the costs across countries. This is all the more difficult since the practice differs widely among groups of companies depending on the circumstances, structures and strategies of each group.

Those difficulties are compounded by the fact that associated enterprises may charge a single price for several benefits that are normally treated differently for tax purposes. In the case of the licensing of patents or know-how, for example, tax authorities may require profit charges reflecting fair market value; whereas a related-party service transaction might require only a cost charge. It is very hard to get adequate information and documentation on these issues from different countries. The risk of double taxation also tends to increase under conditions of integrated international production.

C. Alternative methods for dealing with the allocation of income

Although the traditional arm's-length standard remains the principal test in use, others are being used or explored which may be better suited to allocating profits in conditions of integrated international production, or may complement the traditional methods to ensure that they produce the arm's-length result.

1. Mutual agreement procedure

This method is not new; it was originally designed to avoid the risk of double taxation under double-taxation treaties. It provides a mechanism for tax authorities in two or more countries to discuss their adjustments and correct discrepancies. Since allocations of profits between associate enterprises under complex corporate strategies are likely to be adjusted by tax authorities, "mutual agreement procedures" have become increasingly important. Despite the obvious advantages of this mechanism over more formal arbitral or judicial procedures, it does have weaknesses. In particular, it compels the national tax authorities to discuss and negotiate with each other, but not to reach an agreement. However, in a growing number of instances, this mutual agreement procedure includes arbitration of tax disputes between competent authorities. For example, the members of the European Community agreed in 1990 to a convention that provides for binding arbitration in connection with the adjustment of profits of associated enterprises;[14] the same applies for the treaty concluded in 1989 between Germany and the United States.[15] Thus, there are possibilities for improving and adapting this established mechanism to the new realities (Langbein, 1986; Eden, 1985; Wickham and Kerester, 1992).

2. Advance pricing agreements

Another avenue explored in recent years is the possibility for a TNC to obtain advance agreement from the tax authorities on the methodology for allocating its profits. The agreement may be limited to specific affiliates and specific transactions. This is a significant departure from usual tax practice in most States, where such matters have normally been dealt with only in the framework of government audits, which may take place several years after a transaction has occurred. Some countries (e.g., Japan, the Netherlands, the United States) have legitimized advance pricing agreements in recent legislation or administrative practice, and encourage the use of such agreements.[16] To achieve consistency and avoid conflicting adjustments, it would be preferable, of course, that all tax jurisdictions concerned participate in the agreement. Critics of this approach (e.g., Wickham and Kerester, 1992) have argued that the up-front administrative costs for tax authorities are high and that they are affordable only for a few countries and for medium-to-larger TNCs.

For TNCs themselves, advance pricing agreements do have some disadvantages too. They require the firm to submit to an in-depth government review of their allocation policies (which foregoes, at least for smaller companies, the possibility that the Government might not examine those policies for a given year). They carry the risk that the methodology accepted under an agreement might adversely affect earlier audits. And they do involve considerable up-front costs. But this system also has certain advantages—at least for medium to large TNCs, which are anyway already being audited on an annual basis. These include the prospect of obtaining certainty of tax results in advance of transactions; minimizing the risk of double taxation owing to inconsistent positions taken by the countries in which the related parties are located; the ability to use the methodology developed in the advance pricing agreement as a basis for resolving open years; the reduced need for a tax reserve for government audits of profit-allocation practices; and the saving of time and expense (which could be considerable) that might otherwise have to be incurred to defend those practices.

The use of advance-pricing agreements can be helpful for both business and Government. However, given the large number of TNCs and the much larger number of goods and services involved, it is questionable whether that approach can become the predominant method used to solve allocation issues in the years to come.

3. Methods for allocating central management and services costs

For TNCs as much as for tax authorities, it is vital to be able to identify the suppliers and recipients of system-wide services, and to quantify the costs involved. To help in this process, in 1984 the OECD Committee on Fiscal Affairs endorsed a classification of the various types of intra-group services (OECD, 1984):

- activities of the parent firm as a shareholder of the group;
- activities clearly performed for the benefit of one or more affiliates;
- activities benefiting the group as a whole in various degrees.

This classification has become increasingly useful to deal with the new types of TNC structures. It encourages people to start by identifying what functions should be included in each of those categories. Once that is determined, the activities in the third category raise special problems over the allocation of income. For them, several methods are used for charging group members:

- charging directly for individual services;
- apportioning the costs to each of the affiliates (usually on the basis of a cost-benefit ratio);

- contributions in relation to the gross turnover or a similar formula; and
- including a mark-up in the prices of products sold to an affiliate.

In principle, tax authorities prefer the direct method. They consider that it is the easiest for establishing the arm's-length price, and it may reduce the risk of double taxation. For highly integrated groups, however, the indirect methods might be more appropriate. Such groups find it hard to establish how much should be charged, as the inclusion of a profit margin might not always be appropriate.

4. Profit-split method

This method has certain merits, one of which is that it is conceptually simple. Typically, the income of a TNC's various affiliates is shared out in relation to the functions they perform and the risks associated with them. This method is therefore different from the "comparable profits" approach, which looks at the profits of other independent enterprises (OECD, 1993). The difference between the profit-split method and the formulary apportionment methods (which have come to be called "unitary taxation") is that the former tends to focus on a functional analysis unique to the transaction. This said, the profit-split method may occasionally look at the profits of similar enterprises, at least as an additional cross-check.

5. Unitary taxation

One of the approaches to intra-group services that was pursued in 1984 by OECD was for costs to be apportioned according to a predetermined formula. The unitary taxation method (Langbein, 1986; Wickham and Kerester, 1992; Plasschaert, 1992) applies this notion to the allocation of business profits in general.[17] It rests on the assumption that it is too difficult to determine precisely what income is being generated by any particular affiliate and, hence, what should be allocated to it. Instead, a proportion of a TNC's world-wide profits is allocated to the taxing jurisdiction, based on the relationship of assets, payroll and sales (or formulae taking into account several combinations of them) of the foreign affiliate located within that tax jurisdiction to the TNC's world-wide assets, payroll and sales. In effect, this method pierces the corporate veil of foreign affiliates and treats all related affiliates as one corporation. Critics of this method have argued, among other things, that unitary taxation assumes that profit is uniformly related to all stages in an integrated production system and that production costs are the same in different countries; in practice, however, this is not so in the majority of cases. Also, if the operations of a firm in a unitary taxation jurisdiction are more profitable (more efficient) than the rest of its world-wide operations, the affiliate company would be likely to pay less taxes under that method than under a regular arm's-length method; conversely, if the local operations are less profitable (less efficient), the local company is likely to pay more taxes under this method than under the arm's-length method. In effect, unprofitable firms would be more likely to pay more taxes in relation to their real income than profitable ones. To avoid those distortions, a complex analysis would be needed of the different functions of the various associated firms and the different risks and profit opportunities at various different stages of production. Such calculations require complete information about all the activities of the entire TNC. In addition, a number of Governments and TNCs have argued that this approach runs counter to the internationally accepted arm's-length principle and exposes TNCs to double taxation.[18]

D. Some implications for tax policy

The more TNCs engage in integrated related-party transactions, the harder it is for them and the tax authorities to allocate profits and costs among firms in different countries. For tax authorities, the goal is to ensure that the State obtains an appropriate share of the revenues generated by TNC operations. For their part, TNCs want to monitor the performance of their foreign affiliates and avoid double taxation.

Both parties are therefore at one in wanting a "level playing field" for taxation. Both parties, too, want a system that is workable. For TNCs, a system that is stable, clear and simple may be preferable to a cumbersome or unpredictable one, even if their tax burden may occasionally be higher; after all, one helpful influence on international investment is the prospect of being able to predict with some certainty the net return of an investment. At the same time, Governments want to ensure that effective tax rates are competitive internationally, for otherwise this has negative effects on their ability to attract FDI.

With those general observations as a background, the following points deserve more attention:

- *Improving the methods for determining allocation of income and profits in accordance with the "arms's-length" standard.* Where intra-firm transactions can be compared with unrelated ones, the arms's-length standard continues to be a reasonable way to decide how an allocation should be made. The rules should be practical, should take into account how different TNCs actually allocate their profits and be flexible. The full potential of this standard has not yet been exhausted.
- *Alternative methods for the allocation of income.* Although the arm's-length standard remains an acceptable measure for allocating costs and profits across borders, it may suffer from the fact that market characteristics are often unequal. In those cases, or where the standard is difficult to establish because there is no open market for a particular product, it might be better to choose the profit-split method or some pre-agreed formula, including safe harbours. The safe-harbours method, which is still in an experimental stage, can reduce the administrative burden on both TNCs and tax authorities, and it introduces some predictability about tax liability.
- *Use of unitary approaches for allocating income between jurisdictions.* A method that treats the TNC as a unitary enterprise may be more in tune with economic realities than those based on hypothetical market prices. Apportionment methods may gain more acceptance, although, ultimately, such arrangements still need to be tested by reference to benefits obtained and, eventually, the arm's-length price. In any event, for them to be used effectively, they need to gain broad governmental acceptance and to be based on a universal formula. Thus far, the unitary method has been practised only in a very limited way.
- *Use of advance pricing agreements.* These might provide concrete advantages for Governments and TNCs in specific cases, particularly for larger TNCs. To be more effective, agreements should involve

all the tax jurisdictions affected. But the use of advance pricing agreements might not be practical for developing countries because of the potential administrative burden involved in negotiating with corporations on a one-to-one basis; in fact, the large number of small- and medium-size TNCs may preclude this approach from becoming generally accepted. It should not be taken as a substitute for clear and transparent rules.

- *Strengthening international cooperation.* Since TNCs often face the risk of double taxation, internationally coordinated approaches could provide better solutions than unilateral ones. Perhaps more could be done to build on the coordination efforts of such organizations as the United Nations and OECD. The model conventions which they have prepared do provide the basis for tackling the problems associated with the allocation of income in an integrated international production system, but they could be addressed more explicitly. If a multilateral approach is not followed, the risk of multiple (not only double) taxation will increase. There have recently been several calls for multilaterally agreed approaches and standards (for example, in 1990, the United Kingdom invited the United States to seek multilateral, rather than bilateral solutions, to the tax problems facing TNCs—see Wickham and Kerester, 1992, p. 361).

- *Improving mechanisms and procedures for mutual agreement among tax authorities.* This approach is already included in model tax conventions and bilateral treaties. Despite the limitations of mutual agreement, it has been useful in reaching negotiated solutions on an informal basis. It should therefore be encouraged by Governments, which should consider compelling tax authorities to reach agreement, rather than just to negotiate.

- *Improving information and accounting systems.* Too little is known about the way the modern TNC operates. More research and disclosure are needed, and they should be complemented by efforts to improve and standardize accounting practices in different countries.

In summary, it is necessary to adapt the ways of allocating and taxing TNC income to take account of the growing integration of international production. This is certainly a challenging task for policymakers. It is easy for a Government to assume that it is competing against other Governments for a share of TNC tax revenues, but that conclusion is superficial. All Governments would gain if their tax authorities were to pool the information on TNC costs, prices and profits.

Notes

1 This chapter deals with the allocation of business income only. Consequently, other types of investment income, such as dividends, interest, royalties or income from immovable property are not discussed here.

2 See, Article 7 (3) of the United Nations Model Convention (United Nations, 1980), and Article 7 (3) of the OECD Model Convention (OECD, 1992).

3 Article 7 (4) of the United Nations Model Convention (United Nations, 1980), and Article 7 (4) of the OECD Model Convention (OECD, 1992).

4 See, Article 9 (1 and 2), United Nations Model Convention (United Nations, 1980), and Article 9 (1 and 2) OECD Model Convention (OECD, 1992).

5 The various tests and approaches for the determination of the arm's-length standard in related-party transactions were discussed at length in a report prepared by the OECD (OECD, 1979). The report was approved by the Committee on Fiscal Affairs of the OECD in January 1979. The Council of Ministers of the OECD endorsed the report and adopted the recommendation annexed to it on 16 May 1979.

6 The "comparable uncontrolled transactions" method was set down in the 1979 OECD Report as the primary method and has been widely recognized as having that status.

7 This method was not endorsed by the above-mentioned OECD report (1979).

8 It appears that a mark up over the costs is not taken into account in the majority of countries except perhaps in special circumstances (Langbein, 1986).

9 See Article 7 (4) of the United Nations Model Convention (United Nations, 1979) and Article 7 (4) of the OECD Model Convention (OECD, 1992).

10 Such an approach was recommended in the 1979 OECD Report.

11 See, Langbein, 1986, for a review of trends in the United States courts.

12 See Article 25, United Nations Model (United Nations, 1980), and Article 25, OECD Model (OECD, 1992b). For an in-depth discussion of this procedure, see OECD, 1984, pp. 9-40.

13 This approach was already suggested by the 1979 OECD report; see OECD, 1979, p. 62.

14 Section 3 of the "Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises", 33 *Official Journal of the European Communities*, 19, L225/10 (90/463 EC) (of 20 August 1990). Thus far, only four member States of the European Community have signed this Convention.

15 Article (25) of the Treaty for the Avoidance of Double Taxation, Germany, United States, T.I.A.A.S. Treaty Doc. no. 101-10, 101st Congress, 2d. session (5 February 1990).

16 In the Netherlands, for example, the administrative practice for many years has been that tax inspectors are authorized to enter into advance agreements with tax payers about matters of interpretation of both law and factual circumstances. The tax courts have confirmed the binding character of these agreements.

17 For a full discussion of the unitary method, see also, OECD, 1979, 1984, 1993; United Kingdom Inland Revenue and United States Treasury, "Joint report: unitary tax, review of progress towards resolving the problems", December 1991 (London and Washington, 1991), mimeo.

18 See, United Kingdom Inland Revenue and United States Treasury Deparment Joint Report, "Unitary Tax, review of progress towards resolving the problems", December 1991, chap. 5, para. 5.4, which quoted the Appeals Court of California in *Barclays Bank International Ltd. v. Franchise Tax Board*: "every single nation in the industrialised Western world has sent letters to the United States Government protesting the use of worldwide combined reporting by American States and it took note of the United Kingdom's enactment of retaliatory legislation and the cancellation of several trade missions to the United States".