Taxing cross-border intercompany transactions: are financing activities fungible?

Kayis-Kumar, Ann

UNSW Australia

24 July 2015

TAXING MULTINATIONALS: ARE CROSS-BORDER INTERCOMPANY TRANSACTIONS FUNGIBLE?

Ann Kayis-Kumar*

ABSTRACT

The Organisation for Economic Cooperation and Development ('OECD') is currently considering best practice approaches to designing rules to prevent base erosion and profit shifting ('BEPS') by multinational enterprises ('MNEs'). However, the OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of various methods of financing.[1] Yet, an unequal tax treatment can create distortions, which incentivises tax planning behaviour.

Accordingly, this paper aims to improve the tax design of anti-avoidance rules governing MNEs' cross-border intercompany deductions by introducing the concept of the tax-induced cross-border funding bias. To date, the literature has focussed on the debt bias, which arises from the distortion in the tax treatment between debt and equity financing. On the other hand, the funding bias also includes licensing and leasing activities in addition to debt and equity financing. This presents a novel contribution to the literature.

This paper examines the conceptual case for why is might be appropriate and feasible to restrict the tax deductibility of cross-border intercompany interest, dividends, royalties and lease payments given their mobility and fungibility. Specifically, it examines whether it is preferable for MNEs to be subject to economic rent taxation, as is attained through reform proposals such as the Allowance for Corporate Equity ('ACE'), in this context. This presents a novel proposal for taxing cross-border intercompany economic rents which aligns with the main aim of corporate tax harmonisation; namely: to reduce, if not remove, distortions relating to the taxation of cross-border intercompany activities.

* BCom(Finance)/LLB(Hons) (UNSW), PhD (UNSW, in progress), School of Taxation and Business Law, UNSW Australia, Solicitor of the Supreme Court of New South Wales and High Court of Australia, a.kayis@unsw.edu.au. The author is deeply grateful to her PhD supervisors, Professor Neil Warren and Professor John Taylor, for their ongoing support and invaluable insights. This paper first appeared in *Australian Tax Forum* (2015) 30(3) 627–661 and is reprinted with kind permission of the Tax Institute.

[1] It is clear that both the OECD's BEPS project and the thin capitalisation rules' *raisons d'être* is primarily concerned with protecting national tax revenue bases, "*In discussing fixed ratio rules it is important to note that in some cases these tests were also introduced to play a wider tax policy role rather than with a focus on combating base erosion and profit shifting. For example, a number of countries introduced such rules specifically to reduce existing distortions between the tax treatment of debt and equity.*": OECD, '*BEPS Action 4: Interest deductions and other financial payments*' (Public Discussion Draft, 18 December 2014), 47.

1 INTRODUCTION AND BACKGROUND

The advent of the global digital economy has heightened opportunities for aggressive tax planning by multinational enterprises ('MNEs') and has spurred harmful tax competition between governments. This has become a major concern in the academic and political debate on the future of international taxation, exemplified by the OECD's base erosion and profit shifting ('BEPS') project, which aims to tax MNEs "*where economic activities take place and value is created*".[2] However, this raises politically charged issues associated with residence- and source-based taxation, most recently culminating in the UK's implementation of a Diverted Profits Tax ('DPT'), which Picciotto observes is largely indicative of a source-jurisdiction earmarking its claim over US-based MNEs' earnings retained offshore.[3] Similar reforms are currently underway in Australia, with plans to introduce a multinational anti-avoidance law to prevent MNEs from using artificial or contrived arrangements to avoid having a taxable presence in Australia.[4]

Despite criticisms of aggressive tax planning behaviour by MNEs, the philosophical framework of neoliberal capitalism appears to justify this behaviour. The profit motive provides the justification for internalising benefits while externalising costs, which includes the minimisation of taxation.

MNEs can shift expenses to, and income from, source countries to minimise tax payable with relative ease.[5] This is exemplified in the context of cross-border intercompany transactions relating to passive or highly mobile income; specifically, interest, dividends, royalties and lease payments. The complexity and fungibility of these activities presents a particularly pressing issue for small, open economies such as Australia and New Zealand, which are net capital importers of capital. Further, this issue extends to all capital importers in general, rendering large capital importers such as the UK[6] and Canada[7] also within scope of the issue.

An MNE's ability to shift expenses or income may be constrained by transfer pricing and thin capitalisation rules, respectively. However, these rules are inadequate, internationally inconsistent, arbitrary and complex.[8] Further, there is a marked absence of specific guidance on these rules at an international level.[9] A further consideration that has attracted little attention in the international literature is that there is an absence of tax neutrality in the tax treatment of these different types of passive investment income. This absence of neutrality in the tax treatment of cross-border intercompany debt, equity, licensing and leasing expenses – otherwise known as cross-border intra-group financing arrangements relating to passive or highly mobile income – is the focus of this paper.

Grubert and Altshuler observe that "*[i]t is hard to argue that the current system is based on any*

---

[2] OECD, *Explanatory Statement: 2014 Deliverables*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2014), 7.

[3] "*A strengthening of rules on controlled foreign corporations, which may result from another of the BEPS action plan points, would reinforce the tax claims of the MNC's home jurisdiction while also acting as a disincentive to shifting profits from source countries. The DPT seems to be an assertion of a tax claim from the source country side, pre-empting residence country claims that might result from such stronger CFC rules. The intention may be not only to influence the BEPS process but also to pressure the U.S. Congress to reform the U.S. CFC rules in subpart F*": Picciotto S, 'The U.K.'s Diverted Profits Tax: An Admission of Defeat or a Pre-Emptive Strike?' [19 January 2015] *Tax Notes International* 239, 242.

[4] At time of writing this reform was in the consultation phase, see further, Australian Government, Department of the Treasury, *Tax Integrity: Multinational Anti-avoidance Law* (12 May 2015), available at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Tax-Integrity-Law.

[5] "*...the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs.*": see further, OECD, *Public Discussion Draft, BEPS Action 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (including risk, recharacterisation and special measures)*, 1 December 2014 – 6 February 2015, 38. For completeness, residence issues are beyond the scope of this paper.

[6] Picciotto, above n 3.

[7] Inotai A, 'Macroeconomic Impacts of the 2008–09 Crisis in Europe', in: DeBardeleben J and Viju C, *Economic Crisis in Europe: What it Means for the EU and Russia* (Houndmills, Basingstoke, Hampshire; New York: Palgrave Macmillan, 2013), 21-46, 43.

[8] Rules are inadequate, internationally inconsistent, arbitrary and complex: "*The present system raises little revenue, is complicated, creates incentives for aggressive income shifting, and interferes with companies' efficient use of capital as they try to avoid the dividend repatriation tax*": Grubert H and Altshuler R, 'Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax' (2013) 66(3) *National Tax Journal* 671, 672.

[9] Further, the inadequacy of these regimes has been criticised by the OECD, observing that the "*[current] rules provide opportunities to associate more profits with legal constructs and intangible rights and obligations, and to legally shift risk intra-group, with the result of reducing the share of profits associated with substantive operations*": OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), 5.

coherent concept of how an optimal system should be designed".[10] At present, MNEs are clearly at an advantage, with access to global debt and equity markets, various jurisdictions' tax rates and various tax systems in general. These opportunities are nearly impossible to eliminate without full international tax coordination, which is nearly impossible in itself. So, governments and policymakers are increasingly faced with the competing objectives of remaining internationally competitive and encouraging foreign investment while also trying to maintain the integrity of their national tax bases. The *"... spirit of tax coordination runs counter to that of tax competition*",[11] presenting a conflict that is a legitimate struggle from a policy perspective.

Section 2 begins by observing the growing academic consensus that the arm's length principle is outmoded. This section examines the background, issues in practice and hurdles to reform associated with the arm's length standard. In particular, this section highlights that the arm's length principle as fundamentally flawed in design and highly complex in practice. This is supplemented by examining the literature which suggests that this standard considerably complicates the international tax system and can be exploited by MNEs to assist their tax planning activities, yet remains in practice due the political difficulties associated with changing international tax policy.

Section 3 of this paper presents a two-fold extension of the literature, specifically: first, that all cross-border intercompany financial, leasing and licensing activities are fungible and should therefore be treated equally for tax purposes; and second, that the framework utilised for this could be modelled on economic rent taxation. This section also merges these two concepts to present the possibility of implementing a combination of the ACE and Comprehensive Business Income Tax ('CBIT') ('combined ACE-CBIT') in the cross-border context as an alternative method of taxing cross-border intercompany activities.

Finally, section 4 summarises the findings of this paper and includes areas for further research.

2 IS THE ARM'S LENGTH STANDARD PRINCIPLED?

2.1 PRACTICE

Since the 1920s, through the League of Nations, then the United Nations and now the OCED, tax authorities have developed international principles for tax treaties in attempts to address the problem of international tax coordination. Their focus was traditionally centred on the question of avoiding international double taxation and has evolved into designing international principles to prevent both the double taxation and double non-taxation of MNE income, as noted by Sørensen:[12]

> "*The issue of international tax coordination has often been seen mainly as a problem of alleviating double taxation. This problem arises because most countries insist on their right to tax all income originating within their borders as well as all income earned by their residents. However, since some countries have found it in their interest to play the role of "tax havens", the international tax coordination problem may often be one of preventing tax evasion rather than a problem of double taxation*"

The current international tax framework incentivises the location of expenses in higher-tax jurisdictions and income in low- or no-tax jurisdictions as it can result in significant tax minimisation. It is possible to achieve this by interposing subsidiaries in low-tax jurisdictions such as Ireland, The Netherlands or Singapore, and then utilise tax treaties to shift income onto tax havens such as Bermuda or the British Virgin Islands,[13] where profits can be stored for years. This is further exacerbated by the plethora of jurisdictions for MNEs to choose from, many of which are engaged in a 'race to the bottom' on corporate income tax rates. Of course, broader-based corporate taxes with

[10] Grubert and Altshuler, above n 8, 675.
[11] Musgrave PB, 'Combining fiscal sovereignty and coordination: National taxation in a globalising world', in: Kaul I and Conceicao P (eds.), *The New Public Finance: Responding to Global Challenges* (Oxford University Press, 2006), 175.
[12] Sørensen PB, 'Issues in the Theory of International Tax Coordination' (Bank of Finland Discussion Papers No 4/90, 20 February 1990), 7-8.
[13] Somewhat relevantly, one of the British Virgin Islands is reputedly the model for Stevenson's 'Treasure Island'.

lower rates promote efficiency, investment and growth. However, if governments narrow their tax bases to attract the rerouting of flows of capital *through, rather than to,* their economy, then this quickly exits the realm of productive competition and enters the terrain of harmful tax competition. MNEs such as Apple, eBay, Google, Starbucks (to name a few) are reportedly engaging in practices similar to this in order to minimise their worldwide taxation.[14]

In order to counter this behaviour, most advanced countries have implemented transfer pricing rules, thin capitalisation rules and withholding taxes as an important means of trying to defend source-based taxation. For completeness, thin capitalisation rules are limited in scope to debt financing[15] and withholding taxes are vulnerable to bypassing techniques readily available to MNEs.[16] Further, commentators such as Avi-Yonah are sceptical with regards to the future effectiveness of withholding taxes in developed countries.[17] There is an extensive literature on these source-based taxes and the focus of this paper is on transfer pricing as it is most relevant to the issue of taxing intercompany activities.

2.2 ISSUES IN PRACTICE – AND HURDLES TO REFORM

Even though the cross-border issue cannot be isolated from the rest of the tax system,[18] the focus of this paper is the cross-border setting because opportunities for tax planning are most prevalent in this context. MNEs are clearly at an advantage, with access to global debt and equity markets; various jurisdictions' tax rates; and, various tax systems in general. In the absence of international tax coordination, these opportunities are nearly impossible to eliminate. The literature contains ample international empirical evidence that MNEs can, and do, shift their profits to countries with lower statutory tax rates and their expenses to countries with higher statutory tax rates.[19] On the other hand, policymakers are increasingly faced with the competing objectives of remaining internationally competitive and encouraging foreign investment while also trying to maintain the integrity of their national tax bases. This ensures that profit-shifting and debt-shifting remain important constraints on tax policy in open economies.[20]

The advent of capital mobility affords MNEs the advantage of earning cross-border investment income largely free from both host and home country taxation.[21] Simultaneously, the ability of governments to tax said cross-border investment income is severely limited because actions taken unilaterally or bilaterally can be usurped given the interactions among country tax systems.[22]

---

[14] See further: Australian Government, Senate Committee on Corporate Tax Avoidance: available at: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Submissions, which contains 70 submissions from academics, practitioners, businesses and policymakers.

[15] Kayis-Kumar A, 'Thin capitalisation rules: A second-best solution to the cross-border debt bias?' (2015) 30(2) *Australian Tax Forum* (forthcoming).

[16] "*... the withholding-bypassing techniques described about are based on the fact that the source country's tax authorities are faced with partial information*": Herman D, *Taxing Portfolio Income in Global Financial Markets* (Amsterdam, The Netherlands: IBFD, 2002), 175.

[17] Avi-Yonah RS, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113(7) *Harvard Law Review* 1575-1674; see also, Mintz JM and Weichenrieder AJ, *The Indirect Side of Direct Investment: Multinational Company Finance and Taxation* (Cambridge, Massachusetts: MIT Press, 2010), 47; "*While dividend payments are typically subject to withholding taxes, interest payments and income derived from financial derivatives are typically exempt by double taxation treaties from withholding source taxes. This discontinuity is ridiculous given taxpayers' ability to replicate equity investments with the use of hybrid financial derivatives.*": Benshalom I, 'Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method' (2009) 28 *Virginia Tax Review* 619, 642.

[18] Grubert H and Altshuler R, 'Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income', in: Diamond J and Zodrow G (eds.) *Fundamental Tax Reform: Issues, Choices, and Implications* (Cambridge, MA: MIT Press, 2008), 319–321.

[19] de Mooij RA and Ederveen S, 'Corporate tax elasticities: a reader's guide to empirical findings' (2008) 24(4) *Oxford Review of Economic Policy* 680-697; Altshuler R and Grubert H, 'Governments and multinational corporations in the race to the bottom' (2006) 41(5) *Tax Notes International* 459.

[20] Australian Government, Department of the Treasury, 'Australia's Future Tax System: Report to the Treasurer', December 2009 ('Henry Review'), Chapter B.

[21] Avi-Yonah RS, 'Globalization and tax competition: implications for developing countries' [August 2001] 74 *CEPAL Review* 59, 60-61; and references cited therein.

[22] "*Policy prescriptions for any one country are hard to implement. Actions taken by one government alone could result in an inadvertent economic cost to the national economy – "shooting itself in its foot" – which is not very appealing*": Mintz and Weichenrieder, above n 17, 141.

A multilateral solution is essential to preserving the fundamental goals of taxation.[23] This is exemplified by BEPS Action 15, which consists of developing a multilateral instrument to modify bilateral tax treaties.[24] Of course, in the absence of international tax coordination, full tax neutrality cannot be obtained, as tax rates and systems will still differ. Further, even if a multilateral solution is devised, in practice it is likely that revenue base protection concerns will be prioritised over the tax design principle of efficiency.[25]

Nonetheless, from a tax point of view as a second-best solution, it is still possible to encourage neutrality between intercompany financing, licensing and leasing activities. This may be achieved by implementing fundamental reforms designed to equalise the tax treatment of cross-border intercompany financing, licensing and leasing activities.

One of the key benefits of encouraging neutrality between these intercompany activities is that it will likely counteract the current conventions that allow manipulation of income categories. The literature contains a plethora of empirical evidence that MNEs use intercompany financial transactions to avoid taxes by engaging in tax planning strategies to, for example: render futile tax authorities' transactional analysis attempting to trace and allocate financial income and expenses to specific corporate entities within MNEs;[26] manipulate location decisions to minimize taxes;[27] inflate foreign tax credits; and, engage in double-dip deductions.[28]

Given that cross-border intercompany transactions account for more than 60% of global trade in terms of value,[29] and remain largely absent from a group's consolidated accounts (and therefore beyond public scrutiny), there is an urgent imperative to address these tax design issues. As observed by Benshalom: "*Transfer pricing loopholes are of great concern given the growing impact of MNEs on the global economy, the integration of markets and sectors, and the increase in the volume and sophistication of cross-border affiliated transactions.*"[30]

Unsurprisingly, the substantial media and political focus on transfer pricing issues has resulted in it being a major item on the agenda of the latest G-8 and G-20 meetings, and the third pillar of the OECD's BEPS project. In the context of intercompany financing, the OECD is currently considering best practice approaches to designing rules to prevent BEPS using interest,[31] which is pertinent since the literature is currently missing guidance at an international level on these rules.[32]

Transfer pricing issues relating to intercompany transactions are largely governed by the international norm of the arm's length principle,[33] having been incorporated into most jurisdictions' bilateral tax treaties through the OECD Model Tax Convention.[34] However, the arm's length tests have been the

[23] Avi-Yonah, above n 21, 65; Picciotto S, 'The International Crisis of Income Taxation: Combating tax havens, capital flight and corruption' (Paper presented at the Critical Legal Conference, Kent, UK, February 2007), 22.

[24] See further, OECD, *BEPS Action 15: A Mandate for the Development of a Multilateral Insturment on Tax Treaty Measures to Tackle BEPS*, 16 September 2014, available at: http://www.oecd.org/ctp/beps-action-15-mandate-for-development-of-multilateral-instrument.pdf.

[25] Mintz and Weichenrieder, above n 17, 156-7.

[26] Benshalom, above n 17, 633-635.

[27] "*There is significant empirical evidence that multinational groups manipulate intra-group debt, and the location of third-party debt, through interest deductions*": Burnett C, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40, 45.

[28] These can arise from deductible charges for intercompany services including leasing and insurance expenses: Mintz and Weichenrieder, above n 17, 45.

[29] ICC Commission on Taxation and the ICC Committee on Customs and Trade Regulations, 'Transfer pricing and customs value' Policy Statement, Document No. 180/103-6-521, February 2012, 2.

[30] Benshalom, above n 17, 670.

[31] Both interest and financial payments economically equivalent to interest, and other expense incurred in connection with the raising of financing such as arrangement and guarantee fees are being targeted. The OECD is exploring the 'fixed ratio', 'deemed interest', 'interest cap' rules, the global group-wide test and a combined approach: OECD, above n 1. The global group-wide test appears one of the best suited options in this context. Criticism of this option mostly consists of speculation that this will tend to encourage groups to incur external debt which is not otherwise needed and which may further contribute to BEPS.

[32] Steeds P, 'Transfer pricing considerations including guarantees' (Conference paper presented at Second IBA/CIOT Conference, London: Holdon Bars, 12 February 2013.

[33] Eden L, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (Toronto, Canada: University of Toronto Press, 1998), 32.

[34] See further, Article 9 of the OECD Model Tax Convention on Income and on Capital, available at: http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2010_9789264175181-en;jsessionid=4naiu3f38brmg.x-oecd-live-02; see also: Commentary on Article 9, available at: http://www.oecd-ilibrary.org/docserver/download/2310111ec043.pdf?expires=1423358268&id=id&accname=ocid177499&checksum=7737E69983CEAB5DC741337B0640FA48. For completeness, the OECD Model Tax Convention was elaborated on by the OECD Transfer Pricing Guidelines for

subject of much criticism in the academic literature.[35] Interestingly, in the context of the BEPS project, OECD member states have excluded the arm's length principle from being incorporated into a best practice recommendation on debt deductibility.[36] Nonetheless, the arm's length principle[37] remains within the scope of BEPS Actions 8–10.[38] The OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of debt and equity.[39] Yet, it is the decision of the revenue authorities to create a tax-induced debt bias which arguably results in said tax base erosion.[40] Rather than merely addressing the 'symptom' of debt shifting via excessive interest deductions, it is arguably more effective to instead align the tax treatment of cross-border intercompany transactions to eliminate the tax incentive for said tax planning behaviour.

There is a growing body of literature that criticises the arm's length standard as an inadequate solution to the transfer pricing problem in the taxation of MNEs.[41] MNEs unique ability to shift the location of assets, liabilities, profits and expenses by 'paper transactions' renders the location of MNEs' production ambiguous and, at times, unobservable. This impairs the accuracy of the allocation of output and income across countries and geographic regions,[42] and is in stark contrast to observable market transactions which formed the conceptual basis for the arm's length principle.

This divergence may cause confusion on a theoretical level, and is even more problematic on a practical level when policymakers implement and attempt to administrate the concept.

2.2.1 Arm's length is 'a fundamentally flawed fiction'

The international norm of the arm's length principle enables intercompany transfer prices to be set as if related parties were transacting as unrelated parties in a competitive environment.[43] However, this contradicts the modern theory of the firm, which posits that intercompany transactions differ significantly from market transactions[44] and that the "*raison d'être of multinational firms is that the whole is greater than the sum of the parts*".[45] Since an MNE would likely prefer to use intercompany transactions when the transaction costs of market transactions are relatively higher, this presents a fundamental flaw in the arm's length principle.

Multinational Enterprises and Tax Administrations published in 1995 and 2010, available at: http://www.oecd.org/tax/transfer-pricing/transfer-pricing-guidelines.htm.

[35] "*Nonetheless, there is universal agreement that this standard leaves substantial room for tax incentives to affect pricing, as arm's length prices are often difficult to establish ... [and] has become administratively unworkable in its complexity ... [it] rarely provides useful guidance regarding economic value.*": Avi-Yonah RS and Clausing KA, 'A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation', (Law & Economics Working Paper Art 70, University of Michigan Law School, 2007).

[36] "*Countries engaged in this work agreed that fixed ratio rules, group-wide rules and targeted rules should all be given further consideration ... neither arm's length tests nor withholding taxes should be included as options for a best practice recommendation*": OECD, above n 1, 12-14. For completeness, withholding taxes are beyond the scope of this paper, as are CFC rules.

[37] For completeness, the OECD Transfer Pricing Guidelines considered the global formulary apportionment proposal as a possible alternative to the arm's length approach. However this was rejected by both OECD member countries and non-member countries, and is beyond the scope of this paper. See further "*...OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected*": OECD, 'Review of Comparability and of Profit Methods: Revision Of Chapters I-III of the Transfer Pricing Guidelines', 22 July 2010, 10.

[38] "*As the BEPS Action Plan indicates, the main aim of the Transfer Pricing Actions (8-10) is to assure that transfer pricing outcomes are in line with value creation. The BEPS Action Plan also indicates that in order to achieve this aim 'special measures, either within or beyond the arm's length principle, may be required with regard to intangible assets, risk and over-capitalisation'.*": OECD, above n 5, 2.

[39] It is clear that both the OECD's BEPS project and the thin capitalisation rules' *raisons d'être* is primarily concerned with protecting national tax revenue bases: OECD, above n 1, 47.

[40] Hanlon D, 'Thin Capitalisation Legislation and the Australia/United States Double Tax Convention: Can They Work Together?' (2000) 3(1) *Journal of Australian Taxation* 4.

[41] See, for example: Rectenwald G, 'A Proposed Framework For Resolving The Transfer Pricing Problem: Allocating The Tax Base Of Multi-national Entities Based On Real Economic Indicators Of Benefit And Burden' (2102) 23 *Duke Journal Of Comparative & International Law* 425, 427-428.

[42] Kozlow R, 'Multinational enterprises, foreign direct investment and related income flows', Chapter 3, in: UNECE, *The Impact Of Globalization On National Accounts*, (New York and Geneva: UN, 2011) 15-16 and references cited therein.

[43] Raboy DG and Wiggins SN, 'Intangible capital, hedonic pricing, and international transfer prices' (1997) 25(4) *Public Finance Review* 347, 348, and references cited therein at footnote 1.

[44] "*This logic lies at the heart of Coase (1937) and is central to the remaining modern work on the theory of the firm*": Raboy and Wiggins, above n 43, 348, and references cited therein at footnote 2.

[45] Bird RM and Brean DJS, 'The interjurisdictional allocation of income and the unitary taxation debate' (1986) 34(6) *Canadian Tax Journal* 1377, 1388.

Avi-Yonah observes that:[46]

> "*... multinational groups of companies arise precisely in order to avoid the inefficiencies that arise when unrelated companies must transact with one another at arm's length ... the problems with the current system derive not from rules at its periphery, but instead from a fallacy that lies at the system's central core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement*".

There is resounding academic support for this proposition, with commentators such as Rectenwald, Benshalom, Schön and Morse describing the arm's length principle, particularly in the context of intercompany transactions, as: "*hopelessly outmoded and broken*";[47] " *... subject to widespread abuse using transfer pricing*";[48] "*theoretically bankrupt*";[49] "*a sad fiction rather than a fundamental guidepost ... lack the principled underpinning*"; [50] "*commercial rationality' within a firm is clearly not what the arm's-length standard is about*";[51] "*systematically disconnected*";[52] "*simply does not exist in any unrelated 'comparable'*";[53] "*a fallacy*";[54] and, "*broken beyond repair ... the arm's length standard is so inept at dealing with these transactions*".[55]

However, this idea that arm's length pricing is not consistent with the commercial realities of MNEs intercompany transactions is not a recent finding.[56] The seminal work of both Schmalenbach[57] and Hirshleifer[58] over a century ago and over fifty years ago, respectively, showed that the starting point for intercompany optimal transfer pricing should be the 'marginal cost' not the 'market price'.[59]

This assessment in both the German literature and the Anglo literature is part of the business, rather than economic or tax, literature. Even though transfer pricing issues are subject to intensive controversies within these disciplines,[60] this scepticism extends beyond the academic realm into industry. This is exemplified by both national[61] and international[62] accounting standards approaching arm's length pricing in the intercompany context with scepticism.

---

[46] Avi-Yonah RS, Clausing KA and Durst MC, 'Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split' (2009) 9(5) *Florida Tax Review* 497, 503.
[47] Rectenwald, above n 41, 449.
[48] Rectenwald, above n 41, 446: see also; Benshalom, above n 17.
[49] Benshalom I, 'Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions' (2007) 26 *Virginia Tax Review* 631, 641–45: noting the "theoretical deficiency" and "enforcement deficiency" of the arm's length standard; see also: Avi-Yonah, Clausing and Durst, above n 46, 500; Vann RJ, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World' (2010) 2(3) *World Tax Journal* 291.
[50] Morse SC, 'The Transfer Pricing Regs Need a Good Edit' (2013) 40 *Pepperdine Law Review* 1415, 1427–1428.
[51] Schön W, 'Transfer Pricing, the Arm's Length Standard and European Union Law', in: Richelle I, Schön W and Traversa E (eds.) *Allocating Taxing Powers Within the European Union* (2013).
[52] Schön, above n 51, and references cited therein at footnotes 89–91.
[53] Morse, above n 50, 1421 and references cited therein at footnote 34.
[54] Morse, above n 50, 1422; see also, describing "*the fruitless search for source*": Kleinbard ED, 'Stateless Income's Challenge to Tax Policy, Part 2' (2012) [November] *Tax Notes International* 671, 750–52.
[55] Benshalom, above n 17, 628-629.
[56] Schön, above n 51, and references cited therein at footnotes 89–91.
[57] The original text is in the oldest and most prestigious German business journal: Schmalenbach E, 'Über Verrechnungspreise' (1908/09) 3 *Zeitschrift für betriebswirtschaftliche Forschung* 165-185.
[58] "*If the market is imperfectly competitive, or where no market for the transferred commodity exists, the correct procedure is to transfer at marginal cost (given certain simplifying conditions) or at some price between marginal cost and market price in the most general case*": Hirshleifer J, 'On the Economics of Transfer Pricing' (1956) *Journal of Business* 172-184.
[59] Schön, above n 51, and references cited therein at footnotes 89–91.
[60] Schön W, 'Transfer Pricing – Business Incentives, International Taxation and Corporate Law' (Max Planck Institute for Tax Law and Public Finance, Working Paper 2011 – 05, January 2011), 3.
[61] "*Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such terms can be substantiated.*": Australian Government, Australian Accounting Standards Board, AASB 124: Related Party Disclosures (December 2009), 18; available at: http://www.aasb.gov.au/admin/file/content105/c9/AASB124_12-09.pdf.
[62] "*Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.*": Financial Accounting Standards Board of the Financial Accounting Foundation, Statement of Financial Accounting Standards No. 57: Related Party Disclosures (March 1982), 5; available at: http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220127001&acceptedDisclaimer=true.

2.2.2 Arm's length is 'absurdly complex' and ineffective

The absence of an active market for intercompany transactions necessitates implementing a complex regulatory framework with burdensome compliance requirements, which has resulted in a lack of administrability.

Commentators such as Avi-Yonah, Taylor, and Altshuler and Ackerman observe that: "*the current system is absurdly complex*";[63] "*a cumbersome creation of stupefying complexity*";[64] and, "*deeply, deeply flawed … it is difficult to overstate the crisis in the administration of the international tax system*".[65] This is exacerbated by the fact that arm's length pricing may not even be a suitable approach to dealing with BEPS; Vann and Burnett have observed that arm's length tests "*can be resource intensive and time consuming for both taxpayers and tax authorities, [which] can lead to uncertainty and may be ineffective in preventing BEPS in any event*".[66] Rather, the current network of transfer pricing rules has spawned a substantial tax planning industry consisting of lawyers, accountants and economists who specialise in MNE transfer pricing planning and compliance.[67] This is symptomatic of the absence of a theoretically sound, principled underpinning for these rules.

2.2.3 Arm's length and the political dynamics of international policy

Nonetheless, international organisations, governments and policymakers including the OECD, the European Union, the United Nations and the US Treasury support arm's length pricing as "*an appropriate benchmark for the assignment of income and deduction items to different affiliates in a MNE*".[68] It is also noteworthy that any attempts to replace the arm's length principle with a more transparent system would likely be prone to substantial resistance from the few large MNEs capable of benefiting most from the existing system. This political asymmetry is difficult to overcome because "*the corporate taxpayers with the greatest pull over tax policy are preoccupied by a culture of tax avoidan*ce".[69]

2.2.4 Arm's length and the law 'beyond discrimination'

The literature also raises the issue that if cross-border intercompany transactions were treated distinctly this would constitute a discriminatory obstacle, or restriction, to the freedom of establishment principle, as codified in both EU law and the OECD Model Tax Convention and as applied by the ECJ.[70]

While this may appear to be an insurmountable hurdle, Schön makes the observation that deliberate attempts by MNEs to engage in base erosion by manipulating so-called 'arm's length' pricing can be countered by domestic anti-avoidance legislation.[71] Accordingly, it may be possible to extend this

---

[63] Avi-Yonah and Clausing, above n 35.

[64] Taylor W, 'Testimony before the President's Advisory Panel on Federal Tax Reform, March 31, 2005' *Tax Notes* (4 April 2005), Doc 2005-6654.

[65] Altshuler R and Ackerman J, 'International Aspects of Recommendations from the President's Advisory Panel on Federal Tax Reform' (International Tax Policy Forum Presentation, 2 December 2005).

[66] Vann R and Burnett C, 'Re: BEPS Action 4 Discussion Draft dated 18 December 2014' (Comment received on Public Discussion Draft, BEPS Action 4: Interest deductions and other financial payments, 6 February 2015), 234.

[67] Avi-Yonah and Clausing, above n 35, 9.

[68] Morse, above n 50, 1421: see further, "*[T]he view of OECD Member countries continues to be that the arm's length principle should govern the evaluation of transfer prices among associated enterprises … The arm's length principle is sound in theory … [it] reflects the economic realities of the controlled taxpayer's particular facts and circumstances and adopts as a benchmark the normal operation of the market.*": OECD, 'The Arm's Length Principle', in: *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2009* (OECD Publishing), 29; "*In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.*": US Treasury Regulation § 1.482-1(b)(1) (2012); see further: Schön, above n 51, 77: citing Case C-311/08, Société de Gestion Industrielle SA v. Belgium, 2010 E.C.R. I-00487, decided by the European Court of Justice, which referenced the arm's length standard as an appropriate tool to combat "abusive arrangements": United Nations Department of Economic and Social Affairs, United Nations Model Double Taxation Convention between Developed and Developing Countries, at 15–16 and 66–67.

[69] Rectenwald, above n 41, 449; see also references cited therein.

[70] *Société de Gestion Industrielle v Belgian State* (Judgment of the European Court of Justice (Third Chamber)) [21 January 2010], Case C-311/08, 56-75; Schön, above n 51.

[71] In 2013, Australia attempted to address this by introducing the *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013* (Cth), which amended the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* (Cth) and

doctrine 'beyond discrimination'[72] such that there is justification for applying transfer pricing controls solely to cross-border intercompany transactions.

3 ARE CROSS-BORDER INTERCOMPANY FINANCIAL FLOWS FUNGIBLE?

3.1 ASCERTAINING FUNGIBILITY

Complementing the formidable research on the debt bias[73] is a growing body of academic literature examining the fungibility of debt and equity financing in the context of MNEs, led by commentators including Burnett,[74] Mintz and Weichenreider,[75] Graetz,[76] and Benshalom,[77] among others.[78] The literature is clear with regards to the fungibility and mobility of intercompany debt and its substitutability with equity.

However, considerably less attention has been directed towards the broader concept of the fungibility of intercompany financing, licensing and leasing activities. Many commentators either omit or carve-out these other forms of intercompany financial flows from the scope of their research. For example, Benshalom recognises the mobility and fungibility of intercompany financial transactions, yet proposes of formulary allocation applied only to income derived from transactions that are composed of financial assets *"…representing pecuniary assets (e.g., loans), equity holdings, assets whose value is a derivative of financial indices (e.g., foreign exchange swap transactions), and, with few exceptions, all assets that could be traded in financial markets (e.g., stock, bonds, future contracts, options)*".[79] Accordingly, both intercompany licensing and leasing activities are omitted from the scope of Benshalom's formulary allocation proposal, signalling a gap in the literature.

It goes without saying that both MNEs and independent firms have a plethora of options available for the cross-border flow of funds, as shown in Figure 1 below. However, this paper is limited to

introduced new transfer pricing provisions into Division 815 of the *Income Tax Assessment Act 1997* (Cth). For completeness, the Board of Taxation more recently released a number of reports dealing with the debt and equity tax rules, the thin capitalisation arm's length debt test and tax arrangements applying to permanent establishments, among others: see further, Australian Government, The Board of Taxation, *Better Tax – A National Conversation about Tax Reform* (4 June 2015), available at: http://www.taxboard.gov.au/content/Content.aspx?doc=current_activities/default.htm.

[72] Schön, above n 51.

[73] See, for example, De Mooij RA, 'Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions' (IMF Staff Discussion Note SDN/11/11, 3 May 2011); IMF Fiscal Affairs Department, 'Debt Bias and Other Distortions: Crisis-related Issues in Tax Policy' (International Monetary Fund Study, 12 June 2009); Blessing PH, 'The Debt-Equity Conundrum – A Prequel' (2012) 66(4-5) *Bulletin for International Taxation* 198.

[74] Burnett, above n 27, 44, 63 and 67.

[75] "*… we focus on debt financial structuring by multinationals although some of the analysis we provide could be easily applied to leasing and insurance structuring*": Mintz and Weichenrieder, above n 17, 13.

[76] "*… the treatment of cross-border interest payments is now one of the most complex aspects of income tax law. Rules differ among countries and contexts … because money is fungible, it is difficult in both theory and practice to know the 'purpose' of specific borrowing. Nevertheless, many countries attempt to 'trace' borrowed funds to their use, creating opportunities for creative tax planning and inducing inevitable disputes between taxpayers and tax collectors*": Graetz MJ, 'A Multilateral Solution for the Income Tax Treatment of Interest Expenses' [November 2008] *Bulletin for International Taxation* 486, 487.

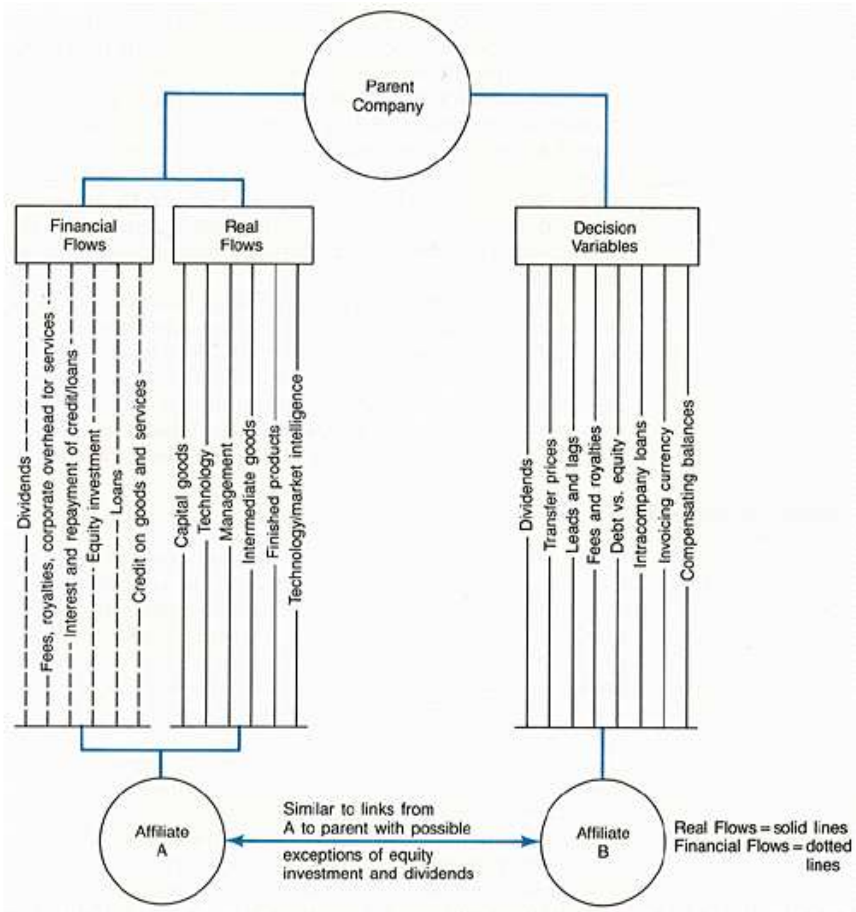
[77] "*The most startling example is withholding taxes on financial payments. While dividend payments are typically subject to withholding taxes, interest payments and income derived from financial derivatives are typically exempt by double taxation treaties from withholding source taxes. This discontinuity is ridiculous given taxpayers' ability to replicate equity investments with the use of hybrid financial derivatives*": Benshalom, above n 17, 642; Benshalom I, 'The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase' (2008) 28 *Virginia Tax Review* 165; Benshalom I, 'Rethinking the Source of the Arm's Length Transfer Pricing Problem' (2013) 32(3) *Virginia Tax Review* 425.

[78] "*The task of objectively determining a particular branch's equity capital is significant since money is fungible and both equity capital and debt capital may be moved between different parts of an international bank with ease*": Kobetsky M, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge, UK: Cambridge University Press, 2011), 265-266; Rosenbloom HD, 'Banes of an Income Tax: Legal Fictions, Elections, Hypothetical Determinations, Related Party Debt' (2004) 26 *Sydney Law Review* 17; see further, beyond the tax law literature: "*Because the roles of debt, equity, and hybrid debt-equity instruments in the capital structure of the firm are to a significant extent interchangeable…a formal legal distinction between debt and equity in insider trading law does not make sense*": Strudler and Orts, 'Moral Principle in the Law of Insider Trading' (1999) 78 *Texas Law Review* 375-438, 392-393; see also, Huang H, *International Securities Markets: Insider Trading Law in China* (The Netherlands: Kluwer Law International, 2006), 155.

[79] Benshalom, above n 17, 641.

examining cross-border activities from the MNE perspective because MNEs are uniquely advantaged by having greater control over the mode and timing of these activities.[80]

Figure 1



From the perspective of MNEs, intercompany financing, licensing and leasing activities are profoundly influenced by taxation.[81] This subset of financial activities is described as "Financial Flows" in Figure 1 above. While this Figure 1 appears to omit leasing from its scope, the author considers that, given the literature on financing leases,[82] it would be suitable to categorise intercompany leasing within "Financial Flows". This fungibility of cross-border intercompany transactions, and their capacity to erode the tax base of source jurisdictions, is illustrated in Figure 2, Figure 3 and Figure 4 below.

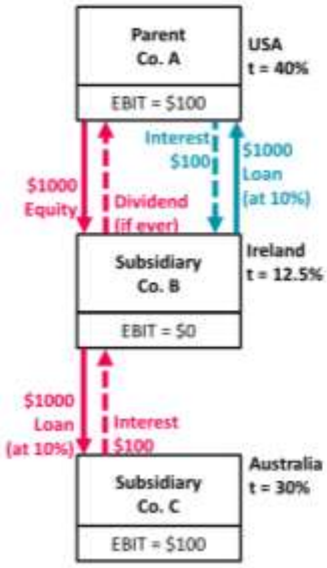
[80] Shapiro AC and Balbirer SD, *Modern Corporate Finance: An Interdisciplinary Approach to Value Creation* (Upper Saddle River, New Jersey: Prentice Hall, 1999), Topic F4 'The Multinational Financial System'; available at: http://www.prenhall.com/divisions/bp/app/finflash/html/onlinehtml/topicf/topicf4.html.

[81] In addition to capital gains taxes, personal income taxes and non-resident withholding taxes: Mintz and Weichenrieder, above n 17, 18.

[82] "*Multinationals can effectively shift income across jurisdictions through leasing arrangements since all debt and imputed equity financing expenses are included in the lease costs*": Mintz and Weichenrieder, above n 17, 13.

Figure 2

Intercompany cross-border debt and equity financing



	Co. A	Co. B	Co. C	Overall
Taxable Income	100 100 0	0 100 200	100 0 0	200 200 200
Tax Rate	40%	12.5%	30%	–
Tax Payable	(40) (40) (0)	(0) (12.5) (25)	(30) (0) (0)	(70) (52.5) (25)
Net Profit	60 60 0	0 87.5 175	70 0 0	130 147.5 175

Figure 2 above illustrates the impact of three options with an intercompany scenario. First, where there are no intercompany financing activities the overall tax payable is $70. However, once Co. A[83] provides $1000 in equity to Co. B,[84] which then funnels those funds through to Co. C[85] in the form of an intercompany loan, then the overall tax payable is reduced to $52.5. A third option is to have Co. B separately extend an intercompany loan to Co. A, which will reduce the taxable income in that jurisdiction and result in an overall tax payable for the MNE at $25. This is almost a third of the original tax liability. Despite the possibility of foreign tax credits and withholding taxes being applicable in this context for all of these scenarios in this paper, this additional layer is beyond the scope of this paper and will instead be the subject for further research by the author. However, it is important to briefly note that, in practice, capital exporters can (and do) reduce the foreign tax on their capital exports by choosing a lower rate of credit for foreign taxes. The US foreign tax credit rules are unfortunately exemplary in this regard, placing significant restrictions on the ability of US parent companies to realise tax credits for the taxes paid by their foreign subsidiaries.[86] Sørensen observes that in this way "*capital exporters can use their credit rates as a retaliatory weapon against capital importers*".[87] This is a particularly pressing issue for small, open economies such as Australia and New Zealand, which are net capital importers of capital. Further, this issue extends to all capital importers in general, rendering large capital importers such as Canada and the United Kingdom also within scope.[88]

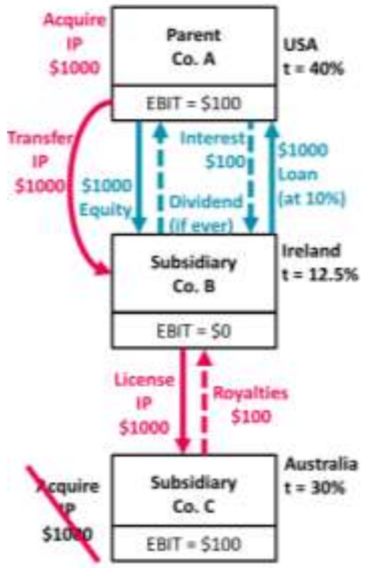
Separately, further tax minimisation may be possible by the Parent (Co. A) obtaining a loan from a financial institution, or if a group member grants a loan to the Parent through a conversion of equity to debt financing or the creation of intra-group debt. This is shown in as the third option within this scenario with the inclusion of the loan between Co. A and Co. B, whereby new interest is deducted twice (in both the US and Australia) while interest income is taxed in Ireland, a low-tax jurisdiction. For completeness, any jurisdiction with relatively low taxes is a contender for the interposed entity scenario illustrated in this paper. In the Australian context, it appears that Singapore is a relatively more popular jurisdiction than Ireland in terms of the volume of intercompany payments made by Australian companies.[89]

---

83 Co. A is the parent and is a tax resident of the US where the corporate income tax rate is 40%.
84 Co. B is a subsidiary and is a tax resident of Ireland where the corporate income tax rate is 12.5%.
85 Co. A is also a subsidiary and is a tax resident of Australia where the corporate income tax rate is 30%.
86 PricewaterhouseCoopers LLP, *Mergers and Acquisitions: A Global Tax Guide* (John Wiley & Sons, 2006), 14.
87 Sørensen, 50, http://www.suomenpankki.fi/pdf/SP_DP_1990_04.pdf.
88 Inotai, above n 7, 43.
89 Butler B and Wilkins G, 'Singapore, Ireland top havens for multinational tax dodgers', Sydney Morning Herald (online), 1 May 2014; available at: http://www.smh.com.au/business/singapore-ireland-top-havens-for-multinational-tax-dodgers-20140430-37hzi.html.

Figure 3

Intercompany cross-border licensing (and financing)

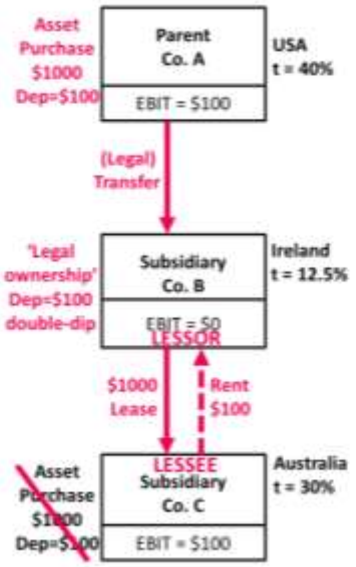


	Co. A	Co. B	Co. C	Overall
Taxable Income	100 100 0	0 100 200	100 0 0	200 200 200
Tax Rate	40%	12.5%	30%	–
Tax Payable	(40) (40) (0)	(0) (12.5) (25)	(30) (0) (0)	(70) (52.5) (25)
Net Profit	60 60 0	0 87.5 175	70 0 0	130 147.5 175

Figure 3 demonstrates the fungibility of financing and licensing by showing how the exact same result can be arrived at through Co. C paying Co. B royalties instead of interest. Separately, it is important to note the possibility of extending additional sub-licenses to other subsidiaries to minimise tax. This example excludes tax deductions that may also be available for the acquisition or creation of intellectual property, for example, research and development concessions, general deductions, uniform capital allowances and capital gains tax treatment.

Figure 4

Intercompany cross-border leasing



	Co. A	Co. B	Co. C	Overall
Taxable Income	100 0	0 0	0 0	100 0
Tax Rate	40%	12.5%	30%	–
Tax Payable	(40) (0)	(0) (0)	(0) (0)	(40) (0)
Net Profit	60 0	0 0	0 0	60 0

This third type of cross-border intercompany activity shows the tax base eroding impact of both double-dipping depreciation expenses and claiming lease payment expenses. The original option of Co. C purchasing an asset would have resulted in an overall tax payable of $40,[90] as Co. A would

[90] Co. A would have originally been taxed on its $100 EBIT and Co. C had its taxable income reduced to 0 after deducting the $100 depreciation expense from its $100 EBIT.

have originally been taxed on its $100 earnings before interest and taxes ('EBIT') and Co. C had its taxable income reduced to 0 after deducting the $100 depreciation expense from its $100 EBIT. However, by arranging for the purchase through the Parent and a sub-lease via Co. B, the result has been to reduce overall tax payable to $0. It is possible to 'double-dip' due to varying tax laws regarding depreciation allowances exist across jurisdictions (some countries apply legal ownership tests while others apply economic ownership tests – Irish rules have a reputation for being a 'good fit' with other jurisdictions' rules, rending the possibility of even a 'triple-dip'). Further, Mintz and Weichenrieder observe that MNEs can "…*effectively shift income across jurisdictions through leasing arrangements since all debt and imputed equity financing expenses are included in the lease costs*".[91] Leases can also be used to avoid customs duties, achieve a lower cost of borrowing with no minimum equity balance on investment and can also be used to achieve off-balance sheet financing. For completeness, the "Royalty and Interest Directive" which impacts equipment leasing has been excluded. If a double-dip is not available, it would be possible to lower the Parent's taxable income through an intercompany loan from its subsidiary, Co. B.

At a theoretical level, Benshalom provides the most relevant analysis on the fungibility of these activities, observing that "*almost every type of tax reduction plan that uses affiliated financial transactions could be executed via other types of affiliated transactions*".[92] The fungibility and mobility of these intercompany financial flows means that attempts to allocate ownership to any one entity within an MNE is an arbitrary exercise.[93] However, Benshalom's research is limited to separately and distinctly analysing the taxation of intercompany financing[94] and licensing, briefly mentioning leasing activities but distinguishing them as separate from financing transactions,[95] despite acknowledging that "*it is impossible to draw a perfect line between financial transactions and non-financial transactions … affiliated leasing transactions could replicate the consequences of related lending*".[96] Nonetheless, Benshalom observes that the mobility of intercompany activities erodes the source jurisdiction's tax base from both the perspective of intangible and tangible manufacturing and merchandise activities.[97] So, while the literature implicitly contains support for the proposition that cross-border intercompany financing, licensing and leasing activities are fungible, there is very little literature that directly studies the taxation implications of this observation.

At a practical level, evidence in support of the proposition that cross-border intercompany financing, licensing and leasing activities are fungible is contained in both some existing regulations and the academic literature. Regarding legislation, US Treasury Regulation §1.882-5 views interest as fungible, using a formula to determine the attributable interest expense.[98] An extract of this regulation is as follows:[99]

> "*The term financing transaction also includes any other advance of money or property pursuant to which the transferee is obligated to repay or return a substantial portion of the money or other property advanced or the equivalent in value.*"

This is considered a valuable step in equalising the playing field between MNEs and tax authorities. On one hand, MNEs are largely indifferent to the structuring of their internal financial flows because these are fungible and mobile with no substantial economic cost. In contrast, tax authorities generally do not have adequate resources to audit the increasing volumes of intercompany activities.

[91] Mintz and Weichenrieder, above n 17, 13.
[92] Benshalom, above n 77, 193-195; see also: Benshalom, above n 49.
[93] Benshalom, above n 49, 660-661.
[94] Benshalom, above n 77, 193-195; see also: Benshalom, above n 49, 647.
[95] Benshalom, above n 49, 647.
[96] Benshalom, above n 17, 642.
[97] Benshalom, above n 49, 647.
[98] Ring DM, 'Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime' (1997) 4(4) *Boston College Law Review* 667, 712.
[99] On August 10, 1993, US Congress enacted section 7701(1) of the Internal Revenue Code; Section 1.881-3(a)(2) of the final regulations provides definitions of certain terms used throughout the regulations. A financing arrangement is defined as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or the right to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity; see further: http://www.irs.gov/pub/irs-regs/td8611.txt.

Administrative complexity is further exacerbated by the arm's length standard requirement of finding the proper market comparables of specifically tailored financial flows.[100]

In this context, by disallowing tax deductions in relation to all intercompany financing activities, Benshalom's proposal is "*motivated by a desire for administrative convenience at the expense of economic accuracy*"[101] and aims to incapacitate the ability of MNEs from using the most mobile class of intercompany assets to attain tax planning objectives.[102] While this proposal does not underperform the existing international tax system,[103] it is questionable that it would be a politically viable option, given the discussion in section 2.2 regarding reform hurdles in the context of MNEs.

Accordingly, this paper establishes the scaffolding for further research by the author to extend the existing literature by examining the viability of allowing a partial deduction for the cost of intercompany financing, licensing and leasing activities on the basis that they are economic equivalents.

This is a particularly pressing issue to address given the "*effective end of withholding tax in developed countries*",[104] as described by Avi-Yonah. As mentioned in section 2.1 above, even though levying withholding taxes on non-residents was originally designed to protect source jurisdictions from tax base erosion via cross-border deductible expenses such as interest, lease payments, royalties, this is arguably no longer the case. Accordingly, it is important to explore a 'middle ground' between Benshalom's proposal and the existing system that mitigates issues that exist within both of these options, while also anticipating issues associated with 'plugging one hole while leaving exposed another hole'.

Alternative reforms have been proposed that aim to address existing concerns in this context, in particular, with the arm's length standard. While there exists an extensive literature canvassing these proposed reforms, a thorough analysis is beyond the scope of this paper. For completeness, the reform options range from implementing modifications to the arm's length standards by applying more rigid arm's length tests[105] with, for example, an imputed interest rate;[106] applying a combination of the arm's length standard and formulary methods;[107] to moving towards worldwide taxation through consolidation[108] and formulary apportionment.[109] Most relevantly, Rectenwald suggests a novel implementation of formulary apportionment based on applying different formulas tailored to different categories of income;[110] specifically, intercompany transactions, such as financial transactions, which

---

[100] Benshalom, above n 77, 193-195; see also: Benshalom, above n 49.

[101] Benshalom, above n 17, 642.

[102] See further: Brabazon ML, 'The Attribution Of Profits and Capital Structure To A Permanent Establishment Under The OECD Model Tax Treaty' (2003) 18 *Australian Tax Forum* 347, 358-361.

[103] Benshalom, above n 17, 642.

[104] Avi-Yonah, above n 17. Relevantly, the Henry Review criticised Australia's current treatment of foreign debt as complex and distortionary, recommending a reduction in the interest withholding tax rate to zero among tax treaty partners. With an effective interest withholding tax rate of 3.5%, liability for withholding tax would likely not outweigh the advantages of interest deductibility given comparative levels of corporate tax. While the literature has recognised the debt bias as prevalent in the foreign debt context, policy makers have called for the reduction of interest withholding tax to 0% provided appropriate safeguards exist to limit tax avoidance: "*Recommendation 34: Consideration should be given to negotiating, in future tax treaties or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance*"; Henry K, Harmer J, Piggott J, Ridout H and Smith G, *Australia's Future Tax System: Report to the Treasurer*, Commonwealth of Australia, December 2009, Part 2, Chapter B1–4, available at: http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b1-4.htm.

[105] Morse focussed on planning under the transfer pricing regulation, with an extensive summary of the literature and proposing a modification to the transfer pricing regulations to enable them to "*operate more like rules and less like standards*" as an alternative to a more fundamental reform of these rules: Morse, above n 50.

[106] Benshalom proposes "*maintaining the arm's-length standard but applying it more rigidly—that is, to re-characterize intra-group equity investments as long-term subordinated debt (with imputed interest rates)*": Benshalom, above n 77.

[107] Benshalom, above n 17, 630.

[108] "*An alternative approach to cutting statutory tax rates to combat income shifting through financial decisions is to move to worldwide taxation whereby resident multinationals would be fully taxed on their foreign source income with a credit (or deduction) given for foreign corporate income and withholding taxes (Alworth 1988, Grubert and Altshuler 2006). At the same time, deferral of residence-based taxes to the time when foreign income is repatriated would be ended. Effectively, this would extend the current tax treatment of branches and passive income, as it is applied in many countries, to all sources of income, including that earned by subsidiaries. It would require rules for consolidation of income on an international basis, thereby requiring threshold rules to determine membership in the corporate group.*": Mintz and Weichenrieder, above n 17, 160; see also, Graetz, above n 76, 492.

[109] Avi-Yonah et al propose a formula-based profit split system of apportionment: Avi-Yonah, Clausing and Durst, above n 46, 506–525.

[110] Rectenwald, above n 41, 427-428.

he observes "*the current transfer pricing system especially fails to account for accurately*".[111]

3.2 THE RELEVANCE OF ECONOMIC RENTS

Devereux presents a highly comprehensive and concise literature review in the context of the taxation of economic rents from the perspective of a small, capital-importing economy.[112] This review suggests there is little emphasis in the literature regarding the taxation of economic rent in the small, open economy context.[113]

Taxing only economic rents has long been advocated by economists[114] on the basis that, at least in principle, decisions at the margin are not affected by tax since the marginal investment is not taxed.[115] This is particularly important in the context of a small, open economy where the marginal investor is likely to be a foreign investor.[116]

Given their fungibility and the issues associated with the arm's length principle, this section examines the conceptual basis for an alternative method of taxing intercompany financing, licensing and leasing activities on their above-normal rents by reference to an imputed allowance for the cost of these activities.

The starting point for this analysis is the seminal work of Hirshleifer, who observed that:[117]

> "*If the market is imperfectly competitive, or where no market for the transferred commodity exists, the correct procedure is to transfer at marginal cost (given certain simplifying conditions) or at some price between marginal cost and market price in the most general case*".

Relevantly, there is an extensive literature suggesting that MNEs typically exist in order to earn economic rents,[118] and that they bear no substantial economic costs of structuring their internal financial flows one way or the other.[119] So, from an economic efficiency perspective it is preferable for MNEs to be subject to economic rent taxation[120] because economic rent taxes are neutral and thereby minimise distortions.[121]

The key criticism in the literature that is associated with taxing mobile rents through source-based taxation is that this may reduce investment[122] by simply shifting the investment to a lower tax

---

[111] Rectenwald, above n 41, 446; see also: Benshalom, above n 17.

[112] Devereux MP, 'Some Optimal Tax Rules for International Portfolio and Direct Investment' (2004) 60(1) *Finanzarchiv* 1.

[113] Devereux, above n 112; see also references cited therein.

[114] In terms of its historical development, economic rent taxation proposals originated in the 1970's with the basic economic idea contained in the report of the Meade Committee, which proposed alternatives to the UK tax system: Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor JE Meade* (London, George Allen & Unwin: 1978); available at: http://www.ifs.org.uk/docs/meade.pdf; see further elaborations and subsequent research published: Boadway RW and Bruce NDB, 'A general proposition on the design of a neutral business tax' (1984) 24(2) *Journal of Public Economics* 231; Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990S*, Fourth report of the IFS Capital Taxes Group, Commentary No 26 (Chameleon Press: 1991), available at: http://www.ifs.org.uk/comms/comm26.pdf; Devereux M and Freeman H, 'A general neutral profits tax' (1991) 12(3) *Fiscal Studies* 1. An alternative approach is to combine a corporate tax on economic rent with a residence-based individual tax on the normal return, as proposed recently by Kleinbard ED, 'Rehabilitating the business income tax' (The Hamilton Project Discussion Paper 2007-09, The Brookings Institution, June 2007).

[115] Devereux MP, Mokkas S, Pennock J and Wharrad P, 'Interest Deductibility for UK Corporation Tax', (Working Paper, Oxford University Centre for Business Taxation, December 2006), 12.

[116] Sørensen PB, 'Taxation of Shareholder Income and the Cost of Capital in an Open Economy: Theory and Applications to the Nordic Countries' (2005) *Danish Journal of Economics* 143, 144-5.

[117] For completeness, "*This statement is itself an oversimplification, since pricing at marginal cost is a necessary but not a sufficient condition. What is involved is a whole mode of procedure, described below, for finding the optimum price from the point of view of the over-all interests of the firm.*": Hirshleifer, above n 58.

[118] Avi-Yonah, above n 17, 1622; and references cited therein; see further: Devereux MP and Hubbard RG, 'Taxing Multinationals' (2003) 10 *International Tax and Public Finance* 469, 470.

[119] Benshalom, above n 77, 193-195; see also: Benshalom, above n 49.

[120] Bärsch SE, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context: Issues and Options for Reform* (Germany: Springer, 2013), 24; Mintz J, 'The Corporation Tax: A Survey' (1995) 16(4) Fiscal Studies 23, 34.

[121] Bird RM, 'Why Tax Corporations?' (Working Paper No 96-2, Technical Committee on Business Taxation, December 1996), 5; Devereux MP, 'Trade-offs in the Design of Taxes on Corporate Profit' (Paper presented at the Oxford Sydney Conference, Ross Parsons Centre: The University of Sydney, 30-31 March 2012), 3-4; see also, Grubert and Altshuler, above n 8, 674-5.

[122] Stewart M, Moore A, Whiteford P and Grafton RQ, 'A Stocktake Of The Tax System And Directions For Reform: Five Years After The Henry Review' (Tax and Transfer Policy Institute, February 2015), 64; "*a source-based tax on rent (such as proposed by the Meade*

jurisdiction in order to receive a greater share of the rents.[123] Given the mobility and fungibility of intercompany activities this is likely the most significant hurdle on a conceptual level for source jurisdictions. Yet, since corporate taxation in general is known to affect investment this does not provide a definitive counter-argument.[124] Indeed, there is strong support in the literature that this criticism is less valid in regard to foreign direct investment ('FDI')[125] compared to portfolio investment.[126] This is particularly important given MNE's cross-border intercompany flows are included within the scope of FDI, despite scepticism from key policymakers that these investments are always 'real'.[127]

Accordingly, it would be necessary to either achieve a degree of international coordination,[128] for example, on tax bases and minimum tax rates – or ensure that the tax is levied at sufficiently low rates so as not to significantly alter incentives for location. Admittedly, international tax coordination is difficult to enforce and sources of rents are unlikely to be very location-specific where activities are inherently very mobile.[129] Nonetheless, the literature does note that it is, in principle, optimal to allow capital-importing countries to use source-based taxes as an indirect way of taxing pure economic rents.[130] In any event, the proposal earmarked by this paper only needs to offer a sufficiently improved alternative to the current regime – rather than a perfect alternative.[131]

3.3 TAXING INTERCOMPANY ECONOMIC RENTS

The following section proposes a method of taxing cross-border intercompany economic rents by merging this paper's two-fold extension of the literature, specifically: first, that all cross-border intercompany financial, leasing and licensing activities be treated equally for tax purposes; and second, that the framework utilised for this be modelled on economic rent taxation.

As examined by the Henry Review,[132] several fundamental reform options exist which would tax economic rent, one of which is an ACE. The ACE reform proposal originated in the 1970's with the Meade Committee,[133] and ACE has since been the subject of an extensive literature. This literature has been briefly examined in a paper previously written by the author.[134]

Committee) could divert economic activity abroad, where it could face a lower tax rate": Auerbach AJ, Devereux MP and Simpson HD, 'Taxing Corporate Income' (NBER Working Paper No. 14494, November 2008), 53; Bond S, 'Corporate Tax' (Paper presented at the Royal Economic Society Special Session on the Mirrlees Review, Coventry: University of Warwick, 17 March 2008); Auerbach AJ, Devereux MP and Simpson HD, 'Taxing Corporate Income', Chapter 9, in: Mirrlees J et al (eds.) *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010).

[123] Australian Government, above n 20.

[124] Federici D and Parisi V, 'Do corporate taxes reduce investments? Evidence from Italian firm-level panel data' [February 2015] 3 *Cogent Economics & Finance* 1012435; and references cited therein.

[125] FDI is usually associated with strategic choices, imperfect competition, and the generation of economic rent: Devereux and Hubbard, above n 118; see further, Caves RE, *Multinational Enterprise and Economic Analysis* (Cambridge: Cambridge University Press, 2nd ed, 1996).

[126] Avi-Yonah, above n 21, 62-63.

[127] "*Although these flows are booked in FDI due to their intercompany nature, these flows may be considered as non-FDI as it lacks a real (lasting) investment character*": IMF Committee On Balance Of Payments Statistics and OECD Workshop On International Investment Statistics, Direct Investment Technical Expert Group, 'FDI – Other Capital (with focus on short-term)' (Issue Paper No. 22, November 2004), 3.

[128] Avi-Yonah, above n 21, 62-63; and references cited therein.

[129] Keen M, Krelove R and Norregaard J, 'The Financial Activities Tax', Chapter 7 in: Claessens S, Keen M, Pazarbasioglu C (eds.), *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material* (IMF, September 2010), 133.

[130] Keen M and Piekkola H, 'Simple Rules for the Optimal Taxation of International Capital Income' 99(3) *The Scandinavian Journal of Economics* (1997) 447; Auerbach, Devereux and Simpson, above n 122, 35.

[131] Benshalom, above n 77, 452.

[132] Australian Government, above n 20.

[133] Institute for Fiscal Studies, above n 114.

[134] Kayis-Kumar, above n 15; see further: Gammie M, 'Corporate tax harmonization: an "ACE" proposal: harmonizing European corporate taxation through an allowance for corporate equity' (1991) 31(8) *European Taxation Journal* 238; De Mooij, above n 73; Devereux M and Freeman H, above n 114; Staderini A, 'Tax reforms to influence corporate financial policy: the case of the Italian business tax reform of 1997-98' (Banca D'Italia No 423, 2001); Keen M and King J, 'The Croatian profit tax: an ACE in practice' (2002) 23(3) *Institute for Fiscal Studies* 401; Chen D, Lee FC and Mintz JM, 'Taxation, SMEs and Entrepreneurship' (OECD Science, Technology and Industry Working Papers 2002/09, OECD Publishing, August 2002); Klemm AD, 'Allowances for Corporate Equity in Practice' (CESifo Economic Studies, Volume 53, 2/2007, 12 June 2007) 229; Princen S, 'Taxes do Affect Corporate Financing Decisions: The Case of Belgian ACE' (CESifo Working Paper Series No 3713, January 2012); Cooper GS, 'Implementing an allowance for corporate equity' (2012) 27 *Australian Tax Forum* 241; Schepens G, 'Taxes and bank capital structure' (Working paper, Department of Financial Economics, University of Ghent, October 2013).

The ACE is one of several fundamental reform options which would, in theory, eliminate the distinction between debt and equity in the corporate tax regime. Proposed fundamental reforms include, but are not limited to, the ACE, the CBIT, the combined ACE-CBIT and the allowance for corporate capital ('ACC'). These reform options address the debt bias either by disallowing deductions for the cost of debt financing, providing deductions for the cost of equity financing, or allowing deductions for the cost of both debt and equity financing. Of these fundamental reforms only the ACE has been experimented with in practice and even then it has only been conceptualised as a domestic-level solution. Nonetheless, the ACE literature contemplates that under an ACE there would be no need for rules restricting the deductibility of interest in the cross-border context.

Previous work by the author presents the possibility of implementing a combined ACE-CBIT in the cross-border context as an alternative to thin capitalisation rules.[135] A combined ACE-CBIT, consisting of a partial ACE and a partial CBIT,[136] mitigates the discrimination between both debt and equity financing. First referred to in 2009,[137] the combined ACE-CBIT has a substantial number of advantages; first, it was designed as a revenue neutral policy, and is also independent on whether the CORTAX model[138] is extended to tax havens or discrete location choices.[139] Further, economic analysis shows that moving to the combined ACE-CBIT could potentially bring substantial benefits in terms of reducing leverage, reducing systemic risk and reducing profit-shifting,[140] by bringing the amount of interest close to its efficient level.[141] Finally, empirical estimates suggest that the combined ACE-CBIT would raise welfare by 0.3% of GDP due to the more neutral tax treatment of debt and equity.[142] Although relatively new to the literature, there is persuasive empirical evidence suggesting that the combined ACE-CBIT would expand welfare due to its more efficient financial structure.[143]

However, the combined ACE-CBIT has not yet been analysed in detail by the literature;[144] for example, in Australia, recommendations for reform have featured detailed analysis of the ACE, ACC, CBIT and DIT – entirely omitting the combined ACE-CBIT.[145] The question of whether a cross-border combined ACE-CBIT would be a viable alternative to thin capitalisation rules remains understudied in literature. Further, the ACE literature currently overlooks intercompany issues.

On the other hand, this paper suggests that since intercompany financing, licensing and leasing activities are fungible,[146] it is arguably more effective and robust to addressing BEPS in this context

---

[135] Kayis-Kumar, above n 15.

[136] The CBIT eliminates the debt bias by denying existing debt deductibility, thereby denying tax deductions for both the costs of debt and equity financing. First proposed by the US Department of the Treasury, and more recently proposed by the IMF, the CBIT aims to end the classical double taxation of source income; see: United States Government, Department of the Treasury, 'Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once', January 1992; see also: IMF, 'A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20' (June 2010), available at: http://www.imf.org/external/np/g20/pdf/062710b.pdf.

[137] De Mooij R and Devereux MP, 'Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT reforms' (European Union Taxation Papers, Working Paper No 17, 2009).

[138] The CCH CorTAX product ('CORTAX') is a computable general equilibrium model widely utilised in the literature.

[139] De Mooij and Devereux, above n 137; it is interesting that this observation was not included in the subsequent 2011 version of this paper.

[140] Fatica S, Hemmelgarn T and Nicodème G, 'The Debt-Equity Tax Bias: consequences and solution' (Taxation Papers Working Paper No 33, European Commission, July 2012).

[141] Gérard M and Princen S, 'Investment and Financing Strategy of a Multinational Enterprise under Alternative Tax Designs' (CESifo Working Paper No 3838, June 2012).

[142] De Mooij and Devereux, above n 137; De Mooij RA and Devereux MP, 'An applied analysis of ACE and CBIT reforms in the EU' (2011) 18(1) *International Tax and Public Finance* 93.

[143] De Mooij and Devereux, above n 142, 93–120.

[144] De Mooij and Devereux, above n 142; Marres O and Weber D, *Tax Treatment of Interest for Corporations* (The Netherlands: IBFD, 2013). Some commentators have suggested applying the *same* notional return (which strong arguments suggest should approximate some risk-free return) to equity as well as debt without referring to it as an ACE-CBIT; see, for example, Chaudhry SM, Mullineux AW and Agarwal N, 'Balancing Bank Regulation and Taxation' (4 February 2014), available at: http://dx.doi.org/10.2139/ssrn.1141090. The ICC has observed that, in the context of cross-border limitations of deductions of interest payments, ideally there should be neutrality between equity and debt financing from a tax point of view. On the basis of their draft scoping paper, the ICC suggested a list of recommendations be prepared and circulated to governments, noting that the sections dealing with thin capitalisation and the combined ACE-CBIT should be elaborated on and further extended to deal with technical issues. No updates have been made since: ICC Commission on Taxation, 'Limitations of deductions of interest payments' (International Chamber of Commerce Policy Statement No 180-520, February 2012).

[145] Sørensen PB and Johnson S, *Chapter 9: Taxing Capital Income – Options for Reform in Australia*, Melbourne Institute, *Australia's Future Tax and Transfer Policy Conference*, June 2009, 203.

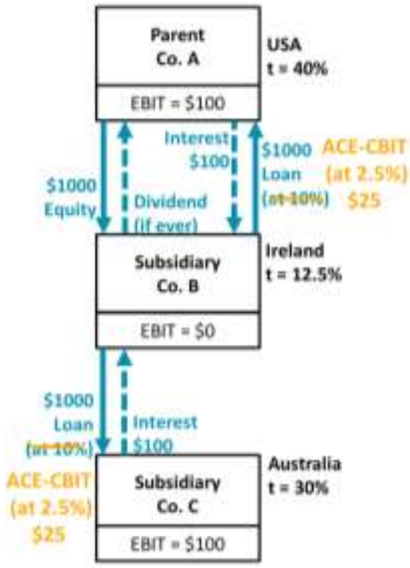
[146] Burnett, above n 27, 45 and 64; For completeness, the OECD defines financial payments economically equivalent to interest as "*... those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time*": OECD, above n 1, 17.

through a cross-border ACE-CBIT with an equal allowable deduction for both the cost of intercompany financial flows in place of existing thin capitalisation rules.

An unequal tax treatment between these fungible intercompany activities can create distortions, which in turn incentivises tax planning behaviour. Accordingly, in the context of cross-border intercompany transactions pertaining to activities such as financing, licensing and leasing, the deductibility of all expenses could be restricted to a portion of a suitable proxy for the economic rent (or normal rate of return; such as the risk-free rate), as illustrated in Figure 5, Figure 6 and Figure 7 below.

Figure 5

Intercompany cross-border debt and equity financing

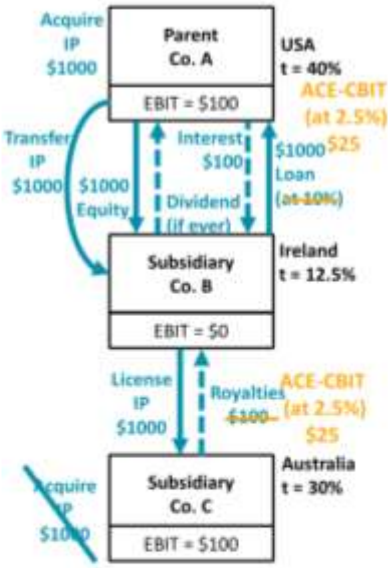


	Co. A	Co. B	Co. C	Overall
Taxable Income	0 75 (100-25)	200 200 (100+100)	0 75 (100-25)	200 350
Tax Rate	40%	12.5%	30%	–
Tax Payable	(0) (30)	(25) (25)	(0) (22.5)	(25) (77.5)
Net Profit	0 45	175 175	0 52.5	175 272.5

Using the last permutation offered in Figure 2 as the base case for Figure 5, it is clear that a restriction on the deductibility of cross-border intercompany financing activities limits the extent of opportunities available for BEPS in this setting. While the overall tax payable was originally $25, under a cross-border ACE-CBIT this increases to $77.5. This exceeds the originating scenario illustrated in Figure 2, where overall tax payable was $70. For completeness, despite the neatness of this scenario, it is important to recognise that MNE behaviour would likely be responsible to this new regulatory framework. This brings to the fore the issues anticipated in previous section 3.2, and is the subject of further research by the author.

Figure 6

Intercompany cross-border licensing (and financing)

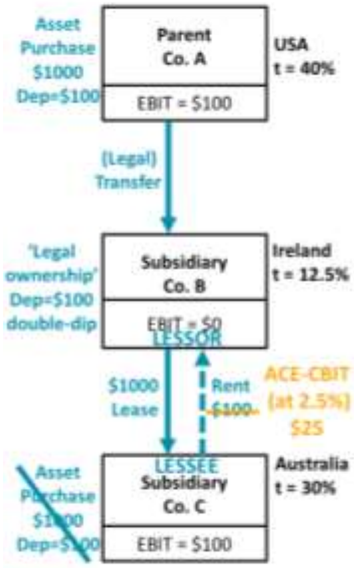


	Co. A	Co. B	Co. C	Overall
Taxable Income	0 75	200 200	0 75	200 350
Tax Rate	40%	12.5%	30%	–
Tax Payable	(0) (30)	(25) (25)	(0) (22.5)	(25) (77.5)
Net Profit	0 45	175 175	0 52.5	175 272.5

The above Figure 6 reiterates the implications of the fungibility of cross-border financing and licensing activities, replicating the outcome of Figure 5. This scenario has assumed that amortisation is not applicable.

Figure 7

Intercompany cross-border leasing



	Co. A	Co. B	Co. C	Overall
Taxable Income	0 0	0 0	0 75	0 75
Tax Rate	40%	12.5%	30%	–
Tax Payable	(0) (0)	(0) (0)	(0) (22.5)	(0) (22.5)
Net Profit	0 0	0 0	0 52.5	0 52.5

Similarly to the above two scenarios, a restriction on the deductibility of cross-border intercompany leasing activities limits the extent of opportunities available for BEPS in this setting. While the overall tax payable was originally $0, under a cross-border ACE-CBIT this increases to $22.5. This does not exceed the originating scenario illustrated in Figure 4, where overall tax payable was $40, but this is by virtue of the full amount of the depreciation remaining available to Co. A and Co. B operating at a tax loss regardless of whether there is a restriction on its depreciation expense. Despite the neatness of this scenario, it is important to recognise that MNE behaviour would likely be responsible to this new regulatory framework by possibly shifting depreciation expenses to Co. C rather than Co. B, if possible.

Regarding the selection of the appropriate ACE-CBIT rate, it is instructive to revisit the ACE literature. The ACE literature suggests that the risk-free[147] interest rate[148] is the preferred rate for the notional return on equity ('the ACE rate'). Leading commentators agree the best proxy for this is the long-term government bond rate.[149]

However, the use of the long-term government bond rate can result in issues at both the domestic and the international levels, which the literature has thus far remained silent on.

Domestically, the issues are two-fold. First, on a pragmatic level, if a country has a relatively fragmented or unstable financial market, there is no obvious choice for a risk-free rate.[150]

Second, it is arguable that the risk-free rate does not necessarily reflect the actual cost of equity for each firm. Sørensen and Johnson observe that, *"in practice, the ability of the ACE to eliminate the debt bias depends crucially on ... whether actual interest rates differ from the notional return chosen to relieve equity"*.[151] This was the rationale for the US Treasury's critique of the ACE system, which commentators such as Rumble highlight when rejecting the viability of the ACE. However, Rumble's observation that "*the ACE proposal is a detailed exposition of a dividend deduction scheme*"[152] suggests that he has arguably conflated the ACE with dividend deductibility. The degree of non-neutrality would depend on the size of the difference between the actual and the appropriate rate of the notional interest.[153] Since a substantial amount of information would be required to set the ACE rate[154] this may be overly burdensome administratively, requiring different rates for different companies.[155] Nonetheless, a key counter-argument is that even if the ACE rate were set at the "wrong level" this would still be preferable to a zero ACE rate, as effectively provided under the existing system. On the other hand, some commentators suggest that the ACE rate could simply equal the interest rate paid on debt financing.[156]

Internationally, particularly when dealing with MNEs, it is questionable that a domestic risk-free rate is the best indicator of a MNEs notional return on equity. Rather, a worldwide rate would arguably be a more suitable proxy. This has been overlooked in the context of the ACE literature, most likely due to the traditionally domestic nature of ACE reform proposals. A "worldwide debt-to-capital ratio interest limitation rule" (otherwise known as the "worldwide gearing ratio") currently exists in both the theory and practice of thin capitalisation rules, whereby interest deductions on debt financing are denied to the extent that the proportion of a company's assets exceeds the proportion of the group's worldwide third-party debt to asset ratio.[157] This rule is inherently suited to international harmonization,[158] which would also be compatible with an ACE system.[159]

However, as demonstrated in a previous paper written by the author,[160] it is questionable that an ACE equalises the tax treatment of debt and equity financing. Rather, an ACE simply mitigates the debt bias. On the other hand, it is arguably more effective to instead align the tax treatment of intercompany financial flows to eliminate part of the tax incentive for BEPS-related tax planning behaviour. This is particularly timely because in the context of intercompany financing, the OECD is

[147] This is "*calculated by reference to a normal commercial rate of interest, fixed by the government*"; see further, Gammie, above n 134.
[148] De Mooij and Devereux, above n 142, 96.
[149] Gammie, above n 147; Bond SR and Devereux MP, 'On the design of a neutral business tax under uncertainty' (1995) 85(1) *Journal of Public Economics* 57; De Mooij and Devereux, above n 142, 96.
[150] Keen M and King J, 'The Croatian profit tax: an ACE in practice' (2002) 23(3) *Institute for Fiscal Studies* 401.
[151] European Commission, 'Tax reforms in EU member states 2013: Tax policy challenges for economic growth and fiscal sustainability: 2013 Report', European Economy 5 (Brussels: European Commission, DG ECFIN and DG TAXUD, October 2013), 64; Sørensen and Johnson, above n 145, 203, 213.
[152] Rumble T, *Synthetic equity and franked debt: Capital markets savings cures* (PhD Thesis, UNSW 1998), 345 and 382.
[153] Keen and King, above n 150, 415.
[154] Boadway and Bruce, above n 114; Bond and Devereux, above n 149.
[155] Sørensen PB, 'Swedish Tax Policy: Recent Trends and Future Challenges', Report to the Expert Group on Public Economics, Swedish Ministry of Finance, May 2010; see further, Sørensen and Johnson, above n 145, 203, 212.
[156] Radulescu DM and Stimmelmayr M, 'ACE vs. CBIT: Which is Better for Investment and Welfare?' (CESifo Working Paper No. 1850, January 2006).
[157] Burnett, above n 27.
[158] Burnett, above n 27.
[159] De Mooij and Devereux, above n 142.
[160] Kayis-Kumar, above n 15.

currently considering best practice approaches to designing rules to prevent BEPS using interest.[161] However, the OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of debt and equity.[162] Yet, it is the decision of the revenue authorities to create a tax-induced debt bias which arguably results in said tax base erosion.[163]

This paper's proposal for a tax on intercompany economic rents is a non-distortionary,[164] novel extension of the literature aligning with the main aim of corporate tax harmonisation.[165]

4 CONCLUSION

This paper approaches the issue of taxing MNEs from a novel perspective by extending the observation in the literature regarding the fungibility of intercompany financing by exploring the broader question of conceptualising cross-border intercompany financing, licensing and leasing activities as fungible.

Given the mobility and fungibility of these intercompany activities, this paper explores the lack of conceptual basis for the arm's length principle, observing that this approach is not a second-best solution to the issue of BEPS by MNEs. An analysis of the practice, issues in practice and hurdles to reform of the arm's length principle is provided, with a focus on source jurisdictions vulnerable to tax base erosion, particularly in the context of a small, open economy where the marginal investor is likely to be a foreign investor, such as Australia or New Zealand. There is currently a gap in the literature regarding the taxation of economic rent in the small, open economy context. Further, this issue extends to all capital importers in general, rendering large capital importers such as the UK[166] and Canada[167] also within scope.

This paper revisits the literature to highlight that since intercompany activities operate in an imperfectly competitive market, the theoretically correct procedure is to tax the marginal cost of investment, as would be the case under an economic rent tax. Specifically, this paper examines whether it is possible to address commentators' and policymakers' growing concerns regarding BEPS by adapting an economic rent tax; namely, the combined ACE-CBIT, into the cross-border context to improve or replace existing rules governing the taxation of cross-border intercompany activities.

---

[161] Both interest and financial payments economically equivalent to interest, and other expense incurred in connection with the raising of financing such as arrangement and guarantee fees are being targeted. The OECD is exploring the 'fixed ratio', 'deemed interest', 'interest cap' rules, the global group-wide test and a combined approach: OECD, above n 1. The global group-wide test appears one of the best suited options in this context. Criticism of this option mostly consists of speculation that this will tend to encourage groups to incur external debt which is not otherwise needed and which may further contribute to BEPS.

[162] It is clear that both the OECD's BEPS project and the thin capitalisation rules' *raisons d'être* is primarily concerned with protecting national tax revenue bases: OECD, above n 1, 47.

[163] Hanlon, above n 40.

[164] Grubert and Altshuler, above n 8, 674-5.

[165] Namely: to reduce, if not remove, distortions arising as a result of cross border investment. This proposal is also largely consistent with the intention of the EU Parent-Subsidiary Directive (2011/96), which in the long run aims "... *to extend the directive to all inter-company interest, dividend and royalty payments*". See further: James S and Oats L, 'Tax harmonisation and the case of corporate taxation' (1998) 8 *Revenue Law Journal* 36, 55. For completeness, it is noteworthy that, in January 2015, the EU Council formally adopted a new anti-abuse rule to the Parent-Subsidiary Directive. The new anti-abuse rule exempts profit distributions paid by subsidiary companies to their parent companies from being misused for the purposes of tax avoidance. EU Member States will have until 31 December 2015 to introduce an anti-abuse rule into national law; see further: European Commission, 'Commissioner Moscovici welcomes the adoption of measures against tax evasion and aggressive tax planning' (Brussels, Statement No. 15/3720, 27 January 2015); available at: http://europa.eu/rapid/press-release_STATEMENT-15-3720_en.htm.

[166] Picciotto, above n 3.

[167] Inotai, above n 7, 43.