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Interjurisdictional Allocation of Multinational Banking Income:
Aligning Taxation Principles with Economic Activity

By

Kerrie Sadiq BCom, LLB (Hons) (Qld), LLM (QUT)

Submitted in fulfilment of the requirements for the degree of
Doctor of Philosophy
Deakin University, May, 2003
I certify that the thesis entitled *Interjurisdictional Allocation of Multinational Banking Income: Aligning Taxation Principles with Economic Activity*, submitted for the degree of Doctor of Philosophy is the result of my own work and that where reference is made to the work of others, due acknowledgment is given.

I also certify that any material in the thesis which has been accepted for a degree or diploma by any other university or institution is identified in the text.

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Full Name: **KERRIE LEE SADICK**

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Thank you to Barry Williams for assisting me with the economics of multinational banking. Thank you to Professor Duncan Bentley, for taking time out of his busy schedule to read a final draft of this document and provide valuable comments to improve the thesis. Thank you to Mike Kobetsky for the professional encouragement given. He has been a great sounding board and is one of the few people I know who think it is fun to talk about the taxation of multinational banks. I also wish to thank colleagues at the University of Western Ontario, particularly Tim Edgar and Daniel Sandler for helping me refine my topic. A special mention also needs to be made of the Australasian Tax Teachers Association, which has provided a valuable forum in which to present my research.

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Parts of this thesis are based on papers and commentary published during candidature (some under the maiden name of Chalmers).

Articles:


Conference Papers and Presentations:


University of Waterloo, School of Accountancy, Waterloo, Ontario, Canada, 22 October 1997 ‘International Transfer Pricing - The Australian Approach’.


Abstract

This thesis argues that one type of multinational entity – the multinational bank – poses particularly significant challenges to the international tax regime in terms of its current profit allocation rules. Multinational banks are a unique subset of multinational entities, and as a consequence of their unique traits, the traditional international tax regime does not yield an optimal interjurisdictional allocation of taxing rights. The opportunity for tax minimisation, achievable because of the unique traits, and realised through exploitation of the traditional source and transfer pricing regime, results in a jurisdictional distribution of taxing rights which does not reflect economic reality.

There are two distinct ways in which the traditional international tax regime fails to reflect economic activity. The first way that economic activity may not be reflected in the distribution of the taxing rights to income from multinational banking is through the application of traditional source rules. The traditional source rules allocate income where transactions are completed rather than where the intermediation services are arranged. As a result of their unique commercial role as financial intermediaries, by separating intermediary economic activity from legal transactions with third parties, multinational banks may distort the true location of the activity giving rise to income.

The second way in which the traditional tax regime may fail to reflect economic activity is through the traditional transfer pricing regime requiring related or internal transactions to be undertaken at an arm’s length price. The arm’s length pricing requirement is theoretically deficient in its failure to recognise the highly integrated nature of multinational banking. In practice, the arm’s length pricing requirement is also difficult, if not impossible, to apply to multinational banks because of the requirement of comparability. The difficulties associated with the current model have resulted in a subtle move by multinational banks towards global formulary apportionment.
This thesis concludes that, for the international taxation of multinational banks, the current source regime should be replaced with a system that allocates profits for tax purposes on the basis of income source, with source determined using a unitary taxation or global formulary apportionment system. It is argued that global formulary apportionment is a theoretically superior model that provides both jurisdiction to tax and allocates profits on the basis of the economic activity that generates the income.
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Chapter 1

The Taxation of Multinational Banking in Context

1.1 Motivation

Internationalisation and globalisation have made the problems associated with the taxation of multinational entities key financial and economic issues for governments. As Dale Wickham and Charles Kerester posited over a decade ago:

We believe that the dramatic internationalization of business over the last 30 years has rendered international tax systems outmoded and inadequate to tax income from international transactions. In other words, we believe that the present system for income taxation of international business -- especially transfer pricing and inadequate sourcing rules -- is a horse-and-buggy mechanism that is woefully inadequate to the demands being made on it. (Emphasis added)

Arguably, this growth of the multinational entity has caught both governments and economists unawares. As such, the traditional tax regime is said not to have kept pace with the evolution of the multinational entity, rendering it ineffective in taxing these businesses according to economic activity. The inadequacies are said generally to stem from the inability of the legal concepts, upon which the traditional rules governing jurisdiction to tax and allocation of income are based, easily adapting to this new phenomenon of the modern multinational entity.

The arguments above contain two key contentions. The first is that there has been a change in the character of the marketplace such that there has been a significant increase in the number of multinational entities, and those entities tend to be larger and more widespread. The second contention is that multinational entities are increasingly undertaking more globalised and complex trading operations.

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Multinational entities are becoming more highly integrated. Rather than merely providing goods, these enterprises are providing goods and services that are not easily attributed to any particular jurisdiction. This thesis is motivated by these contentions, and the affect they have on the international rules governing jurisdiction to tax and allocation of income, to examine the regulatory approach that should be adopted to distribute the taxing rights to the profits of a particular type of multinational entity, the multinational bank.

The focus of this thesis is the multinational bank. Multinational banks pose particularly significant challenges to the current tax regime because of its inadequate jurisdictional (sourcing) and allocation (transfer pricing) rules. The traditional banking business of borrowing and on lending money creates difficulties from a tax perspective when undertaken in a multinational setting. The difficulties are multiplied when a bank carries out a global trading role. While commercial and investment banks (along with securities dealers) are the principal intermediaries which undertake global trading, it is also conducted by other financial intermediaries. The most globally traded product in the financial sector is foreign exchange.

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4 Dale W Wickham and Charles J Kerester, 'New Directions Needed for Solution of the Transfer Pricing Tax Puzzle' (1992) 5 Tax Notes International 399, 401. See also, Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 Cornell Law Review 18, 18. Robert Green explains the problem as follows: 'Multinational enterprises can avoid one country's corporate income tax by moving their investment to another country. More significantly, the current international tax system allows multinationals considerable latitude to leave their investment in place but to shift the reported source of income. Multinationals can accomplish this by manipulating the prices that their affiliates charge one another in intercompany transactions or by strategically arranging their financial structures.'

5 Charles T Plambeck, 'The Taxation Implications of Global Trading' (1990) Bulletin for International Fiscal Documentation 527, 527. 'Global trading' is the practice by financial intermediaries to execute customer orders and to take proprietary positions in financial products in markets around the world and around the clock.


Whether they undertake traditional banking business or the more innovative and modern business of global trading, multinational banks are creating taxation issues that have previously gone largely unnoticed. Due to the increase, however, in the number of multinational banks globally, these taxation issues are now being considered. Initially, the taxation of these banks was not a significant issue due to the small number of multinational banks in existence. Internationally, it was not until 1984 that the Organisation for Economic Co-operation and Development (OECD) specifically addressed some of the substantive transfer pricing issues relating to multinational banks. Recently, the OECD issued a discussion draft on the attribution of profits to permanent establishments, which was intended to update the issues and situations described in the 1984 report. It also deals with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets, which have been such a feature of the global economy in the late 20th Century.

The global expansion of multinational banks has had ramifications for domestic jurisdictions. Many jurisdictions have had to address the increase in multinational banking by undertaking legislative changes regarding their regulatory control. Yet, little has been done to consider the tax consequences. Australia is an example of a

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10 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001), updated by OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) and OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments: Part III (Enterprises Carrying on Global Trading of Financial Instruments) (2003). The original document was released in February 2001 in two parts. On 4 March 2003 a revised version of Part II was released, along with a new Part III. The OECD is still working on a revised version of Part I.

11 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments: Part II (Banks) (2003) 3(2). The OECD discussion draft provides '[f]or example, while risk has always been of significant concern to banks, technological developments in the late 20th Century have resulted in the ability and willingness of banks to undertake pro-active risk management as a means of maximizing shareholder wealth and of dealing with risk-based capital adequacy requirements.'
jurisdiction which has faced this issue. Despite Australia’s banking industry undergoing substantial changes aimed at addressing its restrictive policy and encouraging foreign entry into Australia by non-Australian financial institutions, little has been done to consider the taxation consequences of entry by these banks.\textsuperscript{12} Similarly, with this change in policy, Australian banks are entering foreign markets, with little government regard to the taxation consequences of such events. The loosening of regulatory restrictions has led to an increase in foreign banking activity. Along with deregulation, the communications revolution and technological change have had a significant effect on the increase of globalisation of financial markets.\textsuperscript{13}

The significance of the growth of multinational banks, without a consideration of the international taxation rules governing jurisdiction to tax and allocation of income, is that there is a very real possibility that multinational banks are minimising their tax through the utilisation of outmoded principles, thereby depriving the relevant taxing authority of its \textit{fair share} of revenue. Because of the increase in cross-border transactions, the importance of examining the international rules governing jurisdiction and allocation has increased dramatically since its inception in the 1920s. There is, therefore, an argument that the international tax regime per se should be examined.\textsuperscript{14} It is this added complexity, however, of the modern phenomena of multinational banking that makes it timely to examine the rationale of those areas of the regime applicable to this type of entity.

It may be possible for multinational banks to reduce their tax burden through one of two mechanisms: manipulating the source regime, and/or manipulating the transfer pricing regime. Manipulation of the source regime is made possible because of the unique commercial role multinational banks undertake as financial intermediaries, and the ability to separate the intermediary economic services provided from legal

\textsuperscript{12} Charles T Plambeck, ‘Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives’ (1996) \textit{Taxes} 1129, 1134. As Charles Plambeck points out ‘There are few sources that specifically address the issues raised in transfer pricing analysis of global trading activities.’


transactions with third parties. It is the ability to make the location of the product provided superficially appear to be the source of the profits, which allows multinational banks to shift profits to low tax jurisdictions. Manipulation of the transfer pricing regime is also made possible because of the unique intermediary role. In the case of multinational banking transactions one location may provide the services and undertake negotiations, while another location provides the product, with no actual transactions occurring between the two. As such, there are no internal transactions to price. Furthermore, even where there are internal transactions, it will be difficult to apply the arm’s length requirement, again because of the unique features of multinational banks.

There are certain suppositions underlying the traditional international rules governing jurisdiction and allocation. This thesis maintains that it is these suppositions that are not accurate for multinational banks and allow manipulation to take place. The three problematic assumptions underlying the current international tax system are that; it is possible to ascertain a geographical source for income; that it is possible to treat each part of a multinational entity as a separate unit and to allocate profits based on an arm’s length notion; and, that the place of incorporation is a matter of fundamental significance.\(^\text{15}\)

A multinational bank operates globally and in an integrated manner, which makes it difficult to separate the entity into component parts. The consequence is that ‘there is no single source of income and separate accounting for each unit of a multinational is impossible.’\(^\text{16}\) The location of the multinational bank head office is not relevant to the profit location as income is derived from global operations.\(^\text{17}\) Any attempt to


allocate income on these principles is ‘as Justice Brennan said in the *Container case*, like “slicing a shadow”. 18

1.2 **Evaluative Framework**

This thesis, over nine chapters, examines the taxation of multinational banks to investigate whether the current rules governing jurisdiction to tax and allocation of income for multinational entities in general is optimal for taxing this specific category of multinational entity. An examination of the general faults of the international tax rules governing jurisdiction and allocation is not the purpose of this thesis. It is acknowledged, however, that many of the problems with the international tax rules that arise when applied to multinational banks also arise in the application to other modern multinational entities. Some even arise when the regime is applied to traditional multinational entities in a modern setting.

It is not denied that the traditional regime and international standards developed by the OECD have been ‘tolerably robust’. 19 Currently, however, there is disparity between taxation principles and economic activity, with the problem accentuated by the growing sophistication of international business. 20 This thesis proposes that most faults, where they already exist, are exacerbated in the context of multinational banking, while others arise because of the unique nature of multinational banks. It is acknowledged that many of the problems with the taxation of cross-border transactions existed prior to economic globalisation and financial innovation, however, both trends have exacerbated their effects. 21

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This thesis proposes that multinational banks be excepted from the current regime and subject to discrete regulation. This proposition is not normally espoused. Rather, it is generally accepted that new financial instruments are the leading example of the current difficulties in the international tax regime.\(^\text{22}\) This new type of market has brought to the attention of tax administrators the discrepancies in the traditional tax regime, highlighting the inability of the regime to deal with modern financial transactions.\(^\text{23}\) While this thesis maintains the former proposition, the latter is not inconsistent, and as such, is acknowledged.

This thesis advocates that a unitary taxation model based on global formulary apportionment represents the optimal way to reflect the economic activity of modern multinational banks in an allocation scheme. As the purpose of this thesis is to examine whether the current regime governing jurisdiction and allocation of income is optimal for taxing multinational banks it is necessary to consider what is meant by this term.\(^\text{24}\) Broadly, the traditional criteria for evaluating a tax system, generally credited to have been founded in Smith's principles of taxation (equality, certainty, convenience, and economy),\(^\text{25}\) can be applied to this modern phenomenon of multinational banking.\(^\text{26}\) More specifically, an optimal regime, for the purposes of


\(^{24}\) 'Optimal' is also a term used by Alex Bessen to describe a system which would remedy the generally accepted defects of the current regime: Alex J Bessen, 'A New International Tax Order - Responding to the Challenge' (1991) 45 Bulletin for International Fiscal Documentation 465, 465. Other authors use various terms. For example, John Azzi uses the term 'good' when talking about the aim of an international tax system: John Azzi, 'Policy Considerations in the Taxation of Foreign-Source Income' (1993) 47 Bulletin for International Fiscal Documentation 547, 547-548.


\(^{26}\) Most analysis of the tax system use similar criteria for evaluating a taxation system. For example, the Asprey Committee, in 1975, considered the dominant tests of merit for a tax system as a whole as Fairness (Equity), Simplicity, and Efficiency: Asprey Committee, Australian Taxation Review Committee (1975). More recently, and in the context of examining formulary apportionment, the Commission of the European Communities used what it described as the economic principles upon which any ideal company tax system should be based as i) equity, ii) efficiency, iii) simplicity, certainty and transparency, and iv) effectiveness: Commission of the European Communities, Commission Staff Working Paper: Company Taxation in the Internal Market (2001) 420.
this thesis, is considered to be one that distributes the taxing rights in an equitable manner between the relevant jurisdictions, while, simultaneously allowing decisions of the international banks to be tax neutral. In this sense, neutrality is viewed as an economic concept and equity is regarded as a legal concept.

A neutral tax system is one in which tax rules do not affect economic choices about commercial activities. Neutrality will ideally be across jurisdictions as well as across traditional and non-traditional industries. The primary focus of this thesis is jurisdictional neutrality, also known as economic efficiency.

A system that distributes taxing rights in an equitable manner between the relevant jurisdictions ensures that each country receives its fair share of tax revenue. Given the increase in multinational banking, jurisdictions should be concerned that they are receiving their fair share. Inter-nation equity is concerned with redetermining proper division of the tax base among countries. Richard Musgrave and Peggy Musgrave argue that sharing of the tax base by countries of source should be seen as a matter of inter-nation equity requiring international cooperation. The rights of the jurisdiction of residency will also be at issue. To this extent, while it is agreed that inter-nation equity is an essential attribute to an international tax regime, there is no

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universal agreement as to how to achieve it. The current system attempts to achieve such equity through a combined residency and source regime, with the transfer pricing rules used to apportion income between the relevant jurisdictions.\textsuperscript{33}

The basic premise of this thesis is that inter-nation equity is not achieved through the application of these strict legal principles.\textsuperscript{34} In a broad context, the fundamental problem in dividing the tax base is that an economic solution is needed.\textsuperscript{35} Equity, therefore, would be achieved through a unitary taxation regime that reflects economic reality.\textsuperscript{36} This economic reality could be achieved via the implementation of global formulary apportionment.\textsuperscript{37} Source-jurisdiction taxation should be maintained, but should use a model that reflects economic reality. The unitary method is one such model, which would have, as its guiding principle one of fair shares.\textsuperscript{38}

\begin{flushright}
\textsuperscript{33} It is not the purpose of this thesis to debate the merits, or determine the existence, of capital export neutrality and capital import neutrality, which have been described as 'the normative universe' as they fail to explain the international tax system as it actually exists; See Michael J Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 26 Brooklyn Journal of International Law 1357. Rather, this thesis concentrates on determining whether the current regime results in a distribution reflecting economic reality.

\textsuperscript{34} There is academic support for the argument that the current system does not achieve inter-nation equity. See, eg, Alex J Easson, 'A New International Tax Order – Responding to the Challenge' (1991) 45 Bulletin for International Fiscal Documentation 465; Richard M Bird, 'Shaping a New International Tax Order' (1988) 42 Bulletin for International Fiscal Documentation 292. However, it has also been suggested that much of the existing literature about equity in international taxation defend the prevailing framework of residence and source: Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 Law and Policy in International Business 145.


\textsuperscript{36} See, eg, Daniel J Frisch, 'The Economic of International Tax Policy: Some Old and New Approaches' (1990) 47 Tax Notes 581. Daniel Frisch argues that while international trade economics has made progress in studying the activities of modern multinational entities this work has not yet been applied to international tax policy issues.


\end{flushright}
An optimal regime also strives to achieve equity between taxpayers. In the context of multinational banking, in order to achieve inter-taxpayer equity, it is imperative that domestic and international banks, as well as bank and non-bank entities, are taxed similarly. Inter-taxpayer equity is not achieved where there is distortion through double taxation or less than single taxation. This thesis investigates the latter – that distortion arises because of the ability of multinational banks to understate their income in high tax jurisdictions, through either the current source regime or the transfer pricing rules.

Within the context of multinational banking, this thesis examines the current international tax rules governing jurisdiction and allocation, with the aim of exposing the 'outmoded economic assumptions' upon which the present tax laws relating to multinational banks are based. It is argued that the present regime, applicable to multinational banks, lacks the requirements of an equitable tax regime, in particular the requirement of consistency, distorting capital allocation within the financial markets. The traditional international tax rules governing jurisdiction and allocation is composed of legal concepts and constructs that fail to reflect the economic realities of multinational entities in general and multinational banks in particular.

This thesis considers an optimal regime from a taxing authority perspective, rather than from the perspective of multinational banks. An optimal regime from the perspective of a multinational bank is one where no tax is paid. Taxpayer and

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40 See eg Richard M Bird and J Scott Wilkie who suggest that the gap between economic reality and the assumptions underlying the existing international tax system needs to be bridged before the source-residence question can be insightfully considered. Richard M Bird and J Scott Wilkie, 'Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?' in Sjibren Chossen (ed), Taxing Income in the European Union – Issues and Options for Reform (2000) 78, 84.


42 Although Scott Wilkie makes the observation that both the taxpayer and taxing authority should be concerned with the allocation: "In a related party context, there is an overriding interest to both taxpayers and tax jurisdiction: the allocation of the "international tax base" in a manner that reflects the economic presence of members of an international group in a jurisdiction and, in the result, the extent to which income of the overall enterprise is properly allocable to activity within the jurisdiction relative to any others which the enterprise has a
Government motivation is also in conflict, as taxpayers have the obvious interest in preventing double taxation, while governments are concerned with collecting revenues which may be missed through under taxation.\(^{43}\) As such, this thesis does not directly consider how the banking industry would characterise the attributes of an optimal regime.\(^{44}\) In other words, in determining the failings of the current regime it is the opportunity not the opportunist\(^{45}\) that is examined.\(^{46}\)

It is, however, suggested that an optimal regime so defined for taxing authorities, meet many of the criteria required for a stable and coherent taxation framework for the taxpayer. A regime, which grants taxpayers such an environment, treats transactions according to economic reality, is largely free from double taxation, limits excessive compliance burdens and has a reasonable degree of certainty.\(^{47}\) Consequently, both tax authorities and taxpayers have an interest in seeing the tax base allocated according to the economic activity undertaken in a particular jurisdiction.\(^{48}\)

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\(^{44}\) As Richard Bird points out ‘Since profit-maximising businesses can always be expected to minimise the taxes they pay on any given level of pre-tax income – ... - the difficult problems of determining the tax based and allocating it appropriately between the jurisdictions must be resolved without depending on an extraordinary degree of goodwill or compliance from taxpayers.’ Richard M Bird, ‘The Interjurisdictional Allocation of Income’ (1986) 3 (3) Australian Tax Forum 333, 333.


\(^{46}\) There is also the question of international tax arbitrage, or the deliberate attempt to take advantage of the different tax characterizations that countries may ascribe to a single set of facts. The two issues are interrelated in the sense that where there is an opportunity present the taxpayer may take advantage of it. See, eg, H David Rosenblum, ‘The David R. Tillinghast Lecture International Tax Arbitrage and the International Tax System’ (2000) 53 New York University Tax Review 137; H David Rosenblum, ‘Arbitrage and Transfer Pricing’ (2000) 2000 World Tax Conference Report 25:1.


In order to consider what constitutes an optimal regime from a taxing authority perspective, both domestic laws and international treaties are examined. The current Australian system is evaluated as an example of a typical international tax regime. As a consequence, the Australian taxation law is used as the domestic law to consider how it applies to multinational banks. The conclusions, however, are not limited to Australia. That is, while the current Australian regime is considered to evaluate whether it is optimal, the thesis concludes that an optimal regime is one adopted internationally.\(^{49}\)

1.3 Hypothesis

The question addressed in this thesis is 'What regulatory approach should be adopted to distribute the taxing rights to profits of multinational banks?'

This thesis proposes:

*The unique nature of multinational banks allows an opportunity for tax minimisation through the utilisation of the traditional source and transfer pricing regime. This minimisation results in a jurisdictional distribution of taxing rights which does not reflect economic activity. In the context of multinational banks, the current international taxation rules for multinational enterprises do not adequately address the problem of profit shifting by means of transfer pricing, with the result that the rules do not yield a fair interjurisdictional allocation of taxing rights. The problems of misallocation are then compounded, as multinational banks can shift profits not only by means of transfer pricing, but also as a result of their unique commercial role as financial intermediaries, by separating intermediary economic activity from legal transactions with third parties. The result under traditional source rules is to allocate income where transactions are completed rather than where the intermediation services are arranged. A result reflecting more accurately the economic source of the income would ensue with the adoption of a unitary tax regime based on global formulary apportionment.*

\(^{49}\) Particularly in light of the fact that the implementation of a unilateral solution to the problem would be severely constraining: Charles H Planbeck, 'The Taxation Implications of Global Trading' (1990) 48 Tax Notes 1143, 1156.
Four propositions are examined to test this hypothesis.

1.3.1 Proposition 1

*Multinational banks are a unique subset of multinational entities. Due to these unique traits, the traditional international tax regime does not yield a fair interjurisdictional allocation of taxing rights.*

The consequence of the unique differences between traditional multinational entities and multinational banks means there may be the need for a distinct international tax regime for the taxation result to reflect economic reality. An examination of the unique nature of multinational banks leads to the conclusion that the appropriate tax treatment of these banks may be different from the appropriate tax treatment of multinational entities more generally.

The growth of multinational banks over the last few decades suggests that there should be concern about the possible tax consequence of lost revenue and a less than optimal allocation of taxing rights. While the current tax principles, designed for traditional multinational entities, may have been suitable when implemented, they fail to adequately address the allocation of income from multinational banks. Yet this shortcoming has not been considered adequately due to the relatively recent arrival of multinational banking to the global world. To this extent, it is argued that multinational banks are not adequately distinguished in the context of taxation.

1.3.2 Proposition 2

*The traditional rules of source, as applied to multinational banks, fail to allocate the right to tax to the relevant jurisdictions in an optimal manner, accurately reflecting economic activity.*

The traditional rules of source result in an allocation of the right to tax to jurisdictions based on a legal notion of source rather than an economic one. Banks may manipulate source rules to determine the jurisdiction of income in a location
equating to the legal source of the income that does not reflect the economic activity undertaken in earning the income. This manipulation is made possible because of the outdated classification paradigm combined with the unique intermediary role undertaken by multinational banks.

1.3.3 Proposition 3

Profits attributed to a jurisdiction may be distorted by a multinational banking entity by the separate but related parts of that entity manipulating the prices at which goods and services are transferred internally.

The distortion through transfer price manipulation occurs because of the different motivation of the multinational entity that considers itself a whole, and the taxing authorities that consider the separate parts of the multinational entity, rather than the whole. The current rules, which allocate income between parts of a multinational economic group based on notional arm’s length prices, allow for manipulation by multinational banks. The arm’s length requirement of the transfer pricing regime has led to problems for a variety of reasons. Again, the difficulty of applying arm’s length rules for allocating income between parts of a multinational entity are exacerbated in the case of multinational banks because of features unique to the business of global banking.

1.3.4 Proposition 4

An alternative to the current regime taxing multinational banks is unitary taxation based on global formulary apportionment. This theoretically superior model would tax these multinational banks in a manner reflecting economic reality.

A unitary tax model, based on global formulary apportionment, is considered an alternative regime for taxing multinational banks, which yields a fair interjurisdictional allocation of income. A unitary tax regime is perceived by some as a means of securing improved inter-nation equity.\textsuperscript{50} Unitary taxation is the

taxation of the worldwide income of a multinational entity, and is normally based on a formulary apportionment method, which allocates income to the relevant jurisdictions based on a percentage of the worldwide profits of the multinational entity. The rationale of this model is that the multinational entity cannot be divided into component parts, nor can income, which is derived globally, be allocated to particular distinct geographic sources. 

1.4 Contribution

This thesis acknowledges the recent work of international commentators in developing underlying international tax law theory, and uses this body of work to critique the current jurisdictional and allocation rules governing the taxation of multinational banks, to establish whether it meets the ultimate goal of any tax regime to achieve an optimal taxation model. It applies this body of work specifically to multinational banks in order to establish the outdated nature of such a regime. The development of multinational banks is paralleled with the developments in the taxation of such entities to establish that the latter has not kept pace with the former. By failing to keep pace, the current system is outdated and fails to recognise the true economic position of the multinational bank.

This thesis identifies the recurring themes of the role of source, and transfer pricing as legal principles applied to economic entities. These concepts are examined comprehensively in extant literature, however, due to the diverse nature of both the international tax regime and the multinational entities to which it applies, the connections and their application to multinational banks has not been comprehensively articulated together. Two premise arise in the examination the general international tax regime as it applies to multinational banks. The first premise is that because of the unique nature of the multinational bank, in its intermediary role, the legal source of the income can be easily manipulated. The

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second premise is that the nature of the intra entity services means that the price at which those services are transferred may also be easily manipulated.

By identifying the ways in which a multinational bank is able to distort the true economic location of the income which it derives, it is possible to consider an alternative model. It is argued that the alternative model achieves a result that is considered optimal in the sense that it reflects the true source of the income, rather than the legal source of the income, and is one which allocates the income and expense between the jurisdictions according to the appropriate activity undertaken.

To summarise the conclusions, a regime of unitary taxation, based on formulary apportionment, achieves a result which has greater parity with the economic theory of the multinational bank. While a model based on formulary apportionment does encounter significant implementation barriers, along with various technical details to be determined, it does provide a tax regime which ultimately serves the needs of a taxing jurisdiction much more adequately than the current regime.

1.5 Chapter Outline

Although this thesis is primarily a work of taxation law, chapters two and three establish the basis for arguing that multinational banks should be considered separately from other multinational entities for the purposes of taxation. These chapters consider and elaborate on the unique nature of multinational banks, along with the dramatic increase in their presence over the last few decades. The remainder of this thesis concentrates on the international tax issues that arise because of this unique nature and suggests that the current jurisdiction and allocation rules are inappropriate for the taxation of multinational banks.

The premise of chapter two is that multinational banks are unique in nature when contrasted with traditional multinational entities. In accordance with generally accepted theory, multinational banks are considered in theoretical terms as a subset of multinational entities, rather than an extension of the functions of domestic
banks. While being a subset of multinational entities, multinational banks have special features that result in the appropriate tax treatment being different from that of multinational entities generally. Chapter two establishes the features that distinguish multinational banks from traditional multinational entities and identifies the tax consequences that result.

The first unique feature of multinational banks relates to the services and consequent products supplied; that is, the innovative financial instruments, developed to meet client global demand. The intangibility and seamlessness of these services and products not only challenges the suitability of the traditional tax system to both the supplier and user of the service but also the suitability to the bank itself - especially when these services are provided across jurisdictions. The essential difference between a multinational bank and its more traditional counterpart is that the bank offers an intermediary service. In doing so, the service may be offered in a different location to the product supplied to the client, whether borrower or lender. It is this ability to perform services for clients anywhere in the world, while providing the product in a low tax jurisdiction that leads to the minimisation of tax for multinational banks. Where the current source rules are applied, the jurisdiction where the services are performed may fail to receive any tax revenue. The interjurisdictional allocation of service costs can also lead to distortion.

Adding to the unique nature of the services and consequent products are the synergistic gains unique to multinational banks. Rather than expanding internationally to meet the needs of a new market, multinational banks are expanding internationally to meet the needs of existing clients. Multinational banks can

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expand either by offering their current client base new financial ‘products’ or by acquiring new clients. In contrast to this, traditional multinationals are usually only capable of the latter.\textsuperscript{57} The externalities provided by being an information-based firm thus avail multinational banks of more synergies than tangibles-based multinationals. Another problem for transfer pricing arrangements is that the client database (a valuable asset in its own right) can be shared between elements of the entity.\textsuperscript{58}

The second unique feature of multinational banks, also a by-product of the aim to meet client global demand, is the non-traditional organisational structure, which introduces issues previously not recognised in a traditional taxation regime. The theory of internalisation of the firm, specifically motivation and structure, is utilised to address this structural difference.\textsuperscript{59}

The unique organisational structure also involves a consideration of the types of trading models adopted by multinational banks. This allows an appreciation of the generally highly integrated nature of the multinational bank as contrasted with the traditional multinational entity. The three types of trading models, recognised by the OECD and represented along a continuum are the ‘integrated trading model’, the ‘centralised product management model’ and the ‘separate enterprise model’.\textsuperscript{60}

\textsuperscript{57} Although it is acknowledged that, it may be argued that other modern types of multinational entities are able to do both. For example, Microsoft would do both.


These trading models not only distinguish the multinational bank from its more
traditional counterpart, but also raise unique tax problems. Again, both source issues
and transfer pricing issues arise. While the legal source is easy to ascertain, given
the three alternate trading models, it is unlikely to be the economic source of the
income. Further, because of the highly integrated nature of the models and the lack
of comparable independent third party transactions, transfer-pricing issues arise.

The unique nature of multinational banks is revealed through an investigation of the
motivation behind the decision to become multinational, and the structural form
adopted by multinational entities in general. Within the framework of foreign direct
investment, it is necessary to consider why domestic banks establish themselves as
multinational banks via this approach to offshore banking, along with the
organisational structure adopted. The economic integration of the financial market,
due to technological development, financial innovation and the political economy, all
influence the adoption of a modern organisational structure.

By examining multinational banks in an economic framework, with reference to both
the services and organisational structure, it is possible to consider how these entities
should be taxed, and whether they should be subject to different juridical and
allocation rules than traditional multinational entities due to their unique character
traits and structure.

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61 Foreign direct investment is any investment by an entity over which they have ultimate
control, with the activity consisting of four dimensions: a transfer of capital, a control
investment, a source of funds for foreign operations, and a balance of payments flow. M V

62 A D Chandler, 'Technological and Organizational Underpinnings of Modern Industrial
Multi-national Enterprise: The Dynamics of Competitive Advantage' in A Teichova, M
Levy-Leboyer and H Nussbaum (eds), *Multi-national Enterprise in Historical Perspective
Plummer, *International Combinis in Modern History* (1934); D K Fieldhouse, 'The Multi-
national: A Critique of a Concept' in A Teichova, M Levy-Leboyer and H Nussbaum (eds),
*Multi-national Enterprise in Historical Perspective (1986)* 14; Barry Williams, 'Positive
Theories of Multinational Banking: Eclectic Theory versus Internalisation Theory' (1997)
11(1) *Journal of Economic Surveys* 71, 74.

International Fiscal Documentation* 527, 529.
Chapter two concludes that multinational banks can be distinguished from traditional multinational entities for tax purposes. This conclusion is based on the fact that the services of the multinational bank are unique in nature and organisational structures adopted by multinational banks are substantially different from those associated with traditional multinational entities. Specifically, this chapter forms the basis for arguing that the current regime is not optimal for taxing multinational banks because it fails to recognise that ‘the whole is different from (and greater than) the sum of the parts’. 64

While chapter two argues that multinational banks are unique, chapter three, by following a chronological development of multinational banks in Australia as an example of a typical regime, investigates how unsuitable jurisdictional and allocation rules applicable to these unique entities has evolved. Throughout this thesis it is argued that this has occurred because multinational banks were not specifically considered when the domestic or international tax rules were written. Contributing to this is the fact that there has been no comprehensive analysis of the applicability of the existing regime to multinational banks, or the specific taxation issues that arise because of the nature of the service and the organisational structure adopted. 65

Chapter three sets the scene for why multinational banking has increased and why the significance of the tax issues has increased exponentially, particularly in light of rapid changes in the way banking is being undertaken today. It is demonstrated that the relaxation of legislative controls, through various inquiries into banking in Australia, led to the entry of multinational banks. It is suggested that due to the failure of these legislative changes to concurrently adjust the tax regime, tax problems that were not previously apparent have resulted. To demonstrate the need to examine the tax implications of multinational banking, chapter three answers the

64 Richard M Bird, ‘The Interjurisdictional Allocation of Income’ (1986) 3 (3) Australian Tax Forum 333, 339. Although it should be noted that Richard Bird argues this applies to all multinational enterprises.

65 The OECD, in several reports, discussed in chapter five, has attempted to address the problems associated with the taxation of multinational banks, but to date has merely attempted to apply the current regime to these entities rather than consider whether this is appropriate.
question of why the taxation of multinational banking is a current issue in Australia, when the taxation of multinational entities in general, has always been an issue.

To answer this question chapter three provides a regulatory outline of multinational banking in Australia. This historical perspective demonstrates that the federal policies on foreign bank entry were restrictive, initially not allowing, and more recently, indirectly discouraging foreign bank entry into Australia. In this context, the regulatory requirements to be satisfied before foreign entry is permitted are examined, along with the changes that have occurred to these requirements.

Chapter three explains how the financial system reviews⁶⁶ led to one of the biggest changes to foreign banking in Australia in recent times - allowing a foreign bank to operate as either a branch or a subsidiary, rather than the previously required subsidiary structure.⁶⁷ The legislative framework applicable to foreign banks and, more specifically, the Banking Act 1959 (Cth) to which substantial amendments have been made to address foreign entry, is examined and is deemed to have placed restrictions on entry into Australia. The governance role of the Australian Prudential Regulation Authority⁶⁸ is also reviewed and considered to create impediments to foreign bank entry.

In the context of multinational entities, it is established that the global expansion by banks is a relatively contemporary phenomenon. This is not only a demand driven result but also a product of the current impediments to foreign banks entering the Australian market and restrictions on their operations. The practical result of this evolving regulated banking industry has two facets, each of which is discussed briefly. First, the ‘major four’ Australian banks and their entry into the overseas

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⁶⁷ This occurred as a result of the Prime Minister’s Economic Statement of 26 February 1992 and the accompanying ‘One Nation’ Policy: The Economic Statement by the Prime Minister, the Hon PJ Keating MP (26 February 1992).

⁶⁸ The Reserve Bank of Australia previously administered these requirements.
markets are considered. Second, with the exception of ANZ's initial establishment as a multinational bank and Banque de Paris' establishment of Australian operations in 1881, the comparative infancy of modern multinational banking in an Australian environment is examined.

Chapter three concludes that determining an optimal taxing regime for multinational banks should be one of the highest concerns for tax reform. This conclusion is based on the fact that while foreign banking was increasing in Australia very little consideration was given as to how the income should be taxed. Furthermore, the issue of multinational banking has been addressed legislatively with respect to non-taxation issues, but to date has not been addressed for tax purposes. The recent trend for Australian banks to operate offshore re-enforces how important it is to consider the taxation of multinational banks, as Australia clearly has a vested interest in ensuring that Australian entities are taxed appropriately.

If the conclusions in chapters two and three are correct, the traditional jurisdictional and allocation rules can be considered to determine whether these suppositions provide a foundation for determining that an alternative tax model would better suit multinational banks.

This thesis investigates both jurisdictional allocation rules (in chapter four), and transactional allocation rules (in chapters five, six, and seven), to consider the inadequacies of the current regime in allocating the taxing rights of multinational banks to the relevant jurisdictions. The current jurisdictional allocation rules considered are those of source, while the current transactional allocation rules considered are those of the transfer pricing regime requiring the arm's length standard.

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69 The Commonwealth Bank of Australia, National Australia Bank, Westpac and ANZ are typically referred to as Australia's major banks, as compared to regional banks and foreign owned banks.

Chapter four argues that to tax multinational banks in an optimal manner, a robust source regime is required. To this extent, it is suggested that the traditional source regime fails to allocate income according to economic activity. Formulary apportionment, as an alternative, is considered to be a source based regime, which may achieve this result. Prior to the examination of whether formulary apportionment is potentially the robust regime needed, chapter four examines whether the current source regime is optimal for taxing multinational banks and suggests that the answer is no. This thesis does not dispute that theoretically, source is a sound basis for taxing multinational banks. Quite the contrary, it suggests that a source regime should be maintained. It contends, however, that the traditional source regime, when applied to multinational banks, fails to allocate income according to economic activity.

When applied to multinational banks, it is argued that the cause of the failure of the traditional source regime is twofold. The first failure of the regime is that it requires the classification of the income of multinational banks, which is based on historic legal notions of source. The second failure of the regime is that the unique nature of multinational banking means that income may be allocated to a particular geographic location different to the location of the economic activity.

The first failure requires an examination of the various possible categories of source of income. In the case of multinational banks, often transactions will not fit neatly

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into one of the legal classifications, as these rules are designed with a reference point in the past. Further, there is the opportunity for manipulation to allow the classification of income into the most advantageous category.

The second cause of the failure to allocate income based on economic activity is the result of the unique nature of multinational banks. The consequence of the unique nature of the intermediation services offered means that these services may be undertaken in a different geographical location to the end product. Further exacerbating this problem is the fact that particular multinational entities such as multinational banks no longer operate as distinct and separate parts of the one entity. Rather, they operate as integrated wholes, with the synergy gains explaining why this type of multinational entity has become so widespread. It is this operation through integrated wholes that make it difficult to apply the traditional source concept to the income of these multinational entities, as income cannot be associated with particular geographical locations.

Chapter four concludes that because of the nature of multinational banks as intermediaries, rather than manufacturers turning out a final product, the apparent source of the income can be a different geographical location to where the effort is expended to generate that income. Where this is the case, formulary apportionment allocates income according to economic activity, also by allocating based on source, but the ‘source’ is where the economic activity takes place, not the legal source of the income.

The outcome of chapter four, relating to jurisdictional allocation, is a conclusion that the traditional principles, when applied to multinational banks fail to allocate the income to relevant jurisdictions in an optimal manner. Furthermore, these legal principles should not form the basis for taxing multinational banks. Essentially, a


formulary apportionment system is designed so that traditional 'source rules and the legal form of doing business do not matter for corporate tax purposes.' Jurisdictional allocation issues, however, do not chronicle all of the problems associated with the allocation of income of multinational banks.

Resolving jurisdictional allocation issues does not mean the income is measured in each jurisdiction according to economic activity. Also distorting the attribution of profits is the transactional allocation issues of transfer pricing. Profits of a jurisdiction may be distorted by a multinational entity by the separate but related parts of that entity manipulating the prices at which goods and services are transferred.

Both anecdotal and empirical evidence suggests that multinational banks are taking advantage of opportunities to reduce their tax burdens in high-tax countries by way of intra-firm transfer pricing. It is very simple for a bank to establish a subsidiary or branch (permanent establishment) in a given jurisdiction and to undertake transactions through that office. It is this manipulation of the current regime that chapter's five to seven examine. The premise of chapter five is that the arm's length pricing method is not a theoretically sound model for taxing multinational banks. Chapter six considers the practical difficulties with the arm's length method when applied to multinational banks, while chapter seven considers the consequences of the theoretical and practical difficulties in applying the arm's length price.

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Chapter five initially outlines the solution to transfer price manipulation devised by the OECD - arm’s length pricing. Each part of the multinational entity is treated as a separate part of the economic entity (whether it is a branch or a subsidiary) and a price is substituted that would have been used in the transaction if it had been with an unrelated third party rather than a related party within the same multinational entity. The OECD has, for many decades provided its solution to this manipulation, however, it has recognised the increasing significance in recent years. As a response to increased cross border-transactions and multinational enterprise operations, the OECD revised its international transfer pricing guidelines (OECD Guidelines) in 1995. The current guidelines represent a consensus among 25 OECD member countries on the approach to international transfer pricing issues.

The arm’s length standard is based on what is referred to as the separate accounting or separate entity approach. The separate parts of an entity are defined by reference to national boundaries, or what is commonly referred to as the ‘water’s edge’. Income and expenses are allocated to the relevant jurisdictions on a transactional basis, that is, specific transactions are considered as if they were between distinct entities, with each entity reporting separate taxable income.

Chapter five also considers the suppositions underpinning the arm’s length requirement when applied to multinational banks. The first supposition is that branches and subsidiaries should be treated the same. This supposition is not disputed. However, both domestic laws and double tax agreements have different provisions dealing with the respective structures. The second supposition is that

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multinational banks should be treated in the same manner as traditional multinational entities. This thesis disputes this supposition.

This thesis argues that when applied to multinational banks, the arm’s length method is an artificial one, which fails to take into account economic reality. This is contrary to the OECD view that the transfer-pricing regime, imposing the requirement of an arm’s length price for related party transactions, is an optimal model to determine the price of transfers between different parts of a multinational entity. Current literature advocates the arm’s length requirement of the transfer-pricing regime based on four perceived advantages: it is the internationally recognised standard; it is an objective and determinate standard; it creates neutrality between affiliated and unaffiliated firms; and the allocation of income is based on economic reality.

Examination reveals that these theoretical advantages do not necessarily exist. This thesis argues that the arm’s length requirement fails to recognise the economic reality of multinational banking. It is suggested that the arm’s length standard is fundamentally flawed because it is inconsistent with economic reality, and that this is particularly relevant to multinational banks due to the highly integrated nature of the intermediary services being provided. It is argued that this conclusion is

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84 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003); OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001).


supported by academic tax literature, which demonstrates the highly integrated nature of modern multinational entities.\(^8\)

It is also argued that these theoretical advantages do not exist because there is a failure of the arm’s length standard to recognise the integration benefits achieved by multinational banks. It is maintained that, from a theoretical perspective, the arm’s length standard fails to take into account the synergies arguably inherent in a multinational enterprise.\(^9\) That is, it fails to take into account the fact that it is more cost effective to undertake foreign direct investment, than contracting with arm’s length parties.\(^10\) The arm’s length requirement ignores the industrial organisation theory of the multinational entity\(^11\) and fails to allow for internal organisation economies.\(^12\) Further, the fact that separate parts of the multinational entity are not motivated by their own economic interest, but rather the economic interest of the group as a whole, is considered inconsistent with the separate enterprise paradigm. Chapter five concludes that the arm’s length pricing regime is a theoretically deficient model for taxing multinational banks.


While chapter five concludes that arm's length pricing is theoretically deficient, chapter six considers the practical difficulties in its application. In chapter six, it is argued that the fundamental practical failing of the traditional transfer pricing regime is the concept of comparability required to determine the arm's length price. In particular, chapter six considers why the arm's length pricing requirement produces a fiction, rather than one that reflects economic reality.

Chapter six investigates the application of the arm's length standard to multinational banks and discusses what it refers to as the 'Alice in Wonderland' syndrome, that is, that the arm's length pricing regime operates in a universe of pretense. It is argued that the current regime is one of fiction, requiring conceptual and transactional comparability where it is simply not possible to make such comparisons. The principal purpose of chapter six is to examine the fiction of the two-step process suggested in the OECD discussion drafts in applying the arm's length concept to multinational entities, when this process is applied to multinational banks.

The first step is one of conceptual comparability to determine what the hypothetical distinct and separate enterprise would look like. It is argued that, in undertaking the required functional analysis, a fiction is created in the case of multinational banks because of their unique features. The highly integrated nature of the multinational bank is considered a primary factor in the increasing difficulty in separating the component parts. The unique organisational structure adopted by multinational

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banks also contributes to the fiction, especially where the integrated trading model is adopted. The very reason for the existence of multinational banks often means that there will not be any arm’s length competitors. Further, it is difficult to allocate activities to the different parts of the multinational bank because the relationships between related parties are different to those of non-related parties.

The second step is one of transactional comparability to determine the actual profits attributable to the subsidiary or branch of the multinational bank. In this part of chapter six, operating on the premise that subsidiaries and branches are to be treated the same, issues specific to a permanent establishment are considered. The application of the acceptable arm’s length pricing methodologies is then undertaken to argue the fiction of step two. It is claimed that there are three interrelated fictions in applying this step. The unique organisational structure and the highly integrated nature of multinational banks mean that often there is no direct evidence of comparisons in an uncontrolled situation. In addition, there is frequently an absence of comparables because of the unique services provided by multinational

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Finally, the type of inter and intra entity dealings for multinational banks are highly specialised and regularly intangible.  

Chapter six concludes that it is difficult, if not impossible, to apply the arm’s length standard to multinational banks. As a result, this gives rise to a fiction that would be avoided if there were no ‘comparable’ requirement and a formulary apportionment model was to be adopted.

Chapter seven considers the current response (or consequences) to the difficulties in applying the arm’s length price. The use of non-traditional arm’s length methodologies is examined as a solution to the problems of applying the traditional standard to multinational banks. Chapter seven also recognises the administrative burdens placed on multinational banks in complying with the regime, and the use of advance pricing arrangements as a practical solution to the problems presented to multinational banks in attempting to comply with the arm’s length standard. It is suggested that advance pricing agreements are a practical solution to the problems facing multinational banks but they do not address the underlying failure of the arm’s length principle to allocate income to jurisdictions according to economic reality.


Chapter seven concludes that there is a furtive move towards formulary apportionment. As such, it would appear logical for taxing jurisdictions to embark on a proactive program of reform.

Chapter eight examines unitary taxation using global formulary apportionment as an alternative regime to the current one for taxing multinational banks. Unitary taxation is the taxation of the worldwide income of a multinational entity, and is normally based on a formulary apportionment method, which allocates income to the relevant jurisdictions based on a percentage of the worldwide profits of the multinational entity.\textsuperscript{104} It is concluded from the earlier chapters that the traditional regime is not optimal for taxing multinational banks. If this is the case, the question for chapter eight to address is whether unitary taxation based on global formulary apportionment is an optimal regime for these banks. It is argued because the unitary approach is activity - rather than enterprise - based it is more aligned with economic reality.\textsuperscript{105}

Internalisation theory, relied on early in the thesis may also be used to argue that the unitary tax model is consistent with economic reality and may be used to posit this alternative to the arm's length price.\textsuperscript{106} It is contended that, consistent with economic reality, unitary taxation looks at the unitary business and the profits of the whole, while recognising that it is difficult to allocate income as being derived from a particular geographic location.\textsuperscript{107}

Criticisms of this method are generally not aimed at the theoretical soundness of the model but rather at the practical problems of implementation and administration. While these problems are not to be dismissed, they do not provide valid arguments for rejecting the unitary taxation approach as a suitable alternative. In the event that


\textsuperscript{107} Richard M Bird, 'The Interjurisdictional Allocation of Income' (1986) 3(3) \textit{Australian Tax Forum} 333, 342.
a formulary apportionment model were to be adopted, agreement would still need to
be reached both on the appropriate formula to be employed and the base to which it
is to be applied.\textsuperscript{108} This thesis aims to demonstrate the robustness of the unitary tax
model for multinational banks in allocating the taxing rights according to economic
reality.

Chapter eight concludes that, while there are significant implementation, compliance,
and enforcement issues to overcome, the unitary taxation model is theoretically
superior to the current arm’s length model, given the highly integrated nature of
modern multinational banks.

Chapter nine provides a summary of this thesis and demonstrates how the four
propositions were proven, thereby confirming the hypothesis.

The table below provides a summary of the chapters, along with the propositions.

\textsuperscript{108} Richard M Bird, ‘The Interjurisdictional Allocation of Income’ (1986) 3(3) \textit{Australian Tax
Forum} 333, 341.
<table>
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<tr>
<th>Ch</th>
<th>Heading</th>
<th>Research Questions</th>
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<td></td>
<td><strong>Part 1</strong></td>
<td><strong>Taxing Multinational Banks in an Economic Framework</strong></td>
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<td></td>
<td><strong>The Taxation of Multinational Banking in Context</strong></td>
<td>Justifies the hypothesis and the four propositions.</td>
<td>Provides the motivation, structure and contribution of the thesis.</td>
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<td>Outlines the hypothesis: The unique nature of multinational banks allows an opportunity for tax minimisation through the utilization of the traditional source and transfer pricing regime.</td>
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<td></td>
<td><strong>Motivation and Structure of the Multinational Bank – Their Unique Nature and Distinguishing Features</strong></td>
<td></td>
<td>Argues that multinational banks are unique in two ways:</td>
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<td>They provide unique services and consequent products. In particular, these services are unique as the bank is operating as an intermediary.</td>
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<td>They have a unique organisational structure. This means that they are highly integrated making it effectively impossible to divide into component parts.</td>
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<td><strong>A Chronicle of Multinational Banking in Australia – and the Importance of tax Reform</strong></td>
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<td>Considers the history of multinational banking in Australia.</td>
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<td>Looks at the affects of the various financial inquiries and the subsequent amendments to legislative and regulatory controls.</td>
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<td>Considers whether there was any tax consideration as part of this process.</td>
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<td><strong>Part 2</strong></td>
<td><strong>Jurisdictional Allocation</strong></td>
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<td><strong>The Traditional Approach to Jurisdictional Allocation and the Classification Paradigm of the Source Regime</strong></td>
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<td>The difficulties in classifying the income of a multinational bank are considered, particularly in determining whether the income is from a service or a product.</td>
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<td>This allows for manipulation by the banks.</td>
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<td>Considers that the reason why it is difficult to classify the income of a multinational bank is because of its unique features.</td>
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<td>Concludes that the current source rules do not allocate to accurately reflect economic activity.</td>
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<td>Part 3</td>
<td>Transactional Allocation</td>
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| **Traditional Rationale of the Arm’s Length Approach to Transactional Allocation** | Addresses the third proposition  
Consider the OECD solution to the problem of transfer price manipulation  
Asks whether the arm’s length standard is a theoretically superior model for the allocation of income to the relevant jurisdictions. | Argues that the OECD solution to transfer price manipulation – the arm’s length standard – does not necessarily stand up to theoretical challenge.  
Argues that the four perceived theoretical benefits (international acceptance, objective and determinate standard, removal of economic incentives and accurate allocation of income) do not necessarily exist, especially when applied to multinational banks.  
This is because the arm’s length standard fails to recognize economic reality or take into account the integration benefits to multinational banks.  
Concludes that the arm’s length pricing model is theoretically deficient. |
| **The Fundamental Failing of the Traditional Transfer Pricing Regime – Conceptual and Transactional Comparability** | Asks whether there are difficulties in the practical application of the arm’s length standard when applied to multinational banks. | Considers the application of the arm’s length standard through the recommended steps requiring comparability:  
Step 1 using conceptual comparability to determine the hypothetical distinct and separate banking enterprise.  
Step 2 using transactional comparability to determine the profits of the hypothesized distinct and separate entity.  
Concludes that the arm’s length pricing model produces a fiction when applied in practice. |
| **Implications of the Failure to Address the Inconsistencies between the Separate Entity Paradigm and Economic Reality** | Addresses the question of what banks are doing in response to the difficulties outlined in chapters five and six. | Looks at the non-traditional arm’s length methodologies and their use.  
Considers the practical solution of advance pricing agreements.  
Concludes that there is a furtive move towards formulary apportionment so taxing authorities should make a pro-active forthright move towards it. |
| Part 4 | The Case for Formulary Apportionment |
| **Alternative Apportionment through a Unitary Taxation Regime Aligning with Economic Reality** | Addresses the fourth proposition  
Considers whether unitary taxation based on global formulary apportionment is a theoretically sound alternative for taxing multinational banks. | Argues that this theoretically superior model would tax these multinational banks in a manner reflecting economic reality.  
Acknowledges the practical problems associated with the model.  
Concludes that the implementation and administration problems should not be a barrier to accepting formulary apportionment as a theoretically superior model for taxing multinational banks. |
| Conclusion | Proves the hypothesis |
Chapter 2

Motivation and Structure of the Multinational Bank - Their Unique Nature and Distinguishing Features

2.1 Introduction

This thesis puts forward the argument that the current international taxation rules governing jurisdiction and allocation of income for multinational entities in general, are not optimal for taxing multinational banks. As such, it is essential to establish that there are fundamental differences between traditional multinational entities and multinational banks. The unique nature of multinational banks is considered to demonstrate how these differences may be used advantageously to assist in the distortion of the allocation of taxing rights.

This chapter is divided into three parts. The first part considers the role of the multinational bank in a global economy. The second and third parts establish the two core differences between multinational entities in general and multinational banks, and why they have an impact on taxation, particularly in failing to arrive at a result which reflects economic reality.

The first distinguishing feature of multinational banks from their more traditional counterparts is the unique nature of the services and consequent products supplied, aimed at meeting client global demand. The second distinguishing feature is the non-traditional organisational structure adopted. The structure assumed, also designed to meet client global demand, introduces issues previously not recognised in the traditional taxation system, which is designed for the structure of traditional multinational entities.
Chapter two concludes that multinational banks are unique in nature. For taxation purposes, therefore, and more specifically, in order to examine whether the current regime is optimal, resulting in a reflection of economic reality, this chapter concludes that multinational banks should be considered separately to that of traditional multinational entities.

2.2 The Role of the Multinational Bank

The role of the multinational bank as an entity is vastly different to that of traditional multinational enterprises. It is not in the business of providing a traditional product or service, but rather acts as an intermediary. In the context of global trading, there are three major parties to transactions: capital users, capital suppliers and the financial intermediaries.\(^1\) The financial intermediaries, generally multinational banks, profit from the intermediating between the capital users and the capital suppliers.\(^2\) This unique nature of the intermediary services (and to a lesser extent the resultant products, or the innovative financial instruments which are used to deliver these services) performed by these multinational banks are designed to meet client global demand. In this context, because the role of the multinational bank is one of intermediary, the product supplied by the bank is ancillary to the true nature of its business. The true nature of its business, therefore, is one of the supply of services. The service provided through the intermediation between borrower and lender, enables borrowers and investors to reconcile their different objectives.\(^3\)

By acting as an intermediary, a multinational bank is in the unique position of being able to separate its services role from the legal contracts that give rise to profit. It can provide advice to clients in one jurisdiction, with those clients completing the transaction (depositing or borrowing money) in another jurisdiction. The latter being

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a low tax jurisdiction. Thus, profits are shifted away from the economic activity to the location of the supply of the ancillary product.

A multinational bank has several sources of income, all of which stem from this intermediation service provided. The sources of income range from the interest and dividends received with respect to the securities it is required to maintain to be a market maker, to trading gains from sales of those securities.\textsuperscript{4} It also earns income from notional principal contracts, and other over the counter derivatives entered into with clients, fee income from structuring transactions, gains from dealing in liabilities, income from stock lending and repo transactions, and broker's fees from exchange transactions executed for clients.\textsuperscript{5} Multinational banks also play an important role in the maintenance of efficiency in the financial markets, not only by operating as intermediaries between borrowers and lenders, but also by managing the risk from a portfolio of transactions.\textsuperscript{6}

The process of global trading consists of a number of roles, which are undertaken by multinational banks to earn this income. These roles can be categorised into trading, sales and marketing, management, and supporting functions.\textsuperscript{7} Novel tax issues also arise because these functions may be conducted across a number of jurisdictions.\textsuperscript{8}


\textsuperscript{8} The OECD discussion draft recognizes that there is unique tax issues associated with global trading. It states that the tax issues '... involve questions as basic as when do trading activities conducted in other countries, either directly or through affiliates acting as agents, constitute a permanent establishment, how to determine the income attributable to those permanent establishments, how to apply traditional transfer pricing methodologies to transactions between associated enterprises involved in an integrated business, and basic timing issues.'; OECD, The Taxation of Global Trading of Financial Instruments, (1998) 13(15).
The difference in the role of the multinational bank stems from the unique features associated with it. Each is examined in turn.

2.3 The Unique Nature of the Services and Consequent Products

The first difference between a traditional multinational entity and a multinational bank is the services and consequent products supplied. The nature of the services and resultant products provided by multinational banks is a response to clients' needs in which the banks undertake the intermediary role in the market place.

This unique feature is examined in three interrelated subcategories. The first subcategory looks at the globalisation and the increase in global trading in the context of multinational banking in order to explain the functions of a multinational bank. This establishes the differences between the functions of the traditional multinational entity and the multinational bank, along with the differences between the multinational bank and purely domestic banks. The second subcategory considers the growth, and evolution of the multinational bank, providing explanations for the rise of these entities. This part of the chapter considers the compulsion by banks to follow clients to international jurisdictions, along with the internalisation theory of undertaking multinational trade. The third subcategory examines the monopolistic nature of multinational banking, with the personal contact advantage providing synthesis of information. This is considered in order to establish further unique source and transfer pricing issues that arise with multinational banks.

2.3.1 Globalisation and the Increase in Global Trading

To demonstrate the unique nature of multinational banking, it is necessary to define a multinational bank and consider the functions undertaken in the world market. This world market is continually changing with business becoming increasingly global, and borders becoming progressively meaningless to those partaking in the provision
of services and products internationally. Different terminology has been used to describe these activities, and, as such it is necessary to consider what ‘multinational banking’ means.

Trading in the international arena does not alone determine an entity to be multinational. A multinational entity deals internationally in a particular way, in that it is a business venture which 'owns and controls income-generating assets in more than one country' or 'an enterprise that owns and controls activities in different countries'. A multinational entity has been more comprehensively defined as '[a] business created and owned by a group of private investors which is engaged in carrying out business and commercial activities in two or more states. A multinational corporation usually owns assets and conducts foreign trade and investment over a number of geographically, politically and economically diverse countries.' It is not necessary, therefore, for an entity to be established in two or more jurisdictions to be involved in international trade, but this is necessary if that entity is to be classified as multinational.

The result of a multinational entity needing to be established in two or more jurisdictions to be so defined means that an entity dealing in the international market, but not established in two or more jurisdictions, is not a multinational entity. Domestic entities may successfully trade in the international market other than as a multinational entity. For example, business conducted through an offshore agent or via a joint venture is not consistent with the definition of a multinational entity. Similarly, a firm that trades on the international market via an internet site is not

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12 Butterworths Australian Legal Dictionary 767.
within the definition of a multinational entity. Conversely, once an entity is established in two or more jurisdictions it is classified as multinational.\footnote{A business enterprise that is considered multinational is commonly referred to as either a multi-national entity (MNE) or a multinational corporation (MNC). These two terms are generally interchangeable with their use depending on authorship. For example, the United Nations in its Code of Conduct (The United Nations Conference on Trade and Development Code of Conduct for Multinational Corporations) refers to MNCs, while OECD, in its Guidelines (The Organisation for Economic Cooperation and Development Guidelines for Multi-national Enterprises) refers to MNEs.}

It follows that a multinational bank is a multinational entity operating banking facilities. A multinational bank has been defined in very simple terms as ‘... a bank that owns and controls banking activities in two or more countries.’\footnote{Mark Casson, ‘Evolution of Multi-national Banks: A theoretical Perspective’ in G Jones G (ed), \textit{Banks as Multi-nationals} (1990) 14.} Like all entities engaging in international business it must be determined whether the bank in question is truly multinational or merely international. A more concise definition of a multinational bank is one which encompasses foreign direct investment by the bank, as a parallel to the requirement that a multinational entity be established in two or more jurisdictions.

Multinational banks may also be considered in the context of globalisation to determine the functions performed. Globalisation and internationalisation are words that have recently become part of everyday language, and are usually used in the context of anything involving more than one jurisdiction. Globalisation, however, is more precise than this, as it involves the process by which the world becomes a single marketplace,\footnote{Butterworths Australian Legal Dictionary (1997) 525.} and is a product of entities undertaking internationalisation, that is, dealing in the international market.\footnote{Although in an international taxation setting Richard M Bird and J Scott Wilkie suggest that “globalization” is little more than an imprecise code word for the fact that national tax authorities everywhere are in trouble owing to the increasing irrelevance of national borders with respect to determining the location of economic activity in traditional tax policy terms.; Richard M Bird and J Scott Wilkie, ‘Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?’ in Sijbren Chossen (ed), \textit{Taxing Income in the European Union – Issues and Options for Reform} (2000) 78, 80.} Globalisation is one of the challenges facing tax authorities today and is a factor driving future tax policy,\footnote{The general view is that globalisation of national economies raises compelling questions as to the continued viability of the existing international tax regime; Victor Zonana,} with the effects
of globalisation having profound implications for tax systems.\textsuperscript{18} Globalisation has been described as the 20\textsuperscript{th} century's greatest economic event,\textsuperscript{19} yet it is a process that has existed for hundreds of years with only the extent and pace of change which is new.\textsuperscript{20}

A multinational bank contributes to the globalisation of the financial market, and most engage in global trading. The OECD discussion drafts, in the context of the taxation of financial instruments, describe global trading as 'the catch-all phrase that focuses on the capacity of these financial institutions to execute customers orders in financial products in markets around the world and/or around the clock.'\textsuperscript{21} Charles Plambeck similarly describes global trading as 'the capacity of financial intermediaries to make markets and to take proprietary positions in financial markets around the world and around the clock.'\textsuperscript{22} Global trading may be complex, where 'typically, a global trading business, through its various offices, will work on a given transaction or project, in varying and unpredictable degrees, developing, monitoring negotiating, and concluding transactions on an ongoing 24-hour basis worldwide.'\textsuperscript{23}

\begin{itemize}
  \item \textsuperscript{18} Victor Zonana, 'Introduction: International Tax Policy in the New Millennium: Developing an Agenda' (2001) 26 Brooklyn Journal of International Law 1253, 1253. Although there is a suggestion that political will could be the determinative factor in driving international tax policy.
  \item \textsuperscript{19} Jack M Minz, 'National Tax Policy and Global Competition' (2001) 26 Brooklyn Journal of International Law 1283.
  \item \textsuperscript{21} Alex J Easson, Taxation of Foreign Direct Investment (1999), 156.
  \item \textsuperscript{23} Gerald C. Shea, 'Transfer Pricing: APAs may Effectively Address Income and Expense Allocation Problems Faced by Global Trading Businesses' (1992) 4 Tax Notes International 1022, 1022.
\end{itemize}
As global trading is a by-product of the motivational factors behind entering a foreign market, most multinational banks undertake at least a proportion of global trading. Global trading raises such tax questions, as whether cross-border trading conducted in a foreign country constitutes a permanent establishment, how to determine income attributable to an existing permanent establishment, and how to apply transfer pricing methods.\textsuperscript{24}

The increase in this global trading is driven by the global demand created by the clients of banks, both borrowers and investors. In particular, the global market established by traditional multinational entities created a demand for the innovative financial instruments subsequently developed by multinational banks.\textsuperscript{25} An explosive growth of these innovative financial instruments has occurred over the last 25 years.\textsuperscript{26} More recently, sophisticated derivative instruments have been created by multinational banks to allow multinational entities to manage risk themselves.\textsuperscript{27} Technological development has accelerated this process of financial globalisation.\textsuperscript{28} By responding to the demand created, multinational banks have allowed the efficient operation of the financial markets.

Contributing to this growth in global trading was the broadening and deepening of the customer base which occurred in the late 1980s, concurrent with an awareness among tax administrators of the unique tax issues relating to the function of global trading undertaken by the financial institutions. While technological, economic, and regulatory developments contributed to the expansion of global financial trading.\textsuperscript{29}

\textsuperscript{24} Allyn Yamanouchi, 'International Tax Issues Affecting Electronic Commerce and Banking' (1997) 14 Tax Notes International 1619, 1621.

\textsuperscript{25} John Neighbour, 'Innovative Financial Instruments Challenge the Global Tax System' (1997) 14 Tax Notes International 931, 931.


such expansion would not have occurred without the increased international trade of traditional multinational entities. This concept of the multinational banks arising out of the need of traditional multinational entities is explored further in the next part of this chapter.

The rising role of global trading undertaken by multinational banks, which consists of a number of functions can generally be categorised into trading, sales and marketing, management, and supporting functions. The commonality among these service roles is that they may be conducted across a number of jurisdictions simultaneously. It is this feature which further distinguishes the services provided by multinational banks from those of other multinational entities, which are normally restricted by geographical boundaries. New technologies expedite tremendously the cross-border capabilities, of these financial service organisations, as compared with manufacturers.

The consequence of this lack of geographical restriction, because of the types of services being offered, is that the tax position of multinational banks may not correspond with economic reality. The growth in financial instruments and the consequential global trading has outpaced the evolution of tax rules, which means that such situations are not adequately dealt with.

Manipulation by a multinational bank may result in less than single taxation but more fundamentally, it may affect an outcome that fails to accord with economic reality. It is the proposition of this thesis that this taxation irregularity is exacerbated for

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32 Vito Tanzi suggests that in some cases of enterprises becoming multinational they have almost lost their original national identity, especially in an economic sense: Vito Tanzi, 'The Impact of Economic Globalization on Taxation' (1998) 52 Bulletin for International Fiscal Documentation 338, 339.

multinational banks because of the nature of their services and consequent products. Adding to this irregularity is the fact that the service role may be conducted across multiple jurisdictions simultaneously. By acting as intermediaries, multinational banks operate seamlessly across borders, through a web of subsidiaries, branches, and representative offices. This allows for distortion both through the application of the current source regime as well as the arm’s length requirement of the transfer-pricing regime.

The principle tax consequence of the intermediary services provided is the ability of multinational banks to perform these services for clients anywhere in the world, while providing the product in a low tax jurisdiction. An application of the current source rules may then result in the jurisdiction where the services are performed failing to receive any tax revenue. The OECD 1998 discussion draft suggests that there are further tax consequences. It suggests that there are four aspects of multinational bank dealings, which increase the likelihood of a distortion of the taxation position from the aim of the traditional regime. The first aspect is the fact that, inherent in the nature of global trading is the necessity to delegate some marketing or trading authority to affiliates. The question then raised is whether the affiliate is acting as a dependent agent for the purposes of determining whether a permanent establishment exists.24 The second aspect relates to the difficulties that arise in allocating profits among the jurisdictions because of the integrated nature of global trading. The third aspect is the mobile nature of capital, a commodity heavily relied upon by multinational banks, which allows expected profits or losses to be transferred between jurisdictions. The fourth aspect is the lack of accounting and regulatory standards.35

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24 As it is the hypothesis of this thesis that there is manipulation of the source and transfer pricing regime by multinational banks, it is outside the scope to consider the ‘permanent establishment’ issues pertaining to these entities.

2.3.2 The Growth and Evolution of Multinational Banks

The relatively late arrival of multinational banks into the international arena, their distinguishing features from other multinational entities and the unique nature of taxation consequences for multinational banks are best illustrated in light of a consideration of the history of multinational banking in a global context.\(^{36}\) This section addresses the evolution of multinational banks, as a subset of multinational entities, within the framework of both the demand driven by multinational clients and internalisation theory.

Before embarking on an examination of the history of multinational banking, it is necessary to acknowledge the lack of common terminology, and the hampering effect this has had on any substantive research into the economic consequences and taxation issues relating to multinational entities in general and multinational banks specifically. Prior to the study of the multinational entity per se, an entity involved in such activities was examined in the context of foreign direct investment or the business corporation.\(^{37}\) It was not until nearly two centuries after the beginnings of the multinational entity, that the first term used to describe the phenomenon, the 'multinational corporation' was coined.\(^{38}\) In 1960 David E Lilienthal described multinational corporations as 'corporations which have their home in one country but operate and live under the laws and customs of other countries as well.'\(^{39}\)

The consequence of the lack of a defined term describing such behaviour was that regulation and tax policy, until relatively recently, was considered within the framework of international investment as a whole, rather than being split into the necessary subcategories, foreign direct investment being one. It has been

\(^{36}\) The history of multinational banking in Australia is considered in chapter three.


demonstrated that a multinational entity deals internationally in a particular way, that is, the entity owns and controls income-generating assets in more than one country. Any research into international trade, however, was done in a much broader context.

The first significant modern analysis of the special features of investment by a multinational entity has been attributed to Australia. Economists in Australia were alerted to the unique nature of the multinational entity, and its investment and profit distribution strategies, through the sudden expansion of General Motors-Holden in the 1950s. The impetus for investigation into the economic effects was the transfer of SUS4.5m, out of a reported 1953 profit of SUS9.8m, to the US as a dividend. Although the modern multinational entity had been in existence prior to this, both in Australia and other jurisdictions, this study was the first to consider the effects of foreign direct investment, concluding that such effects are unique.

Because of the lack of terminology and academic literature, it is generally assumed that the multinational entity is a post-war phenomenon. This type of structure, however, is a feature of modern commerce as old as modern mercantilism. Though there is no doubt that the growth of the multinational entity in the post-war period has been remarkable the beginnings of the multinational entity can be traced back to foreign direct investment in Europe centuries before. Traditionally, the manufacturing market was the leader of multinational firms, initially facilitated through the inventions of the steamship, railway and telegraph. Over time, this geographic diversification of the firm, initiated at a domestic level, has refined itself and transformed into the multinational entity.

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43 As early as the 1780s trade companies involved in the cotton industry were carrying on the functions of what we now consider multinational entities.

Similarly, multinational banking has a long history, with evidence of international banking (as contrasted with multinational banking) in Babylonia as early as 465 BC.\textsuperscript{45} Despite the steady rise of a geographically diversified banking services market, as recently as three decades ago banks were excluded from discussions of multinational entities. For example, Yair Aharoni in his 1971 article suggests that the definition of the multinational entity can be subdivided by three criteria: the types of operations in which they are involved, the size of their operations, and the areas in which they operate.\textsuperscript{46} Corporations, according to the types of operations in which they are involved, are divided into exporters, importers, transporters, manufacturers, traders, and petroleum producers. The obvious omission from this list is the service provider, in which the multinational bank would fall. Multinational entities were thought to be providers of goods rather than services, an assumption, it could be argued that legislators have also made.

Over the course of the last three decades, it has been acknowledged that banking has become a multinational service. The issue then is to why banks have become multinational, and to address this, two theories have been devised. The first, a demand driven argument, is that one consequence of the modern multinational entity is the need for more geographically diversified financial arrangements and products, hence the services market, including banking, gradually entered the multinational arena.\textsuperscript{47} Mark Casson believes that ‘[t]he growth of foreign direct investment in manufacturing by high-technology mass-market-oriented firms created a new demand for corporate banking services overseas.’\textsuperscript{48} In essence, ‘the multi-

\textsuperscript{45} IJ J Burgers, \textit{Taxation and Supervision of Branches of International Banks: A Comparative Study of Banks and other Enterprises} (1991) 27. For a complete history of international banking, see chapter 3 of Burgers.

\textsuperscript{46} Yair Aharoni, ‘On the Definition of a Multi-national Corporation’ (1971) 11(3) \textit{Quarterly Review of Economics and Business} 27, 35.

\textsuperscript{47} Barry Williams states, ‘[t]hat banks follow their clients abroad is the most pervasive proposition in multinational banking.’ Barry Williams, ‘The Defensive Expansion Approach to Multinational Banking: Evidence to Date’ (2002) 11(2) \textit{Financial Markets, Institutions and Instruments} 127, 127.

nationalisation of manufacturing firms creates a derived demand for the multinationalisation of banks as well.\textsuperscript{49}

The emergence of the multinational bank has, therefore, followed the emergence of the traditional manufacturing multinational entity, with growth in recent decades. Banks have become multinational not because of the income opportunities presented by foreign jurisdictions, but rather, for fear of losing their domestic clientele if they failed to follow those clients overseas.\textsuperscript{50} This theory on the global expansion of banks has been termed the 'defensive expansion approach', that is, banks are being reactive rather than proactive in ensuring their client base does not diminish.\textsuperscript{51}

A counter argument to the defensive expansion approach is that banks followed their customers overseas not for fear of losing their domestic base, but because of the knowledge advantage they possess. This knowledge advantage is borne of the client-banking relationship, and becomes a public good within the firm which can be best exploited by expanding offshore. This argument is founded in the theory of internalisation.\textsuperscript{52} As enunciated by Plummer, '[i]nternalisation is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimised for the sector as a whole by bringing interdependent activities under common ownership and control.'\textsuperscript{53} Implicit in the internalisation theory are the assumptions that (1) the primary goal of any capitalist entity is to maximise profit, and as part of achieving that goal, minimise expense, and (2) there is an imperfect market.\textsuperscript{54} Internalisation theory explains why multinational

\textsuperscript{49} Mark Casson, \textit{The Organisation of International Business} (1995) 162.

\textsuperscript{50} Robert A Ferguson, 'Foreign Banks in Australia – A Strategic Reassessment' (1990) 9(3) \textit{Economic Papers} 1, 7.

\textsuperscript{51} For a comprehensive literature review on the defensive expansion theory see Barry Williams, 'The Defensive Expansion Approach to Multinational Banking: Evidence to Date' (2002) 11(2) \textit{Financial Markets, Institutions and Instruments} 127.

\textsuperscript{52} Internalisation theory draws upon the Coasian theory of the firm: A H Coase, 'The Nature of the Firm' (1937) 4 \textit{Economica} 386.


\textsuperscript{54} Mark Casson, \textit{The Organisation of International Business} (1995) 22.
banks exploit their ownership advantages within their own system rather than contracting them in a regular market where there are imperfections.\textsuperscript{55}

Clearly, banks are profit-driven entities and are internalising a market failure, information asymmetry.\textsuperscript{56} That is, due to the existence of information asymmetry, the expense of international banking transactions is minimised if conducted by multinational banks rather than by independent entities. The decrease in expense is due to the intangible nature of the asset, in particular, the fact that it is difficult to efficiently transfer the information, and further, that it is difficult to accurately price the value of this information. This information cost saving is the motivation for domestic banks expanding into multinational banks. It is important to note that information asymmetry would not be a valuable asset were it not for the global expansion of the banks' clientele. This internalisation hypothesis encompasses most of the extant theories as to the multinational expansion of banks.

This theory, while not explicitly adopted, seems to be inherent in the tax literature. For example, Jeffrey Colon explains that the driving force behind the 'continuing creation of new financial instruments is the demand for cost effective mechanisms by which firms can manage their financial price risks -- the risks firms face due to unexpected movements in foreign exchange rates, interest rates, and commodity prices.'\textsuperscript{57} What is very much accepted in the tax literature is that there are the economic advantages to becoming multinational.\textsuperscript{58}


Whether driven by a compulsion to follow clients or driven by internalisation theory, it is clear that multinational banks are a product of the globalisation of business and the establishment of traditional multinational entities. Although it is often stated that technological development, financial innovation and the political economy have all contributed to global trading of multinational banks, all of these factors are associated with demand, driven by traditional multinational entities. Technological advances allow the clients of multinational banks to participate in international transactions, while the innovative financial products allow for greater protection against risk. The political economy, no longer restricting the transfer of capital has also allowed interested parties to become involved. The increasing number of international dealings and transactions, both related and unrelated, has created a market demand for multinational banking and the services that they provide. The multinational bank, therefore, is not a traditional multinational entity but rather a product of the traditional multinational entity.

Being a product of the traditional multinational entity, it is suggested that it is difficult to apply tax rules designed for that traditional multinational entity to a relatively new phenomenon. While critics of the current transfer pricing regime have always argued that it fails to take into account the synergistic advantages of the multinational entity, due to the highly integrated nature of the services provided by multinational banks as well as the intangible nature of the assets being dealt in, the problem of ignoring such synergistic advantages are exacerbated. Rather than expanding internationally to meet the needs of a new market, multinational banks are expanding internationally to meet the needs of existing clients. Synergies, therefore, are taken to the extreme. This difficulty is then compounded by the unique nature of the intermediary services being offered.

2.3.3 Monopolistic Advantages and Network Linkages

There are two further, interwoven distinguishing characteristics in relation to the services of the multinational bank; the monopolistic advantages and the network linkages. First, the monopolistic nature of multinational banking, with the personal contact advantage providing synthesis of information, is a basis for distinguishing the commerce of multinational banks from those of traditional multinational entities. This information is the basis of the service that the multinational bank is providing and is a bank specific asset.

A manufacturer has product and/or technology advantages with the potential to transfer that knowledge to foreign jurisdictions. A bank, on the other hand, has the personal contact advantage. This leads to the creation of a network of information with team specific skills being developed to synthesise bank information. Such monopolistic advantages add to the source and transfer pricing problems arising because of the unique nature of multinational banks. These problems are founded primarily in the integrated and exclusive nature of the information possessed by the multinational banks. Essentially, the integrated nature of the information network means that it is difficult to apply any traditional legal source rule to obtain a result reflecting economic reality. Using a traditional arm’s length methodology to price any related party transactions is also unachievable as, due to the exclusive nature of the transferred services, there are no comparable unrelated transactions.

Related to the monopolistic advantages of multinational banks are the highly sophisticated network linkages within multinational banks. When considering the network structure of multinational banks in comparison with vertically integrated multinational entities, there are two special features. The first special feature is the flow between the facilities that is two way, unlike manufacturing multinational entities where the process is uni-directional. The second special feature is that there are several different locations involved in the network creating a complex set of

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linkages. Such a network is unlikely to be achieved by a manufacturing multinational entity because of the physical nature of the product.

These distinguishing features add to the problems created by the multinational banks’ compulsion to follow clients. Not only are there synergies with respect to the client base and information, but there is also the personal contact advantage providing a synthesis of information. Essentially this leads to a highly integrated multinational entity that is effectively impossible to separate into its components. The difficulties in attempting to do so suggest that it is a fiction to determine the hypothesised independent entity for the application of the transfer pricing regime, particularly to permanent establishments.

The services and consequent products of multinational banks are distinct from those of traditional multinational entities, primarily due to their intermediary nature. Three further distinguishing features underlie and compound the taxation problems associated with this intermediary nature. First, the ability of services of the multinational banks to be implemented simultaneously across multiple jurisdictions is in stark contrast to the unitary nature of multinational entity transactions. Second, multinational bank services are a result of the demand of traditional multinational entities and finally, the personal contact advantage held by multinational banks is fundamentally different to the product and technological advantages held by traditional multinational entities. It is suggested that all of these distinctions allow the multinational bank to manipulate the current tax regime through source and/or transfer pricing manipulation.

It is the contention of this thesis that, in addition to the service and product differences, organisational differences between traditional multinational entities and multinational banks render the rules governing jurisdiction to tax and allocation of income in the current tax regime unsuitable for multinational banks.

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2.4 The Unique Organisational Structure

Due to the role of multinational banks in servicing traditional multinational entities, the organisational structure of the multinational bank, designed to meet client demand, diverges from that of the traditional multinational entity. While the current tax model is designed for traditional multinational entities, the different structure of multinational banks introduces issues previously not recognised by the traditional taxation system. It is the unique organisational structure of the multinational bank that this part of the chapter examines.

The growth of multinational entities, and consequently multinational banks establishes that financial markets are becoming increasingly globalised and integrated.62 The development of the multinational bank also requires a consideration of why these entities choose to become involved in the international market through foreign direct investment rather than merely exporting their services from the parent jurisdiction or by operating through an agent. By doing so, it is possible to consider whether banks are unique not only because of their unique service qualities but also because of their organisational structure.

2.4.1 Entering the Market through Foreign Direct Investment

A bank wishing to enter a foreign market may do so in a number of ways. The bank has three choices. The first choice is to enter the market by exporting the services from the parent jurisdiction to the foreign jurisdiction. This involves little in the way of physical or capital presence in the foreign jurisdiction. The second choice is to enter a foreign market by operating through a local agent, usually a bank already existing within the foreign jurisdiction. The third choice is to enter a foreign market through foreign direct investment. Where the third option is undertaken, that is entry is via foreign direct investment, the multinational bank accesses the market using one of three trading structures: foreign subsidiary, foreign branch or foreign representative office. Regardless of the specific organisational form, however,

foreign direct investment implies the transfer of capital, managerial expertise and the technological assets of a bank from one country to another.\(^{63}\)

Although not unique to the enterprise of banking, the third option of foreign direct investment\(^{64}\) is the preferred method of foreign market entrance adopted by banks. As such, it is important to consider this specific geographical expansion strategy to determine the associated unique taxation consequences. This choice of investment strategy is referred to as foreign direct investment because "the defining mark of a multinational is that it makes and manages direct investments in foreign countries".\(^{65}\) Thus, foreign direct investment may be achieved without a physical presence in the foreign jurisdiction, however, capital investment is necessary.\(^{66}\) For example, a bank can invest offshore by buying shares or bonds. Clearly, this can be distinguished from a manufacturing entity whose investment in their line of business requires a physical presence. Foreign direct investment, in the economic sense, involves any investment by an entity which they have ultimate control over.

Direct investment has been more comprehensively defined as an activity which consists of four dimensions: a transfer of capital, a control investment, a source of funds for foreign operations, and a balance of payments flow.\(^{67}\) According to Eng et al., "direct foreign investment involves transferring capital from a source or home country to a host country. In comparison with other forms of international investment, the distinguishing feature for FDI [foreign direct investment] is the element of control over management policy and decisions."\(^{68}\) The two pre-requisites

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\(^{64}\) For a general discussion on foreign direct investment see: Graham, Edward M and Krugman, Paul R, Foreign Direct Investment in the United States (3rd 1995).


\(^{66}\) A threshold figure of 10 per cent is taken to distinguish portfolio investment from direct investment: Alex Easson, Taxation of Foreign Direct Investment (1999) 2.


for foreign direct investment, therefore, are a transfer of capital and control. Economists provide an insight into the reasons for pursuing such investment strategies.

Fieldhouse, quoting from Plummer,\(^69\) suggests that there are three main reasons for the establishment of what he referred to as international combines or trusts (or what is contemporarily called multinational entities):\(^70\) "the need to keep plants fully employed; desire to escape from severe competition, price cutting and so on; and, ... the desire to substitute certainty for the uncertainties of business as previously conducted."\(^71\) Plummer's reasons are a precursor to 'internalisation' and as discussed previously, according to this theory multinational banks are internalising the market failure of information asymmetry. Internalisation explains how the multinational entity achieves the goal of cost reduction.

Costs associated with the external market, which can be avoided through the establishment of a multinational entity generally are: brokerage costs; costs of defining the obligations of the contracting parties; the risk of scheduling and the related input costs; and the taxes paid on the transactions.\(^72\) In the case of multinational banks, the costs which are commonly avoided by becoming multinational are the costs associated with intangible assets, in particular the cost of effectively transferring information and the cost of accurately determining the sales value of the information.\(^73\)

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\(^69\) A Plummer, *International Combines in Modern History* (1934).

\(^70\) Plummer states that we have an 'international trust' when, to centralised and unified control, there is added the complete merger and ownership of the constituent undertakings, in two or more countries. See D K Fieldhouse, "The Multi-national: A Critique of a Concept" in A Teichova, M Levy-Leboyer and H Nussbaum (eds), *Multi-national Enterprise in Historical Perspective* (1986) 4, 13.


Such benefits have been recognised in tax literature when considering an economically valid basis for establishing jurisdictional allocation of income. For example, Richard Bird provides 'in the absence of such 'intangible assets' that can be exploited by multinational enterprises, it would be hard to understand their existence at all, let alone their dominance in important fields, since foreigners are inherently at a disadvantage compared to local firms unless they have some offsetting internal advantages as a result of being under common control.'

Cho, in addressing the issue of why banks choose to operate in foreign jurisdictions through foreign direct investment, suggests that three questions should be answered simultaneously: (1) what advantages does a bank have which allow it to compete against local and/or other foreign banks; (2) why is a foreign rather than a domestic operation advantageous in serving foreign and/or domestic markets; and (3) why does a bank choose to exploit these advantages itself rather than selling them to local and/or other foreign banks.

In answering these questions it must be remembered that there is the general view that multinational banks arose from the demand produced by the increase in foreign direct investment in manufacturing by high-technology mass-market-oriented firms. Economic theory regards this as the defensive expansion approach, which some economists regard as a specific application of internalisation theory rather than a separate theory as outlined above. In explaining defensive expansion in the context of internalisation theory Barry Williams points out:

The growth in multinational banking is due to foreign direct investment abroad by corporations. Banks respond to the expansion of their clients abroad to defend their client-bank relationship. If the banks do not accompany their client abroad, the client will establish a banking

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relationship that could expand to supplant any domestic banking relationships. A banking relationship consists of a flow of information. This flow of information enables the bank to assess any new loan proposal at low marginal cost, as most of the assessment has occurred previously. This lower marginal cost gives a bank’s offshore subsidiary a competitive advantage over its incumbent competitors. Due to market failure, this information flow cannot be traded or priced within the market and so must be exploited by owning banks.  

This theory is consistent with evidence of expansion into certain jurisdictions. For example, it has been suggested that most banks came to Australia ‘as part of a reluctant world wide globalisation that was based on a defensive mentality rather than an aggressive strategy.’

If the economists’ view that banks capitalise on these market imperfections is accepted, (namely the restraints on trading and pricing customer information) purely to defend their client-banking relationship, then their adoption of the foreign direct investment method is rational. Not only does the foreign direct investment approach give the banks a global presence, it also gives them control over that presence. When compared to the alternative organisational structures of exporting their services or operating through an agent, it is higher level of control associated with foreign direct investment that enables the banks to effectively ‘defend’ their client-banking relationships as required. Expanding, therefore, on what is already accepted in relation to economic theory explaining multinational banking earlier in this chapter, this thesis accepts the defensive expansion approach, as a subset of the internalisation theory, as the basis for the adoption of foreign direct investment by multinational banks.

In this context, foreign direct investment is broadly defined to include the three alternative trading structures adopted by multinational banks; foreign subsidiaries, foreign branches and foreign representative offices. A subsidiary operates as an independent legal entity as distinct from the foreign bank, being separately chartered.

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under the laws of the local country. Subsidiaries are generally wholly owned, or at least controlled, by the foreign parent bank. In contrast, a branch is an integral part of the foreign bank, without a separate legal personality. Of even less independence is a representative office which is ‘a small office in the host nation that coordinates a bank’s correspondent banking relationships and renders assistance to the bank’s existing customers’. While the level of independence of each of these three structures differs, they are all vertically integrated organisation models. This is contrasted with the generally horizontally integrated nature of the traditional multinational entity.

Entering a foreign market through foreign direct investment does not make a multinational bank unique. What does make it unique is the lack of a large physical presence required in a jurisdiction. It is very simple for a bank to establish a subsidiary or branch (permanent establishment) in a given jurisdiction and to undertake transactions through that office. While very little in the way of intermediary activity may be undertaken in that location, in fact, a large percentage of the source of income under the current legal source rules may be attributable to that office and hence that jurisdiction. There are also unique tax issues that arise because of the transfer of capital to a potentially low tax jurisdiction in order to take advantage of the source rules. The transfer of capital of itself raises transfer pricing issues, with the arm’s length requirement for pricing such a transfer often failing to replicate economic reality. The external market costs mentioned above are ignored for these purposes and, as such, the result is not an optimal one.

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2.4.2 Alternate Trading Models and the Highly Integrated Nature of the Multinational Bank

To evaluate the current jurisdiction to tax and allocation of income principles, it is necessary to consider whether the structure and behaviour of the multinational bank mirrors that of the traditional manufacturing multinational entity. While the governing economic principles behind the structure and behaviour are the same, the way that these principles operate in practice may be different.\(^{83}\) The reason for this is the way in which the entity establishes its operations. Manufacturing multinational entities are traditionally, and more commonly, horizontally integrated, while multinational banks tend to be vertically integrated.\(^{84}\) A horizontally integrated multinational entity provides the same goods and/or services from several different locations, while the vertically integrated multinational entity has one location producing output, which becomes input at the next location.\(^{85}\) This type of integration leads to novel transfer pricing issues.\(^{86}\) Where the multinational entity is vertically integrated, it is difficult to find comparables, as often they simply do not exist.\(^{87}\) The reason these comparables do not exist is that they have been driven out of the market place. Brian Lebowitz explains:

*For example, if a parent-subsidiary relationship turns out generally to be more profitable in an industry than contractual arrangements between unrelated parties, one can expect that vertical integration will become the dominant, and ultimately the only, mode of economic organization in the industry because competition will render independent party relationships economically unviable. When that occurs, as it often has, for example, in relationships between manufacturers and distributors, the arm’s-length standard becomes useless because it relies on references to transactions that have become extinct.*\(^{88}\)

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\(^{84}\) Mark Casson points out that the vertical linkages may have the appearance of horizontal integration.


\(^{86}\) Mark Casson points out that the vertical linkages may have the appearance of horizontal integration.


Within this vertical integration, there are three types of trading models a multinational bank can adopt: the centralised product management model; separate entity model; and functionally fully integrated model (integrated trading model). The models can be represented along a continuum: the 'integrated trading model' at one end, 'centralised product management' in the middle, and the 'separate trading model' at the opposite end. A multinational bank may use a combination of these models according to the various services offered and products being traded.

The 'integrated trading model' has traders in separate international jurisdictions trading off the same portfolio of positions. This is what is known as a 'book', the responsibility for which is passed from one location to the next as the market closes in one jurisdiction and opens in the next. The integrated trading model is a true global trading model. The primary concern of the multinational bank operating under the integrated trading model is the time zone. Essentially all functions can be performed in any of the multinational banks locations, and at any given time, will be performed where the market is open. At one time this type of model was regarded the exception rather than the norm, but it is now becoming the more prevalent mode of operation.

The 'centralised product management model' has a central location accepting and managing all risk associated with a particular product with separate branches.

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managing separate products. Various commercial factors, such as market liquidity, ease of hedging, competition, business strategy, location of customers, and skilled staff, influence the location of the centralised trading site. This centralised trading site is essentially a head office, into which all other parts of the entity report.

The 'separate enterprise model' has each location operating as if it were a separate profit centre. Under this model each location, whether a subsidiary or branch, has its own marketers and traders and its own books, reflecting the activities of that location. Provided the branch or subsidiary does not trade outside its trading limits the central committee will not control any transactions undertaken by the individual locations.

No matter which model is adopted, global trading operations within financial intermediaries perform four general functions: trading, sales, management, and support. These four elements of the structure introduce their own unique qualities. Trading is divided into product groups, rather than geographical locations, with traders being rewarded on profitability as a whole. Management, on the other hand, may have responsibilities restricted to product, clients, economic sectors, or particular markets. Sales staff will generally be responsible for a portfolio of clients and, as such, are cross jurisdictional. Finally, the support team are responsible for the integrated entity as a whole, primarily offering support to ensure that global transactions are accomplished.

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These trading models not only distinguish the multinational bank from its more traditional counterpart, but also raise unique tax problems. Again, both source issues and transfer pricing issues arise. Firstly, even if the legal source is easy to ascertain, given the three alternate trading models it is argued this may not be the economic source of the income. Secondly, because of the highly integrated nature of the models and the lack of comparable independent third party transactions transfer-pricing issues arise.

2.4.3 Servicing Clients through Appropriate Locations

The final characteristic of the multinational bank, which differentiates its organisational structure from traditional multinational entities, is location as multinational banks are more likely to be concerned with servicing time zones rather than geographical locations. This is because a multinational bank is concerned with ensuring that part of its organisation is always operating. Banks will also be managed along the lines of products rather than along geographical boundaries. Consequently, it is suggested that tax rules based on such geographical locations is inconsistent with the objectives of the multinational bank.

Despite this concern with time zones, the multinational bank needs to be geographically located. The choice of location, however, is also grounds for concluding that multinational banks are unique. There are two reasons for the location of banks being distinct from that of manufacturing industries. The first reason is that commercial (deposit) banks need to be located where the customer resides. The second reason is that trade banks and investment banks need to be located in just a few centres, but those which are major financial centres. For


100 Although as Dr Ngsee-Choon Chia points out ‘in the 1950s, the comparative advantage of the financial centres depended crucially on the location advantage of favourable time zones. Today, many financial transactions are not limited by conventional business hours and can be carried out instantaneously 24 hours a day’. Ngsee-Choon Chia, ‘Trends in Tax Structures and Fiscal Policy Issues in the New Millennium’ (2000) 6(3) Pacific Rim Taxation.

example, a multinational bank will usually have offices operating in New York, London, and Tokyo. Essentially, because a bank is providing services rather than goods it is easier to have fewer offices dispensing services across a larger area than to have numerous offices each servicing smaller regions. Provided there is representation in each time zone a client can be fully serviced. This means that a multinational bank can take advantage of different locations for taxation purposes.

2.5 Conclusion

The principle distinguishing feature of the multinational bank is the unique intermediary services provided. This feature has been a result of the demand for multinational banks and their subsequent growth.

It has been demonstrated that multinational banks, as a subset of multinational entities, have grown due to the demand generated by their multinational entity clients and due to their internalisation and capitalisation of valuable client-relationship information. Such growth has primarily been in the form of foreign direct investment, which, under the defensive expansion approach allows banks to have ownership and control in foreign markets. It is this vertical foreign direct investment structure, often in locations based on time rather than geographical zones, in conjunction with the unique nature of their services and the associated monopolistic advantages and network linkages, which distinguishes multinational banks from traditional multinational entities. This distinction is particularly poignant in relation to taxation issues of source and transfer pricing.

The following chapters analyse the difficulties associated with applying the present jurisdictional and allocation principles to multinational banks and proposes an alternative to the current system. It is demonstrated that the current international jurisdictional and allocation principles, based on a system originating in 1923, do not always apply in an efficient manner to multinational banks, which are essentially a

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product of the 1980s. Essentially, the allocation of taxing rights to the relevant jurisdictions does not reflect economic reality.

The unique character traits and structure of multinational banks provides the platform for an examination in the ensuing chapters concerning the appropriateness to multinational banks of the current tax rules of jurisdiction and allocation, and the current economic assumptions surrounding the taxation of multinational entities. This examination of the multinational bank within an economic framework facilitates a consideration of how these entities should be taxed, and whether, due to their unique character traits and structure, multinational banks should be subject to a different tax regime than traditional multinational entities.

Prior to this consideration, chapter three, using the Australian regulatory regime as an example, investigates the growth of multinational banking facilitated by various banking inquiries and the relaxation of regulatory controls.
Chapter 3

A Chronicle of Multinational Banking in Australia and the Importance of Tax Reform

3.1 Introduction

Chapter two demonstrated that multinational banks have become increasingly global and unique, both in their role as financial intermediaries and their organisational structure. Chapter two focused on the international aspects of the growth of multinational banks, along with the economic factors driving this expansion. Chapter three, by examining multinational banking in an historical context demonstrates how this was made possible through regulatory changes. As banking regulation is achieved at a domestic level, it is necessary to consider a domestic regime. As such, Australia is used as an example of the changes in banking regulation, which has aided the increased globalisation of multinational banks. The discussion in this chapter also demonstrates why domestic jurisdictions, in this case Australia, should be concerned whether they are receiving the appropriate amount of tax revenue.

The purpose of chapter three is to establish the increase in multinational banking since the various inquiries into the banking industry and consider Australian banks operating offshore. This in turn, allows an explanation for why Australia, along with other taxing jurisdictions, should currently be concerned about multinational banking from an international tax perspective. Having established that multinational banks are different from traditional multinational entities, chapter three considers why the issue of taxation in relation to these banks is currently significant. This chapter discusses the genesis of the increase in multinational banking and why the significance of taxation issues has increased exponentially. Examined is the fact that, while primarily market forces have driven the process of financial system evolution, it has been greatly assisted by prevailing regulatory and supervisory
arrangements. Chapter three discusses the relaxation of legislative controls, through various inquiries into banking in Australia that led to the entry of multinational banks in the market place. This, in turn, resulted in taxation problems that had not previously arisen. The premise of chapter three is that with all of these industry reforms for multinational banks there were no concurrent taxation reforms.

The current position of foreign banks in Australia, and Australian banks overseas, is considered to facilitate an examination of economic and regulatory factors affecting decisions to enter a foreign market, apart from those relating directly to taxation. It is necessary to do this in the context of the Australian Government’s foreign investment policy, taking into account the regulatory background of deregulation, the changes that have been made to accommodate these banks, and the remaining legal obstacles they face. An historical perspective of foreign banking in Australia illustrates the adverse effects of restrictive federal policies on foreign bank entry until fairly recently. Consequently, multinational banking was not a growth area of significance. This in turn, means that taxation was originally not a pertinent issue.

This chapter considers why the taxation of multinational banking should be a current and significant issue in Australia to establish the need to examine the tax implications of multinational banking undertaken in later chapters. The first part of this chapter, via a chronological consideration of the Australian regulatory environment, establishes the taxation of multinational banks as a significant regulatory issue. Prior to the 1980s, taxation of multinational banks was not of significance due to the restrictive policy of the Australian Federal Government in allowing foreign entry to Australia, as well as the reluctance of Australian banks to venture offshore. Changes to the Australian financial system in the 1980s paved the way for official banking industry inquiries, which in turn recommended a loosening of the policy regarding foreign bank entry. Throughout the financial system


inquiries, changes to federal policy encouraging foreign bank entry into Australia were implemented.

While legislative changes encouraged foreign banking and increased the presence of multinational banks in Australia, it is suggested that little consideration was given to the taxation implications of these multinational banks. In particular, it may be argued that no consideration was given as to whether special jurisdictional and allocation rules were required or whether the current regime provided an optimal taxation regime for multinational banks.

In addition to foreign multinational banks in Australia, the ‘big four’ Australian banks are also considered in this chapter, demonstrating that the taxation of multinational banks is not only an issue with respect to foreign banks entering and/or operating in Australia, but also Australian banks entering overseas markets. Due to the increased presence, therefore, of multinational banks in Australia and the vested interest Australia has in ensuring that Australian entities are taxed appropriately, the importance of the issue of taxation of multinational banks is affirmed.

3.2 Opening Doors in the 1980s – The Emergence of Multinational Banks

This part of the chapter demonstrates that the various inquiries into the Australian financial system, and the consequent partial deregulation of the banking sector, have facilitated the increased presence of foreign banks in Australia.\(^3\) As a result, increased globalisation was made possible by domestic changes. While numerous legislative and prudential changes were implemented to facilitate multinational banking in Australia, no concurrent consideration was given to the taxation consequences of these events, or whether the current taxation system would give an optimal taxation outcome, that is, one that reflects economic reality.\(^4\)


\(^4\) This assertion is based on the fact that the banking reviews contained no reference to such a consideration.
The very existence of these financial inquiries also demonstrates the belief by authorities that multinational banking is unique, as does the domestic view that banking needs to be highly regulated. In the multinational entity setting, banking is one of the most highly regulated industries.

The recommendations of these inquiries provided the foundation for the current legislative and prudential requirements. As the current impediments to foreign banks entering the Australian market and the restrictions on their operations influence the structural decisions facing banks entering the Australian market, the tax consequences potentially vary with each structure. While a consideration of the taxation consequences is reserved for later chapters, this chapter details the current legislative and prudential requirements.

3.2.1 Movement towards Deregulation of the Australian Financial Market

The history of the deregulation of the Australian banking market, which occurred in the 1980s, can be traced back two decades earlier. Two forces drove the process: the changes taking place in international financial markets, in the form of both deregulation and integration; and the loosening up of the direct regulation, due to both changes in the economy and the growth of non-bank financial institutions. Consequently, changes at a domestic level were a result of the changes experienced internationally.

Australia has been relatively slow in opening its doors to multinational banks. In Australia, with the exception of the Bank of China, the Bank of New Zealand and

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7 The Bank of China wound up its operations in Australia in 1972 but had its licence reissued at the same time as the First 16 announcement.
the Banque Nationale de Paris, by the mid 1980s foreign banks had not entered as banks per se, but rather as representative offices or non-bank financial institutions. In this form, they were substantially unregulated. As the foreign banks, through non-bank financial institutions, gained a greater share of the banking market, domestic banks became uneasy and the Reserve Bank of Australia became concerned about the loss of control.

The floating of the Australian dollar in December 1983, at which time most exchange controls were suspended, heightened the rising market share held by foreign banks. Offshore banking in Australia became a possibility and many of the financial institutions operating in Australia developed banking business with non-residents.

Although the growth of foreign non-bank financial institutions and economic changes increased the presence of foreign banks in the Australian market, only a small amount of this business involved pure offshore banking transactions. It was not until the initiation of influential inquiries during the 1980s, to determine the validity of Australia becoming competitive in the international financial market, that Australia commenced establishing its reputation as an international financial centre.

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8 Both the Bank of New Zealand and the Banque Nationale de Paris are government owned banks operating in Australia for over 100 years.

9 The Tokyo Specie Bank had previously operated in Australia but closed its doors in 1972, and to date its licence has not been renewed.

10 The representative office allows a bank to provide customers with information and contacts only.

11 Such as Merchant Banks.

12 It should be noted that foreign banks were not the only concern. There was also concern about the growth of domestic non-bank financial institutions relative to the domestic banks.

3.2.2 Two Decades of Financial System Inquiries

The pace of development in the Australian financial system in recent times has been dramatic. Although Australia has been privy to banking inquiries for many decades, the first being in 1935, the last two decades have seen an explosive growth of reviews. It is the rapid changes in the nature of the banking industry that has led to the several financial system reviews. That is, the response by banks to client needs in the form of new and innovative financial instruments and their defensive expansion approach of following traditional multinational entity clients to new locations, along with the highly integrated nature of the services provided, evidenced the need for such inquiries. The most influential reviews are the Campbell Committee report, the Martin Committee Report, the Martin Review, and the Wallis Inquiry. These reviews facilitated one of the biggest changes to foreign banking in Australia in recent times - allowing a foreign bank to operate as a branch or a subsidiary, rather than the previous subsidiary mandate.

In January 1979, the first step towards the deregulation of Australia’s financial system was taken with the establishment of the Committee of Inquiry into the Australian Financial System. The final report of the Committee, chaired by Mr J.K. (later Sir Keith) Campbell, was tabled in the House of Representatives in November of 1981. Following a consideration of various aspects of the Australian financial system, including the banking regime, foreign exchange, and government involvement in the financial system, the overall recommendation of the Campbell

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15 The first inquiry into Australian banking system was established in November 1935. This Royal Commission into the monetary and banking system in Australia was established as a consequence of the near collapse of the banking system during the time of the Great Depression.


Committee was the deregulation of the Australian financial market.\textsuperscript{16}

Part of the deregulation recommended by the Campbell Committee Report required that the strict controls on foreign bank entry be relaxed. In January 1983, the Treasurer announced the government’s decision to allow ten new banks to commence operations in Australia, including foreign banks. Due to a change in government two months later, the government of the day did not have the opportunity to implement the proposed changes.

With the change in government came a new inquiry into the Australian Financial System, and proposals for new bank entry was postponed until the completion of the review. In February 1984, the Committee, chaired by Mr V.E. Martin, handed down its report on the Australian financial system, supporting the continued deregulation of banks and the entry of foreign banks.\textsuperscript{19} In particular, the report supported the view of the Campbell Committee to allow the entry of new banks in Australia. One of the recommendations of the Martin Committee was to issue invitations to foreign banks to apply for trading bank licences to operate as locally incorporated subsidiaries.

In September 1984, the federal government invited applications for bank licences and initiated the entrance of multinational banks into Australia. The response to the invitation was forty-two applications being lodged by the end of 1984.\textsuperscript{20} In February 1985, the treasurer announced that the government had approved the establishment of sixteen foreign trading banks.\textsuperscript{21} Apart from the Bank of China, the Bank of New Zealand, and the Banque Nationale de Paris, no foreign banks were operating in

\begin{itemize}
\item \textsuperscript{16} P M Weaver, \textit{Banking and Lending Practice} (3\textsuperscript{rd} ed 1994) 9.
\item \textsuperscript{20} Committee on Finance and Public Administration, \textit{A Pocket Full of Change, Banking and Deregulation} (1991) 149; (Martin Review).
\item \textsuperscript{21} The sixteen banks were: Citibank, National Mutual Royal, Chase AMP, Natwest Aust Bank, Hong Kong Bank of Australia, Bankers Trust Australia, Barclays Bank Australia, Standard Chartered Australia, IBJ Australia, Deutsche Bank Australia, Lloyds Bank NZA, Bank of Tokyo, Mitsubishi Bank Australia, Bank of America Australia, Bank of Singapore, and JP Morgan (who did not and to date still has not taken up its licence).
\end{itemize}
Australia at this date. In September 1985, Chase AMP Bank was the first new foreign bank to open in Australia.

The granting of the sixteen foreign bank licences, and in effect commencement of multinational banking in Australia, was not the success that was originally predicted. The domestic expectation was that the Australian public would benefit from the entry of foreign banks ‘through the development of a more innovative, efficient and competitive financial sector.’ The foreign banks themselves also had high expectations and were aiming at acquiring twenty per cent of Australia’s banking market within a five year period. This turned out to be far from the case, as evidenced by the 1991 report revealing that the total share of the banking market held by foreign bank subsidiaries was around ten per cent.

By 1990, it was evident that the first sixteen were not faring well and that intervention was necessary if foreign banks were to continue operating in Australia. Not only was the granting of foreign bank licences not the success originally predicted, but in fact, the majority of the foreign banks were operating at a loss. In 1990, the foreign banks operating in Australia had an aggregate loss of $740 million. Further evidence of this disparaging situation came in 1991. In November of 1991, National Mutual Royal Bank closed its doors for the last time, whilst

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22 Malcolm Edey and Brian Gray, ‘The evolving Structure of the Australian Financial System’ in Malcolm Edey (ed) The Future of the Financial System (1996) 6, 26. There had been other foreign banks in Australia before this date however their presence had ended by the end of World War Two.

23 For a discussion on when the new entrants went wrong see Ferguson Robert A, ‘Foreign Banks in Australia – A Strategic Reassessment’ (1990) 9(3) Economic Papers 1, 5.


25 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 150.

26 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 150.


28 Although it should be noted that the closure by National Mutual Royal Bank was not solely due to foreign bank failure but also the failure of the ANZ - National Mutual merger. The National Mutual Royal Bank had 200 branches, which were taken over by ANZ. This event led to Keating establishing the 6 Pillars policy.
Chase AMP officially ceased to exist\textsuperscript{29} in December of the same year.

Thus, attempts by foreign banks to successfully enter the Australian market can be regarded as a failure.\textsuperscript{30} Two central shortcomings are posited as catalysts for this failure: namely 'the inability [of foreign banks] to reach the target they set themselves of a twenty percent market share within five years of entry'; and their minimal impact on the Australian retail banking market.\textsuperscript{31} With respect to the minimal impact on the Australian retail banking market, while the Martin Review concluded that it was a direct product of the high barriers to entry, Malcolm Edey and Brian Gray considered the foreign banks to have retained a focus away from retail markets.\textsuperscript{32} Supporting the argument put forward by Malcolm Edey and Brian Gray, and despite the apparently minor influence on the retail market, there is an abundance of literature to suggest that the foreign banks have a strong focus in the wholesale banking market and, in particular, that the entrance of foreign banks has increased the competition in this market.\textsuperscript{33}

In October 1990, the Treasurer commissioned a review to inquire into the profitability, importance, and competition in the banking industry in Australia. The review, headed by Stephen Martin MP, had its findings tabled in the House of Representatives in November 1991.\textsuperscript{34} The review examined the changes to the

\textsuperscript{29} The partnership between Chase Manhattan and AMP was officially dissolved and the Chase Manhattan Bank took over the operations at a greatly reduced size. This was also due to Westpac and AMP entering a strategic alliance, thus AMP had to dissolve its links with Chase.


\textsuperscript{34} Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991).
banking industry since deregulation and made 103 recommendations, with the aim of guaranteeing the stability of, and confidence in, the Australian financial system.35

In the context of foreign banks, the review specifically considered the reasons for the failure of the 'first sixteen' and contributed the failure to three main factors. The first factor attributed to the failure was the fact that the foreign banks applied for licences under certain misconceptions.36 The foreign banks believed that only a small number of licences – around six - would be granted.37 By issuing sixteen, there was greater competition than was originally anticipated. Also, as with the merchant banks, the foreign banks laboured under the misconception that the issuing of the licences was a one off event38 and, as such, were willing to accept greater competition in order to secure a licence.

The second factor attributed to the failure of the 'first sixteen' was that the foreign banks were disadvantaged in having to operate as subsidiaries. By operating in this manner, the foreign bank subsidiaries were faced with higher costs of raising funds, along with a reduced ability to make certain loans and reduced funds for the total loans made.39 The third factor attributed to the failure of foreign banks to make any impact on the Australian banking industry was the high barriers to competition. Local banks were able to protect their market share through their vast branch and agency networks.40

36 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 151.
37 The Campbell Committee recommended that while the number of licences issued need not be small, it should be finite. Subsequently, the Martin Review quantified this and recommended that the number of licences available be limited to between four and six.
38 Which in fact, has turned out to be the case, however the changes allowing applications by foreign banks to operate as branches was not anticipated.
39 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 151.
40 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 151.
In light of its findings, the report recommended further changes to industry regulations, enabling foreign bank entry into Australia by lifting the restrictions on the number of authorisations granted to foreign banks, and permitting the authorised banks to operate as branches rather than as locally incorporated subsidiaries.41

The Committee formally recommended that the existing restrictions on the number of foreign bank licences be removed for new entrants from countries offering reciprocal access for Australian banks, subject to the maintenance of appropriate prudential requirements42 and the satisfaction of certain other conditions.43 The Committee believed that a policy allowing open entry where there was reciprocal access for Australian banks in the respective overseas market was important for two reasons. The first reason was that it would ensure a continued competitiveness between banks already in the market place because of the continued threat of new bank entry. The second reason was that a policy of reciprocal access would allow Australian banks to compete in the international financial market. The policy had the widespread support of the major Australian banks and of the foreign banks that entered the market after 1985.44

The second recommendation of the Martin Committee, that foreign banks be permitted to operate as branches rather than as locally incorporated subsidiaries, was one of the most significant advances in opening the way for foreign bank entry to Australia. A subsidiary operates as an independent legal entity as distinct from the

41 It is interesting to note that there was a complete reversal of recommendation. At the Campbell review the Reserve Bank of Australia and the Australian banks were against the entry of foreign banks as branches, however, at Martin Review the Australian banks were very much in favour of branch entry.


43 Committee on Finance and Public Administration, A Pocket Full of Change, Banking and Deregulation (1991) 160. This required the maintenance of appropriate prudential requirements specified by the Reserve Bank; provision to the Reserve Bank of information relevant to the foreign banks Australian operations; allowing access by Australian bank examiners to the foreign banks operations in Australia as part of the appropriate supervisory arrangements; and ensuring, to the satisfaction of the Reserve Bank, that Australian depositors with foreign banks are protected to the same level as Australian depositors with Australian banks.

foreign bank, being separately chartered under the laws of the local country.\textsuperscript{45} A branch on the other hand is an integral part of the foreign bank, without a separate legal personality.\textsuperscript{46} Initially foreign banks could only operate as subsidiaries, which meant that they were subject to Australian law and Australian prudential standards.\textsuperscript{47} The Committee, in ensuring that prudential requirements would not be sacrificed in any way merely to increase competition, submitted that prudential requirements could still be maintained if foreign banks operated as branches.

The Committee believed that there were benefits to Australia in allowing foreign banks to operate as branches rather than subsidiaries, particularly from increased competition and the improvement of Australia’s international position. From the foreign banks perspective, the Committee stated that the advantage of operating as a branch was that they would have a broader capital base and improved fund raising capabilities.\textsuperscript{48} This, in turn, would lead to the branch having greater competition capabilities against the domestic banks as compared to a subsidiary. As both world and regional financial centres allow foreign banks to operate as branches, such a policy aligned Australia with the international financial market.

The foreign banks themselves also supported the suggestion that they be allowed to operate as a branch rather than a subsidiary because the branch, being supported by the parent group, has the capital rating of the parent bank. This is contrasted with the subsidiary which needs separate capital and, as a result, will usually have a lower credit rating.

Following this rapid increase in multinational banking in Australia since the release of the Campbell Report in 1981, the Wallis Inquiry, as it became known, was asked in May 1996 to provide a stocktake of the results arising from the deregulation of the


\textsuperscript{47} Committee on Finance and Public Administration, \textit{A Pocket Full of Change, Banking and Deregulation} (1991) 154.

\textsuperscript{48} Committee on Finance and Public Administration, \textit{A Pocket Full of Change, Banking and Deregulation} (1991) 160.
Australian financial system since the early 1980s, beginning with the Campbell Report. The terms of reference also required recommendations on the nature of the regulatory arrangements that would best ensure an efficient, responsive, competitive, and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity, and fairness.\textsuperscript{49}

In relation to foreign bank entry,\textsuperscript{50} the Wallis Inquiry addressed the issue of foreign takeovers and was of the opinion that the present prohibition on foreign takeovers of the big four banks, regulated by the \textit{Foreign Acquisitions and Takeovers Act} (Cth) 1975, should be removed.\textsuperscript{51} Despite this, the Inquiry stressed that prudential concerns and the social and political climate of the time would influence considerations of national interest in the legislation.\textsuperscript{52} Furthermore, it argued that a large-scale transfer of ownership of the Australian financial system to foreign hands would not be in the national interest as it could potentially inhibit future development of Australia's financial system.\textsuperscript{53}

In contrast to the national interest considerations required by the \textit{Foreign Acquisitions and Takeovers Act} 1975 (Cth), the inquiry believed that there would be no economic disadvantage from increasing the percentage of foreign ownership of the Australian financial system, whether this foreign ownership is of major banks or smaller institutions.\textsuperscript{54} This view was based on the inquiry's opinion that foreign ownership can bring with it a range of benefits for countries, including injections of capital, access to new skills and technologies, and enhanced competitive pressure on the domestic market.\textsuperscript{55} The Wallis Inquiry estimated that in 1996 foreign owned


institutions controlled 14.5 percent of total bank assets, while foreign institutions controlled 94 percent of total merchant bank assets.\textsuperscript{56}

Recommendation 85 of the Inquiry entitled 'General foreign investment policy should apply to the financial system' provided:

The policy position prohibiting the foreign takeover of any of the four major banks should be explicitly removed and replaced with a policy which provides that all foreign acquisitions in the financial system will be assessed under the general provisions of foreign investment policy under the \textit{Foreign Acquisitions and Takeovers Act 1975}. The Inquiry believes that a large scale transfer of ownership of the financial system to foreign hands should be considered contrary to the national interest. However, this does not preclude some increase in foreign ownership of aspects of the Australian financial system, including its major participants.\textsuperscript{57}

While the terms of reference required the Inquiry to identify the factors likely to drive further changes, including international competition and integration of financial markets,\textsuperscript{58} it specifically stated that the Inquiry could not make recommendations in relation to policies for the taxation of financial arrangements, products, or institutions.\textsuperscript{59} In spite of the express limitations imposed, the Wallis Inquiry did recognise that 'a goal, and one that is difficult to attain, is the achievement of a taxation system which is consistent with competitive neutrality in an international setting.'\textsuperscript{60} The report went on to state that 'the increasing globalisation of financial markets heightens this challenge, and will require considerable further attention from government in the near term. This is particularly desirable if Australia's full potential as a provider of financial services in a global marketplace is to be reached.'\textsuperscript{61}


Thus, the Wallis Inquiry confirmed the significance of multinational banking in the Australian financial industry and espoused the importance of addressing the related taxation issues.

The consequence of these inquiries, and the resultant changes, is that Australia is now exposed to multinational banking at levels previously unseen. The global expansion of overseas banks into Australia, and the provision of services, which were previously unavailable, means that new legislative issues have arisen. Presently, however, only prudential requirements have been addressed.

### 3.2.3 Legislative and Prudential Changes and Requirements

In accordance with the recommendations of the Martin Committee, the increase in foreign bank entry in Australia is conditioned upon the satisfaction of various legislative and prudential requirements. In order to understand the operating environment for multinational banks and the increasing presence of multinational banks in Australia, it is necessary to outline the legislative and prudential requirements and exemptions which have developed as a result of the various inquiries into the Australian Financial System.

The majority of recent changes to Australia's banking market occurred because of the Prime Minister's Economic Statement of 26 February 1992 and the accompanying 'One Nation' Policy$^{62}$ which was a response to the recommendations of the Martin Review. At this time, it was announced that more foreign banks would be allowed to operate in Australia and that they would be able to operate as branches provided their business was restricted to wholesale banking operations. It is from this date that foreign entrants increased significantly.$^{63}$

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$^{62}$ The Economic Statement by the Prime Minister, the Hon PJ Keating MP, delivered on 26 February 1992.

3.2.3.1 Legislative Requirements

In December of 1992 the Banking Act 1959 (Cth) was amended to give effect to the government’s proposed changes outlined in its ‘One Nation’ Policy, particularly allowing foreign banks to operate as branches. The amendments, introduced under the Banking Legislation Amendment Act 1992 (Cth), did two notable things: one, a definition of ‘foreign banks’ was added; and two, ‘Division 1B - Provisions relating to certain foreign banks’, was inserted.

Section 6 of the Banking Act 1959 (Cth) defines ‘foreign bank’ as a body corporate that is a foreign corporation within the meaning of paragraph 51(xx) of the Commonwealth Constitution of Australia, is authorised to carry on banking business in a foreign country, and has been granted an authority under section 9 to carry on banking business in Australia. This definition of ‘foreign bank’ ensures that the Federal Parliament has the power to legislate for foreign banks. Further, the definition clearly states the criteria that need to be met for a financial institution to be classified as a foreign bank, both authority to carry on banking business in a foreign country, and an authority under section 9 of the Banking Act 1959 (Cth) to carry on banking business in Australia.

Division 1B, in effect, contains consumer protection provisions. A foreign bank must inform any person making a deposit of requirements under the Act to which the bank is not subject because of the exclusion of Division 2 provisions. Further, in the event of a foreign bank being unable to meet its payments, the assets of the bank in Australia must be available to meet the banks liabilities in Australia, in priority to all other liabilities of the bank.

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66 It should be noted that foreign bank in this provision does not include the Bank of China or the Bank of New Zealand (Banking Act 1959 (Cth) s 11D).

67 Banking Act 1959 (Cth) s 11E(2).

68 Banking Act 1959 (Cth) s 11F.
In addition to deeming foreign banks to have certain responsibilities, an external protection device was inserted into the Banking Act 1959 (Cth) allowing the Governor-General, on the recommendation of the Treasurer to revoke an authority given to a foreign bank.69 The authority may be revoked in situations in which the foreign bank does not comply with certain regulatory requirements70, and, as an overriding provision, where it is considered contrary to the national interest for the bank to continue carrying on business in Australia.71

A foreign bank wishing to open an Australian branch should note that only a body corporate can carry on banking business in Australia.72 Additionally it must hold an appropriate authority under section 9,73 which provides that a body corporate desiring authority to carry on banking business in Australia may apply to the Treasurer for that authority.74

One of the major concerns of the foreign banks was the cost of transferring the subsidiary’s assets to the branch.75 Under normal circumstances a transfer of assets results in an assignment of those assets to the branch, that in turn attracts State or Territory stamp duty.

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69 Banking Act 1959 (Cth) s9 (8B): The Governor-General may, on the recommendation of the Treasurer, revoke the authority granted to a foreign bank if:
     (a) the bank does not comply with:
         (i) a condition imposed on the authority; or
         (ii) a requirement of this Act or the regulations; or
     (b) the Governor-General is satisfied that it would be contrary to the national interest for the bank to continue carrying on banking business in Australia.

70 Banking Act 1959 (Cth) s9 (8B)(a).

71 Banking Act 1959 (Cth) s9 (8B)(b).

72 Banking Act 1959 (Cth) s 7.

73 Banking Act 1959 (Cth) s 8.

74 Banking Act 1959 (Cth) s 9(2).

Having initiated sufficient protection provisions in Division 1B of the Banking Act 1959 (Cth), the Government issued a further banking policy on 18 June 1993 which provided for exemptions from taxation on certain transactions being legislated for in the Financial Corporations (Assets and Liabilities) Act 1993 (Cth). This was the first adjustment to taxation rules for specific application to multinational banks. Unfortunately, the motive for the exemptions was not to ensure the fair taxation of multinational banks but rather to encourage the entrance of foreign banks into Australia.

The amendments to the Financial Corporations (Assets and Liabilities) Act 1993 (Cth) primarily provided for three tax incentives. The first tax incentive is for the transfer of assets and liabilities from a foreign bank subsidiary to a foreign bank branch to be free of normal Commonwealth and State taxes and fees. Section 10 of this Act provides that where a transferring [foreign] corporation or a receiving [foreign] corporation would be liable to pay a tax or fee under a law of the Commonwealth, a State, or Territory in respect of a transfer, or registration of a transfer, of an asset or liability they are exempted from that tax or fee. This section has the effect of exempting the payment of stamp duties upon the transfer of assets, and hence increases the profitability and affordability for foreign banks wishing to establish Australian branches.

The second tax incentive is offered in the context of addressing the income tax consequences of a transfer. The Financial Corporations (Assets and Liabilities) Act 1993 (Cth) provides that where a transfer occurs, the transferring corporation is treated as if there was no transfer and the receiving corporation is not entitled to

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77 Transferring and Receiving Corporations are defined in the Financial Corporations (Assets and Liabilities) Act 1993 (Cth) s5:

s5: If a financial corporation is proposing to transfer, or transfers, an asset or liability to another financial corporation, then, for the purposes of this Act:

(a) the first-mentioned corporation is the transferring corporation, and

(b) the other corporation is the receiving corporation;

in relation to the transfer.

any deduction in relation to expenditure\textsuperscript{79} unless there is an acquisition of trading stock.\textsuperscript{80}

There is also a third category of tax incentives, which are provided for in the \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth). Division 4 allows roll-over relief with respect to capital gains tax, under s160ZZO of the \textit{Income Tax Assessment Act 1936} (Cth),\textsuperscript{81} and permits the transfer of capital losses under s160ZP of the \textit{Income Tax Assessment Act 1936} (Cth) in certain circumstances.\textsuperscript{82} As distinct from capital losses, the transfer of tax losses from the transferring corporation to the receiving corporation is provided for under Division 8.

The receiving corporation can also, in certain circumstances provided for in Division 6 receive a deduction for bad debts inherited from the transferring corporation. The final exemption is Division 7, section 23, which allows a continued exemption from interest withholding tax, provided by s128F of the \textit{Income Tax Assessment Act 1936} (Cth). The exemption applies where liabilities relating to widely distributed issues of debentures, on or before the 18 June 1993, are transferred to the receiving corporation. In order for the transferring corporation and the receiving corporation to take advantage of the many tax exemptions provided for in the \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) it is necessary that they, and their transactions, fall within the Act's scope.

The \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) requires that the assets are being transferred from a subsidiary of an 'eligible foreign bank'. An 'eligible foreign bank' is defined in s3 as a foreign bank in possession of a banking authority granted either before the Act commenced or granted after the Act commenced upon an application made either before or not later than three years after the Act commenced. Further, the subsidiary must be an 'eligible local bank' or an

\textsuperscript{79} \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) s 15(2).

\textsuperscript{80} \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) Division 5 deals with the tax treatment of the transfer of trading stock.

\textsuperscript{81} \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) s 18.

\textsuperscript{82} \textit{Financial Corporations (Assets and Liabilities) Act 1993} (Cth) s 20.
‘eligible money market corporation’. This means that the subsidiary must have either been in possession of a banking authority granted before 18 June 1993 or have been a registered money market corporation on or before 18 June 1993. If the foreign bank is not within the definition of ‘eligible foreign bank’ or the subsidiary does not hold a banking authority, or is not a registered money lender, then the foreign bank may not be able to take advantage of the provisions of the Financial Corporations (Assets and Liabilities) Act 1993 (Cth).

In summary, while the legislative environment for multinational banks encompasses consumer protection measures and numerous tax concessions, no provision is made for a unique taxation regime for multinational banks.

3.2.3.2 Prudential Requirements

A significant administrative recommendation by the Wallis Inquiry was the proposal for a new regulatory entity known as the Australian Prudential Regulation Commission84 (APRC), to undertake the prudential regulation functions of the Reserve Bank of Australia,85 the Financial Institutions Scheme, and the ISC.86 The Australian Prudential Regulation Authority (APRA), established on 1 July 1998, is now responsible for the regulation of the banking industry in Australia.

As discussed in chapter two, a foreign bank wishing to enter the Australian market may do so in one of three ways; as a subsidiary of the foreign bank, a foreign bank branch, or a representative office of the foreign bank. As a result of their differences, each organisational structure is subject to varying host nation regulations.

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84 The implementation of this recommendation resulted in the Australian Prudential Regulation Authority (APRA) being established.


Although the traditional method adopted by multinational banks for operating in Australia has been through a subsidiary,97 there has recently been a move towards foreign bank branches rather than the subsidiary structure. This shift has been facilitated by the removal of the previously discussed prohibition against foreign banks entering the Australian market other than as a subsidiary.

'A bank subsidiary is a separately incorporated bank, generally wholly owned by the parent bank, but at the very least, controlled by the foreign parent bank.'88 On the other hand, a foreign bank branch involves the parent bank establishing a branch in a foreign jurisdiction, without the formal act of incorporation. The primary difference between a foreign subsidiary and a foreign branch is the fact that the branch is not separately capitalised.89 A representative office of a foreign bank ‘is a small office in the host nation that coordinates a bank’s correspondent banking relationships and renders assistance to the bank’s existing customers.’90

APRA, in its regulation of the operation of each of the forms of foreign bank entry, provides written consent to successful applicants for licences to operate. The requirements to operate in Australia are contained in prudential statements released by APRA. Prudential Statement J1 entitled ‘Application for a Banking Authority Locally Incorporated Banks’ provides guidelines for foreign banks wishing to establish an Australian subsidiary.

Any entity wishing to operate as a bank in Australia, through a local subsidiary, must obtain a banking authority issued by APRA pursuant to the Banking Act 1959 (Cth). Any authority so granted is subject to two general conditions: first, the bank must consult with APRA regarding prudential supervisory arrangements; and second, the

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bank must conform to any prudential arrangements laid down by APRA. APRA specifically states that locally incorporated banking subsidiaries established in Australia by foreign banks are subject to the same legislative and prudential requirements as locally owned banks.\textsuperscript{91} There are no restrictions on the number of foreign bank subsidiaries allowed to operate in the Australian market.\textsuperscript{92} At present, twelve foreign banks have Australian subsidiaries.\textsuperscript{93}

In addition to the minimum criteria required of all entities, a foreign bank wishing to establish a locally incorporated subsidiary is required to submit further documentation. Required is a description of supervisory arrangements to which it is subject in its country of origin, a statement from its home country supervisor that the foreign bank is of good financial standing, and a statement from the home supervisor consenting to the establishment of a banking subsidiary in Australia.\textsuperscript{94} APRA also requires that a bank's home supervisor confirm that it supervises the foreign bank and its subsidiaries on a consolidated basis in accordance with the principles contained in the Basle Concordat.\textsuperscript{95}

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\textsuperscript{91} Prudential Statement J1, Application for a Banking Authority, Locally Incorporated Banks (1996) paragraph 4.

\textsuperscript{92} Prudential Statement J1, Application for a Banking Authority, Locally Incorporated Banks (1996) paragraph 4.


\textsuperscript{94} Prudential Statement J1, Application for a Banking Authority, Locally Incorporated Banks (1996) paragraph 8.

\textsuperscript{95} Prudential Statement J1, Application for a Banking Authority, Locally Incorporated Banks (1996) paragraph 8. The Basle Concordat of 1975 as updated by the 1983 Concordat sets out the G-10 banking supervisory authorities' views as to how the supervision of cross-border banking should be shared between the respective parent and host banking authorities. Seventy-five non-G10 countries have also endorsed the 1983 paper entitled 'Principles for the Supervision of Banks' Foreign Establishments'.
To establish a local branch, as opposed to a subsidiary or locally incorporated bank, the foreign bank must comply with the requirements of Prudential Statement J2 entitled ‘Application for a Banking Authority – Foreign Bank Branches’. As with the establishment of any form of bank, it is necessary to obtain a banking authority from APRA, in accordance with the Banking Act 1959 (Cth). There are no restrictions on the number of foreign bank branches operating in the Australian market, nor are there any restrictions on the size of their operations. At present, there are twenty-eight foreign banks with Australian branches.

There are two significant differences in the administration and permitted functions of a foreign bank branch as compared to a foreign bank subsidiary. The first significant difference is that the overseeing of the branch operations lies with the home supervisor, which is consistent with the fact that foreign bank branches are not subject to the depositor protection provisions of the Banking Act 1959 (Cth), whereas subsidiaries are subject to these provisions.

The depositor protection provisions in Part 2, Division II, of the Banking Act 1959 (Cth) impose a duty on the Reserve Bank to exercise the powers and functions accorded to it under that Division for the protection of depositors of the banks. The powers vested in the Reserve Bank allow it to require a bank to supply information

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98 Despite not being subject to the depositor protection provisions of the Banking Act 1959 (Cth) a foreign bank branch will still be required to submit their local operations to the prudential supervision of APRA. Prudential Statement J2, Application for a Banking Authority – Foreign Bank Branches, March 1996, Paragraph 4.

99 Banking Act 1959 (Cth) s 12.
relating to the financial stability of that bank.\textsuperscript{100} This Division also requires a bank that considers itself unlikely to meet its obligations, or is about to suspend payments to inform them of such happenings.\textsuperscript{101}

This first significant difference is a catalyst for the second. Given the inability, or more appropriately the unwillingness, of APRA to provide the same level of protection to depositors of branches, as compared to a locally incorporated bank, restrictions have been placed on the deposit taking transactions of branches. Essentially, due to the lack of protection provided by APRA, investor protection is provided by ensuring that foreign branches cannot accept initial deposits less than $250,000 other than from incorporated entities, non-residents, and bank employees.\textsuperscript{102} This has the commercial effect, of severely hampering the foreign branch’s ability to be an active participant in the retail banking market, and limits the majority of branch activities to the wholesale market.

The final and most restrictive means of foreign bank entry into Australia is in the form of a representative office of the foreign bank. Again, it is necessary to seek the consent of APRA to operate. Consent must also be granted for the use of the word ‘bank’ in the corporate name and in association with the representative office.\textsuperscript{103} This means of operation is restrictive because of the conditions attached by APRA to the operation of the representative office.

Primarily, the business of a representative office is confined to the conduct of purely liaison activities\textsuperscript{104}, hence; a representative office must not conduct any form of

\textsuperscript{100} Banking Act 1959 (Cth) s 13.

\textsuperscript{101} Banking Act 1959 (Cth) s 14.

\textsuperscript{102} Prudential Statement J2, Application for a Banking Authority - Foreign Bank Branch (1996) paragraph 7.

\textsuperscript{103} Prudential Statement J3, Representative Offices of Foreign Banks (1998) paragraph 1.

\textsuperscript{104} Prudential Statement J3, Representative Offices of Foreign Banks (1998) paragraph 5. APRA lists the following examples: conducting research into the Australian economy; liaising with Australian customers of the bank; the provision of factual information relating to the bank’s products and services upon request; undertaking credit assessments and reports on Australian entities for the bank.
requirements specified by APRA. The guidelines merely state that 'foreign investment in the banking sector needs to be consistent with the Banking Act 1959 (Cth), the Banks (Shareholdings) Act 1972 (Cth) and the Government banking policy, including prudential requirements'. The guidelines state that permission is granted where APRA is satisfied that a foreign bank should be allowed to operate in Australia. That is, where APRA is satisfied that the bank and its home supervisor are of sufficient standing and is willing to comply with its prudential supervision and arrangements.

In its document entitled Australia’s Foreign Investment Policy - A Guide for Investors the Federal Government advises that any foreign bank proposing to apply for a new banking authority or bid for an already existing bank consult the Foreign Investment Review Board and APRA prior to submitting their final application.

3.3 Australia’s ‘Big 4’ Banks Operating Offshore

In addition to a consideration of foreign banks entering Australia, no discussion of the rise of multinational banks is complete without a consideration of the offshore activities of Australia’s four ‘major’ banks: The Commonwealth Bank of Australia; National Australia Bank; Westpac; and ANZ. All four are large enough to be of world significance, and each has a presence in the overseas markets.

\[\text{\textsuperscript{110}}\text{ \textit{Australia's Foreign Investment Policy - A Guide for Investors} (1992) 6.}\]

\[\text{\textsuperscript{111}}\text{ \textit{Australia's Foreign Investment Policy - A Guide for Investors} (1992) 6.}\]

\[\text{\textsuperscript{112}}\text{ \textit{Australia's Foreign Investment Policy - A Guide for Investors} (1992) 6.}\]

\[\text{\textsuperscript{113}}\text{ The Commonwealth Bank of Australia, National Australia Bank, Westpac and ANZ are typically referred to as Australia’s major banks, as compared to regional banks and foreign owned banks.}\]

The Commonwealth Bank of Australia (CBA) has both offshore branches and representative offices, along with a 75% owned subsidiary in New Zealand. Branches are located in London, New York, Singapore, Tokyo, Hong Kong, and Grand Cayman. Representative offices are located in Beijing, Shanghai, Hanoi, and Jakarta.

The Australia and New Zealand (ANZ) Bank, with $183 billion dollars in assets, boasts being one of the top 100 banks in the world. It has branches located in Asia, the Pacific, New Zealand, the United States of America, the United Kingdom, Europe, and the Middle East. At 30 June 1999, the bank had a total of 1133 branches world wide consisting of 806 Australian Branches, 160 New Zealand Branches, and 167 from other jurisdictions. ANZ also has four representative offices in the Americas. Supporting the view that Australian banks are venturing offshore, one of the aims of the ANZ Bank is to complement the Regional focus with a strong presence in the world's major financial centers of the United States of America, United Kingdom, and Europe, giving them a global reach in support of the international activities of their customers.

The National Australia Bank (NAB) also considers itself international, with 55% of its operating revenue in 1998 generated outside Australia. For the 2002 financial year, international activities contributed $1.672 million to the total net profit.

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117 It is worth noting that until the late 1970's ANZ was domiciled in the UK with its head office and main share register located there. It is now headquartered in Melbourne.


119 Australia and New Zealand Bank, *Annual Report* (1999). This information is not available in more recent Annual Reports.

120 Australia and New Zealand Bank, *Annual Report* (1999). This information is not available in more recent Annual Reports.

121 Australia and New Zealand Bank, *Annual Report* (1999). This information is not available in more recent Annual Reports.


Europe, NAB owns four regional banks: Clydesdale Bank PLC of Scotland; Yorkshire Bank PLC in Northern England; Northern Bank Limited in Northern Ireland; and the National Irish Bank in the Republic of Ireland.\textsuperscript{124} Clydesdale Bank PLC of Scotland, Northern Bank Limited in Northern Ireland and the National Irish Bank in the Republic of Ireland were acquired by NAB from Midland Bank PLC in October 1987, while Yorkshire Bank PLC was acquired from four United Kingdom clearing banks in January 1990.\textsuperscript{125} By 1995 NAB was stating in its Annual Report that it was the second largest foreign owned banking group in the region.\textsuperscript{126}

NAB acquired the Bank of New Zealand in 1992.\textsuperscript{127} In the United States, NAB owns the Michigan National Corporation, a subsidiary of which is the Michigan National Bank. To facilitate its own transactions, NAB has a branch in New York to service its international customers. NABs presence in Asia consists of seven branches and four representative offices, all of which are managed by the regional headquarters in Hong Kong.\textsuperscript{128}

Westpac is the least aggressive of the 'four majors' when it comes to the foreign market. While it is one of the largest banks in New Zealand, and has a presence in the Pacific, it has not ventured further.\textsuperscript{129} Currently, 80 percent of its assets are located in Australia, 16 percent in New Zealand and 4 percent in other locations.\textsuperscript{130}

Consequently, the traditional Australian banks are now operating in locations where they previously did not meaning they are now operating globally. Further, they are now offering a unique intermediary services role internationally, where this was

\textsuperscript{124} National Australia Bank, Annual Report (1998).
\textsuperscript{125} National Australia Bank, Annual Report (1992).
\textsuperscript{126} National Australia Bank, Annual Report (1995).
\textsuperscript{128} National Australia Bank, Annual Report (1998).
\textsuperscript{129} Westpac, Annual Report (2002).
\textsuperscript{130} Westpac, Annual Report (2002).
previously only performed at a domestic level. This increase in overseas activity undertaken by domestic banks confirms the expansion of multinational banks and strengthens the importance of addressing the issue of taxation.

3.4 Conclusion

This chapter demonstrates that multinational banking attached to Australia, whether through foreign bank entry into the market or through domestic banks moving into the international arena, has increased significantly in the last two decades. Although prior to the 1980s, foreign bank entry was substantially inhibited by the Australian Government's restrictive foreign investment policy pertaining to the banking industry, the more recent relaxation of this policy and changes to the regulatory structure and prudential requirements have facilitated the recent growth within the banking sector.

Despite this increase in multinational banking activity in Australia and the significant legislative amendments made to accommodate this change, it has been shown that no corresponding amendments have been made to the taxation regime. Currently, there is no express provision for the allocation of taxing rights to the income of multinational banks as a unique commercial entity. As such, the ensuing chapters analyse the application of the current tax rules governing jurisdiction to tax and allocation of income, which are applicable to multinational banks.
Chapter 4

The Traditional Approach to Jurisdictional Allocation and the Classification Paradigm of the Source Regime

4.1 Introduction

This thesis asks what approach should be adopted to distribute the rights to tax the profits of multinational banks. Chapter two establishes that multinational banks have unique traits that distinguish them from traditional multinational entities. Chapter three provides an example of the domestic changes to multinational banking which has lead to an increase in this industry to a level where taxing jurisdictions should be concerned about whether they are receiving their fair share of tax. This chapter considers whether the traditional approach to the allocation of the rights for taxing multinational entities yields a result which is optimal for taxing multinational banks given their unique characteristics. As such, while it is argued that a robust source regime is required as part of the regime to tax multinational banks, it is contended that the current regime does not provide a result which is congruent with an optimal regime for these entities.

A country’s jurisdiction to tax is founded in domestic principles, with jurisdictions generally claiming a right to tax the income from all sources earned by its residents, and a right to tax income sourced within the jurisdictional boundaries where the income is earned by non-residents. Where countries have entered into double tax agreements this latter right to tax income earned by non-resident entities is (subject to a number of exceptions for particular types of income) generally relinquished in respect of business income, unless the non-resident has a presence in the jurisdiction in the form of a permanent establishment. Where a non-resident has a presence in this form, the source jurisdiction will not relinquish its taxing rights under double tax agreements.

To apply these principles to multinational banks, it is necessary to consider what is
meant by the concept of source of income within a jurisdiction. In the context of
taxing multinational banks there are two questions that need to be addressed. The
first question is whether the traditional source rules make sense when applied to
multinational banks. If the answer is ‘no’, the second question is, what is a better
way to deal with these modern multinational banking transactions. This chapter
addresses the first question.

The Australian legislation and case law is used as an example of a traditional source
regime to establish whether the traditional rules for allocating source reflect the
economic reality of multinational banking. This chapter argues that there are
inadequacies in the traditional source regime, and, while the traditional source rules
may (with difficulty) be applied to multinational banks to determine the taxable
income in the respective jurisdictions, the true economic source of the income is
ignored in coming to this position. Consequently, because of their unique
commercial role as financial intermediaries, by separating intermediary economic
activity from legal transactions with third parties multinational banks are able to
distort the true economic source position.

It is further argued in this chapter that the requirement of source based regimes to
classify income to determine its taxable source is ineffective when applied to
multinational banks. This chapter suggests that this is due to the continual evolution
of new and innovative financial products which may escape generic classification.
Traditional source rules are not designed with this in mind and, as such, may fail to
meet the requirements of these new products and services. Essentially, the criticism
levied against source based regimes is that rather than ever being perfect, they have
merely been tolerated. In an increasingly intangible business community, however,
these imperfections are been exacerbated to the point where the regime no longer
adequately functions.

1 Diane M Ring, ‘Exploring the Challenges of Electronic Commerce Taxation through the

2 Diane M Ring, ‘Exploring the Challenges of Electronic Commerce Taxation through the
This chapter suggests that the result under traditional source rules is to allocate income where transactions are completed or commenced rather than where the intermediation services are arranged. This leads to the proposition that a result reflecting more accurately the economic source of the income would ensue with the adoption of a unitary tax regime based on global formulary apportionment. The unitary method maintains source-jurisdiction taxation, as a formulary apportionment regime is inherently a source based system. It simply measures the source of income by reference to economic criteria (the factors used in a formulary apportionment scheme) rather than the legal criteria now employed. It is submitted that such a regime distributes the taxing rights between the relevant jurisdictions according to the economic source of the income, while, at the same time allowing decisions of the international banks to be tax neutral. By adopting a unitary tax regime based on formulary apportionment the linkage to source is then the location of the real economic activity.

Chapter four is divided into four parts. Part one considers the legal formalisms of the traditional regime. Part two then investigates the traditional concept of source. The requirement to classify the income earned by multinational banks and the difficulties associated with this is examined in part three. Finally, part four further investigates why, when the traditional source regime has been adequate for traditional multinational entities, it fails to allocate income in an optimal manner for multinational banks.


4 Michael J McIntyre, ‘The Design of Tax Rules for the North American Free Trade Alliance’ (1994) 49 New York University Tax Review 769, 776. Although Michael McIntyre disagrees with this assessment of a formulary apportionment regime. He states ‘[i]n some sense, a formulary apportionment system using worldwide combined reporting might be characterized as a “pure” residence based system - that is, a system that taxes exclusively according to residence and eschews source jurisdiction.’


4.2 Legal Formalisms of the Traditional Regime

The aim of any international tax regime is to allocate the taxing rights to relevant jurisdictions. While a multinational bank may produce international business income, there is no one set of taxation principles to tax this income at a global level.\(^7\) Rather, taxation, or more concisely, jurisdiction to tax, is a matter for domestic law.\(^8\) In this context, it is the taxpayers who have become global, not the tax authorities.\(^9\) At a global level, the international norms,\(^10\) or core concepts, which have been developed and embraced by most countries, apply.\(^11\) The two fundamental concepts, the norms of residency and source have been developed over the decades, and despite their age, apply to the relatively new phenomena of multinational banking.\(^12\) Consequently, the effects of globalisation mean that there are potential conflicts between current developments, such as those associated with multinational banking, and the potentially outdated traditional principles.\(^13\) This chapter explores these conflicts.

\(^7\) Although there is no such thing as an 'international tax'. As David Williams explains "international tax" does not make logical or semantic sense, unless we find supranational taxing powers.' Rather, it is the interactions that arise in respect of trans-national aspects of national taxes, that we are concerned about: David Williams, Trends in International Taxation (1991) 8.

\(^8\) Richard Bird and Scott Wilkie suggest that 'the most fundamental rule of international tax is that there are no rules of international taxation – just domestic rules applied to cross-border flows taking into account (or not) that such flows may be subject to taxation in more than one jurisdiction': Richard M Bird and J Scott Wilkie, 'Source- vs. Residence-Based Taxation in the European Union: The Wrong Question?' in Sijbren Croesen (ed), Taxing Income in the European Union – Issues and Options for Reform (2000) 78, 91.


\(^10\) It is asserted that source and residence taxation are customary norms: Nancy H Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 Law and Policy in International Business 145, 148.


The traditional principles are contained in both domestic law and international treaties. The application of these principles of residency and source to multinational entities in general involves a number of legal formalisms. Generally, principles of residency and source are considered competing concepts, with the primary right to corporate taxation tax falling to the source jurisdiction. Each of the traditional concepts turns on the ability to establish a geographical physical

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14 In Australia, these concepts are first contended with in Division 6 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). This Division provides that if you are an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all sources, whether in or out of Australia, during the income year: *Income Tax Assessment Act 1997* (Cth) s 6-5(2). Alternatively, if you are not an Australian resident, your assessable income includes the ordinary income you derived directly or indirectly from all Australian sources during the income year; and other ordinary income that a provision includes in your assessable income for the income year on some basis other than having an Australian source: *Income Tax Assessment Act 1997* (Cth) 6-5(3). These principles of residency and source apply equally to statutory income and income according to ordinary principles: Section 6-5 of the *Income Tax Assessment Act 1997* (Cth) includes 'ordinary income' in the assessable income of the taxpayer, while section 6-10 of the *Income Tax Assessment Act 1997* (Cth) includes 'statutory income' in the assessable income of a taxpayer.

15 *International Tax Agreements Act 1953* (Cth) s 4. The application of Australian domestic principles, without resort to international agreements, will not always present the optimal taxing result, as there is potential for double taxation or less than single taxation. Consequentially the taxing position acquired through an application of those domestic principles is neither the final nor the legally correct result. Adjustments to the domestic principles are facilitated by the overriding effect of the *International Tax Agreements Act 1953* (Cth) which also addresses the key concepts of residency and source. The *International Tax Agreements Act 1953* (Cth) provides that the *Income Tax Assessment Acts* of 1956 and 1997 are incorporated into it and in the case of any inconsistency the former Act will prevail. All of Australia's Double Tax Agreements are contained in Schedules to that Act, thus forming part of Australian domestic law and effecting the taxation position of multinational banks within Australia's taxing jurisdiction. Like most economically sophisticated countries, Australia has entered into numerous comprehensive double tax agreements. The double tax agreements, generally based on the Organisation for Economic Co-Operation and Development (OECD) model treaty, serve two broad purposes; first, to avoid double taxation, and second, to prevent fiscal evasion. The avoidance of double taxation is achieved through mutual agreements as to the specific allocation of income to the jurisdictions, and exemptions or credits for tax paid. At this point, it should be again emphasised that this thesis is not suggesting that multinational banks are undertaking fiscal evasion. Rather, this thesis considers whether the distribution of the right to tax multinational banks across relevant jurisdictions is optimal. Therefore, while the stated aims of the double tax agreements are to prevent fiscal evasion and double taxation, this thesis does not examine whether that is, in fact, achieved. Rather this thesis considers whether the distribution of taxing rights under the current law, both the ITAA97 and the relevant double tax agreements, achieves an optimal result, or one reflecting economic reality.


presence in a particular country. The residual taxing rights generally fall to the residence jurisdiction, with that country providing exemptions or credits for tax paid in the source country in order to avoid double taxation.

As an example of the operation of domestic law, the table below summarises the position for multinational banks operating in Australia.

The general division of Tax Obligations
under Australian Domestic Law

<table>
<thead>
<tr>
<th></th>
<th>Australian Resident Bank</th>
<th>Non-Australian Resident Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Australian Source</strong></td>
<td>Jurisdiction to Tax</td>
<td>Jurisdiction to Tax</td>
</tr>
<tr>
<td>Banking Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Foreign Source</strong></td>
<td>Jurisdiction to Tax</td>
<td>No Jurisdiction to Tax</td>
</tr>
<tr>
<td>Banking Income</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Residence (and permanent establishment) also has a secondary role. Where a multinational entity is the taxpayer in question, the residency principle is generally a threshold test to determine the right to tax. Where the residency requirement is met, under domestic law, the jurisdiction generally has the right to tax income from all sources. These rights are then varied where the jurisdiction has entered into a double tax agreement. The jurisdiction then gives up its right to tax income of residents where that income is sourced through a foreign permanent establishment. Further, domestic legislation generally provides for the taxation of income sourced in a jurisdiction that is earned by a non-resident. Again, where there is a double tax

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19 This position is generally adopted globally.

agreement, the source county gives up the right to tax the income unless there is the presence of a permanent establishment. As such, while the permanent establishment test is thought to be a source rule for taxing business profits, it is used precisely as a threshold test for taxing those profits.\textsuperscript{21} Essentially, where a multinational entity is deriving active income, these principles provide the threshold test for allowing a jurisdiction to exert a primary taxing right to the active income that is sourced within the jurisdictions’ boundaries.

Where domestic law is combined with treaty principles there generally needs to be a minimum threshold of business activity as a prerequisite to source-based taxation of business income.\textsuperscript{22} Currently, this is measured through residence or the presence of a permanent establishment. While there are proposals to abolish a residency based regime altogether, along with proposals to abolish or alter the permanent establishment principle, these concepts are not incongruent with unitary taxation based on global formulary apportionment. As such, it is not the purpose of this chapter to discuss the merits of the tests of residency and permanent establishment, but rather to consider whether the traditional principles of source are sufficiently robust to reflect the genuine economic source of income. The next part of this chapter, therefore, considers the traditional concept of source.

### 4.3 The Traditional Concept of Source

Traditionally, the allocation of the right to tax based on source, is founded on the notion that the source jurisdiction provides benefits and services to the taxpayer.\textsuperscript{23} This contention that the source country has a right to tax income produced within its borders is also grounded in the view that non-residents, whose activities reach a minimum threshold, should contribute to the costs of services provided by the source


\textsuperscript{23} Klaus Vogel, ‘Worldwide vs Source Taxation of Income - A Review and Re-evaluation of Arguments (Part III)’ (1988) \textit{11 InterTax} 393
jurisdiction. This thesis does not argue that this benefits principle is incongruous with the notion that an optimal regime is one which allocates the right to tax based on economic activity. It is suggested that it is correct that economic allegiance to a jurisdiction based on business activities is more important than allegiance to the jurisdiction of residence. Further, a jurisdiction's entitlement to tax at source is the bedrock of most international tax treaties. As such, this thesis accepts that a regime based on source is sound and should be maintained for multinational banks. It merely questions whether the current source regime should be maintained. It is in this context that it is necessary to consider what is meant by source.

4.3.1 Source Defined

Source rules require a relationship between the income and the taxing jurisdiction. This is in contrast to residence rules, which require a relationship between the taxpayer and the taxing jurisdiction. The relationship between the income and the taxing jurisdiction has been described as one where 'the claim of source countries to tax income produced within their borders is analogous to a nation's long-recognised claim of sovereignty over natural resources within its boundaries.' This analogy can be applied to multinational banks, inferring that nations have the right to

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26 See Klaus Vogel, ‘Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part I)’ (1988) InterTax 216, 219, relying on Schanz. Zur Frage der Steuerpflicht. 9 II Finanzarchiv 1, 4 (1892) where he states 'Economic allegiance to a State can be based on mere consumption or it can be based on business activities, including investment activities. ... Where a person is economically bound not only to the state of his or her residence but also another state through business activities or by way of income arising in the other state, Schanz deems the allegiance to this other state, the source state, to be more important than to the state of residence.'


tax income generating activities undertaken by these banks within their boundaries. Consequently, the relationship between source and jurisdiction is valid. The relationship, however, does not define source.

International tax literature clarifies the relationship between source and jurisdiction, however, an authoritative definition of source is not provided. Though most definitions distinguish between residence and source, they fail to define source per se. Hence, the concept can be regarded as being inherently vague.\textsuperscript{29} Klaus Vogel, commenting on this lack of description, relies on Peggy Musgrave and Richard Musgrave’s definition of source as ‘the place of the income generating activity’.\textsuperscript{30} Elaborating on this lack of description of source, Klaus Vogel comments that ‘[a]uthors take source to be a natural, self-defining concept about which not much dissonance or disagreement is possible. However, this is far from the truth.’\textsuperscript{31} He explains that source is only unambiguous in what it excludes, that is, it is different from residence based taxation.\textsuperscript{32} Klaus Vogel goes on to say ‘[t]he only positive statement that can be made on the other hand is that “source” refers to a state that in some way or other is connected to the production of the income in question, to the state where value is added to a good. In contrast, the type of connection that establishes the “source” of income cannot be defined generally.’\textsuperscript{33}

Michael McIntyre also comments on this lack of description of source observing that, '[c]olloquially, the source of income means the geographical place where the income


arises. He also refers to its lack of economic substance in his comment that "[t]here is some limited content to that concept, but it is much less well defined and has less of an economic foundation than many analysts appreciate when they use the term." As such, it is generally accepted that there is no universally acknowledged definition of source.

The consequence of these observations is that there is no definition of source that can be relied on to establish whether a jurisdiction has income sourced within its boundaries. In light of this finding it is suggested that the Peggy Musgrave and Richard Musgrave definition relied on by Klaus Vogel is the generally understood notion of source. That is, source is the place of the income generating activity. Where source is defined as the 'place of the income generating activity', it is open to interpretation as to what this phrase means.

### 4.3.2 The Place of the Income Generating Activity

To the extent that it is necessary to define the 'place of the income generating activity', it is necessary to consider what are known as the source rules. Source rules are generally domestically based rules, with a combination of common law and statute based principles, all of which rely on the classification of income. The double tax agreements also provide a source rule for the business profits of a permanent establishment. They do not elaborate, however, on the classification of the income.

As source rules are generally domestic rules the taxation laws of Australia can be used as an example. The foundation for determining the source of income within the

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Australian jurisdiction is the somewhat nebulous statement made by Isaacs J in *Nathan v FCT.* In considering the source of income, Isaacs J stated:

> The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact. The Act, on examination, so treats it.

The courts have since reiterated this vague principle with the focus being to identify the 'practical' source of income. In *FCT v. Mitchum* Barwick CJ confirmed that 'the matter being judged is one of practical reality. In each case, the relative weight to be given to the various factors, which can be taken into consideration, is to be determined by the tribunal entitled to draw the ultimate conclusion as to source.' More importantly, Barwick, CJ, confirmed that 'there are no presumptions and no rules which require that that question be resolved in any particular sense.'

Source, therefore, in an inherently vague concept. The essence of the source rule is to consider matters on a case-by-case basis to determine this 'practical' source. The difficulty of devising one universal principle for determining source was again emphasized by Barwick CJ, in *Esquire Nominees Limited v. FCT* when he said:

> The concept of the Act is that all income is derived from some source having a geographical location, or, at any rate, that it is possible to predicate of all income that it is so derived. This relation of income to a geographically located source has provided its problems in the past and no doubt will do so in the future. I do not think that any single verbal formula can be devised which by its mere mechanical application to any given

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38 *Nathan v FCT* (1918) 25 CLR 183.
39 *Nathan v FCT* (1918) 25 CLR 183, 189-190.
40 *FCT v. Mitchum* (1965) 113 CLR 401.
41 *FCT v. Mitchum* (1965) 113 CLR 401, 407.
42 *FCT v. Mitchum* (1965) 113 CLR 401, 407.
43 *Esquire Nominees Limited v. FCT* 73 ATC 4114.
situation will yield the answer to the problem of the location of the source of some item of income.\textsuperscript{44}

While these cases provide valuable insight into the views of the court in determining the source of income, very little assistance is given in the context of specific scenarios. As the source of income is determined on a case-by-case basis, a consideration of the relevant factors and a weighing up of those factors determines their attribution. While the cases stress the importance of a 'practical' consideration of the facts, legal norms have been established. The application of these legal norms to multinational banks potentially leads to the income being allocated other than according to economic activity.

The legal norms that have been established generally require a common preliminary approach of the classification of the income. In \textit{C of T (NSW) v. Cam & Sons Limited},\textsuperscript{45} Jordan CJ referred to the application of the general principle of source. He stated:

\begin{quote}
Now, a source may, and commonly does, consist of several factors. The character of the source may depend upon which of the factors is dominant. ... And there are many forms of income which are regarded as wholly derived from property, notwithstanding that an appreciable amount of personal exertion is involved in connection with property. At a certain stage, which in a particular case it may be difficult to define with precision, an accentuation and change of direction of this element of personal exertion may, for example, prevent income derived from property and endow it with that of income derived from personal exertion in an investment business.\textsuperscript{46}
\end{quote}

Consequently, to determine the place of the income generating activity, the Australian source-based regime, both through its domestic legislation and double tax agreements, requires a multi-step approach. The first step is to categorise the income. The second step is to apply the appropriate legal rules relevant to that category of income to determine the source jurisdiction. The third step is to apply the relevant tax assessment rules.

\textsuperscript{44} \textit{Esquire Nominees Limited v. FCT} 73 ATC 4114, 4117.

\textsuperscript{45} \textit{C of T (NSW) v. Cam & Sons Limited} (1936) 4 ATD 32.

\textsuperscript{46} \textit{C of T (NSW) v. Cam & Sons Limited} (1936) 4 ATD 32, 33.
The first step of categorisation of income tends to be the most crucial, as it is this step that dictates which source rule applies. It is also this step that introduces ambiguities into the regime and ultimately may render the source based regime ineffective for allocating the income of multinational banks to the relevant jurisdictions. This is because the classification rules are difficult to apply to multinational banks due to the unique services (and consequent products) along with the intermediary nature of the business of multinational banking.

4.4 The Classification Paradigm for Multinational Banks

The potential reason that the current source rules fail to allocate the income of a multinational bank to the location of the true economic activity is that the location of the source for tax purposes is determinate on the type of income earned, which may be easily manipulated by these banks. Multinational banks are essentially providing services, but these may be repackaged into the provision of a product. For example, multinational banks are able to provide the intermediary services in one location but package the product and undertake supply in another. Where the income is deemed to be sourced in the location of the supply of the product there is no allocation to the place where the intermediary services are provided. Where this occurs the income is not allocated according to economic activity, but rather it is allocated based on a strict legal rule.

The above example demonstrates that it is necessary to consider whether the income of multinational banks is earned from services provided or products provided. For the source regime, therefore, to function adequately (before considering whether there is an economically valid basis for the allocation) there must be obvious categorisations for the relevant income.\(^{47}\) To this extent, the categories for multinational banking transactions are far from self-evident.

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Compounding the categorisation problems is the lack of commentary by taxing authorities and international bodies giving aid to this process. As such, resort to traditional categorisation rules is necessary with analogies drawn between these and modern financial transactions entered into by the multinational banks. The two closest analogies to transactions occurring between global traders are the discussions of transactions in goods and on the performance of services.48

Working within these two paradigms the following analysis considers whether the income from multinational banking can be classified as either income from services rendered or income from products supplied and whether such a categorisation then achieves a result that allocates the profits according to the economic activity performed to earn the profits. The purpose of this analysis is to demonstrate not only that the current source rules fail to allocate based on economic activity of multinational banks but also simply to demonstrate the difficulties in applying the source rules to such entities.

4.4.1 Services Rendered versus Trading Activities

Under the transactions in goods paradigm the traders are cast as purchasers or sellers of goods: ‘global trading would equate to one trader acquiring a product in one jurisdiction and selling it to another trader for resale in the other jurisdiction.’49 This paradigm introduces the issue of whether an agency type relationship exists whereby the trader is acting as agent for another trader or the agent is acting as principal.50 The allocation of income varies according to this legal determination. Where the trader is acting as agent, the income sourced in the trade jurisdiction will be a commission earned. Alternatively, if the trader is acting as principal, thereby

48 Charles Plambeck suggests that theses are the two closest analogies that can be drawn. Charles H Plambeck, ‘The Taxation Implications of Global Trading’ (1990) 48 Tax Notes 1143, 1150.


accepting all of the risk associated with the trade, all of the income arising from the trade will be sourced in that jurisdiction.

The obvious problem with this paradigm and consequent outcome is that very seldom is global trading as definitive as agent or principal. This is particularly so where, under the highly integrated trading model, the distinction between principal and agent begins to blur.\textsuperscript{51} Hence, it becomes difficult to classify the income as either commissions or earnings for risk. Consequently, it is difficult, if not impossible to apply the transaction in goods paradigm to multinational banks.

Domestically, the transactions in goods analogy can also be made. To this extent Australia’s one-sided source rules may be used as an example. Part III, Sub-division 2C of the ITAA, ‘Business Carried on Partly in and Partly out of Australia’, contains several specific statutory rules applicable to the determination of the source of business income. Of particular importance are sections 38 to 43 which deal with sales income from both the importing and exporting of goods where the production or purchase and the sale of goods is across two jurisdictions. These provisions detail the methodology for determining the source of income arising from such transactions and grant authority to the Commissioner to apportion this income between sources. It can be argued that financial products are analogous to physical goods as they can have their origin in one jurisdiction but be sold to a customer in another.

The importation and sale of goods by a manufacturer in Australia is dealt with in section 38. It provides that the Australian source profit is determined by subtracting from the selling price a notional cost price and any transport and selling expenses. This ‘notional cost price’ is the amount for which, at the date the goods were shipped to Australia, goods of the same nature and quality could be purchased by the wholesale buyer in the country of manufacture. This formula results in a ‘notional profit’ being deemed to be sourced from Australia.

In theory, a similar principle could apply to financial products. In essence, the notional profit of section 38 would equal the selling price less the price a purely domestic bank would pay for a product to be provided by an overseas bank to one of its clients. There are, however, several fundamental difficulties with this approach, which are exacerbated when applied to intangible products, such as those of multinational banks. The first difficulty is that there is no guidance as to what constitutes ‘goods of the same nature and quality’ nor are there restrictions on the amount of transport or selling expenses. In the case of financial products, not only would finding a product of the same nature or quality available at wholesale appear impossible, but the allocation of transport and, in particular, selling expenses would also prove highly subjective. The only way any variance from true market price may be overcome is via an exercise of the Commissioner’s discretionary powers and clearly, this solution is not an economically feasible one. The second difficulty is that the sub-division only operates where there is a profit; it does not apply to all business operations across two or more jurisdictions. This produces an inequality between profit and loss making transactions. There is a very real chance that financial products may fall within this category. The third difficulty is that it is questionable whether the section applies where further manufacturing takes place in Australia or where the sale is not business related. Undoubtedly, in the context of financial products there is likely to be further input into the final product supplied.

For the importation and sale of goods in Australia by a person other than the manufacturer, section 39 deems an actual profit to be sourced in Australia. The formula of section 39 provides that the profit deemed to be derived in Australia is the sale price of the goods less their actual purchase price and transportation and selling expenses. Again, this section only applies to business profits and not all business operations, thus resulting in a biased treatment of profit transactions vis-à-vis loss transactions. As to the potential applicability of section 39 to financial institutions,

52 Income Tax Assessment Act 1936 (Cth) s 40, provides that if however the Commissioner is unable to ascertain the Australian source profit to his satisfaction under ss 38 or 39 he may deem such amount as he determines.

53 American Thread Co. V. FCT (1947) 73 CLR 643.

an actual purchase price would be difficult to ascertain, as it is unlikely that a supply would be made by an entity other than the creator of the product in question. Therefore, without an actual purchase price, section 39 offers no assistance for determining the source of income for financial institutions including multinational banks as it cannot be adequately applied.

The second analogy for global trading is the performance of services paradigm. Under this paradigm, the traders are cast as owners or managers of portfolios.\textsuperscript{55} In this case, ‘global trading would equate to the ownership of a portfolio by a trader in one jurisdiction and its management by a trader in another jurisdiction.’\textsuperscript{56} The owner of the portfolio would be entitled to the profits less a management fee because of the burdens associated with that ownership - the managing trader being entitled to that management fee.

This paradigm also encounters difficulties in a global trading context as while ‘any particular entity (such as a tax haven entity) or a number of entities may be designated as “owning” inventory of widely traded products or derivatives, no particular permanent establishment can truly be said to be the “owner” when operations are conducted through branches, and a hedge might be owned by an entity other than the owner of the inventory.’\textsuperscript{57}

In summarising the services rendered versus trading activities paradigm, Charles Plambeck provides:

\textit{Ultimately neither paradigm may prove satisfactory: firms operating in one profit center mode do not divide the economic functions of a global book along national boundaries, hence any tax rules that do so would produce artificial results. Firms would have the incentive to locate inventory in the lowest tax country, where the majority of profits would}


be attributable. A transactional approach would be particularly unworkable for a portfolio of derivative products, where the identity of component cash flows is lost, hedges hedge bundles of cash flows from a variety of sources, and there really is no location (other than information in a computer) to inventory.\textsuperscript{58}

Even if the alternative paradigm debate can be resolved, there is still the underlying issue of the jurisdiction of source. Whether the sale of goods paradigm or the performance of services paradigm is adopted, it is still difficult, in the case of multinational banks, to determine where those acts take place. To this extent, the common law rule generally provides for the source to be the place of contract,\textsuperscript{59} with other relevant factors to be considered. It is this very rule that multinational banks use to their advantage to distort the true location of the activity giving rise to their income.

\textbf{4.4.2 Factors Determining Source}

The clear limitation on a rule that declares the source to be the place of contract is that it is easily manipulated by entering into the contract in a location different to that of the economic activities undertaken in performance. In the context of taxing financial transactions, this is recognised as a potential problem. For example, the Australia Treasury Department, in a 1996 Issues Paper, addressed the practical application of this legal principle to financial arrangements.\textsuperscript{60}

The 1996 issues paper recognises the limitations of the common law rule but states that to determine the source of the income other factors may be considered. These factors include the place or places where: marketing activities (if any) occurred; preliminary risk and/or credit assessment work was performed; pre-contractual negotiations took place; the document was executed; the risk was borne; the relevant

\textsuperscript{58} Charles Plambeck refers to this method as the 'realization approach': Charles H Plambeck, 'The Taxation Implications of Global Trading' (1990) 48 Tax Notes 1143, 1155.

\textsuperscript{59} See eg, Tariff Reinsurances Limited v. C. of T (Vic) (1938) 59 CLR 194; C of T v. Meeks (1915) 19 CLR 568, 588.

payments were made and received and (if different from the country where the payment is made) the place where the associated payment obligation is properly borne; the decision was made to enter into the transaction; the parties to the transaction reside; and support and/or prudential activities are performed.\textsuperscript{61}

Despite stating that these factors should be used to determine the source of the income, the 1996 issues paper also recognises the possibility of tax manipulation where these factors are used. For example, the issues paper points out that if substantial weight is placed upon the place where the contract is signed this may influence the choice of place for entering into the contract, despite any significant economic business connection with a particular jurisdiction.\textsuperscript{62} This is exactly what happens with multinational banks, and the problem becomes one of form over substance. That is, when categorising income it is necessary to determine whether the concern is with the form of delivery or the substance of what is being delivered.\textsuperscript{63}

The 1996 issues paper also highlights the uncertainty of the operation of the existing common law rules. Such uncertainty may lead to the problematic circumstance of a dual source of income or the result that the source is the place where the income is received or the place where the activity is economically funded.\textsuperscript{64} Although the categorisation issue is not novel, it is currently pertinent. As Dianne Ring points out, "what is new is the amount of revenue and the volume of business generated by activities for which there are very hazy applications of existing categories."\textsuperscript{65}

As an alternative to the application of the existing rules, one commendable suggestion in the 1996 issues paper is that clear legislative rules are needed to


determine the source of income of cross-border financial arrangements with more certainty. Specifically the issues paper suggests that "

Australia could legitimately assert a source country taxing right where there is a sufficient territorial connection with Australia. For example, income or gains could be deemed to have an Australian source where there is sufficient territorial connection demonstrated by: the performance of any significant functions in Australia; the transaction involving Australian assets or the use of such assets; the financial risks assumed by or on behalf of an Australian taxpayer, or in connection with a business wholly or partly carried on in Australia; or the making of payments from Australia or where the payments are tax deductible in Australia."

The above statement is essentially about ensuring that the income from financial arrangements is allocated according to economic activity. While the 1996 issues paper does not specifically refer to formulary apportionment, the factors suggested as being suitable for determining whether income has an Australian source, are the factors that may be considered suitable for the basis of an allocation formula.

The 1996 issues paper also comments on the interaction between domestic and treaty law, recognising that financial arrangements that occur in the course of carrying on a business would be covered by the Business Profits article where a double tax agreement exists. It also recognises that the common law principles may lead to a result that does not accord with economic reality. It states:

The application of common law rules in a strict legal sense could result in a mis-allocation of profit where the transaction occurs between related parties or where an intermediary (eg, bank) is a counterparty to two or more related parties. In these circumstances it is proposed that the income or gains from financial arrangements be deemed to have an Australian source to the extent that economically valuable functions are performed in Australia and/or Australian assets are used and/or risks are assumed in or allocated to Australia. The effect of this will be to align Australia's source rules with


68 The possible factors are considered in detail in chapter eight.

the concepts that would be applied under a double tax agreement which
deen income attributable to a permanent establishment in Australia to be
sourced in Australia.\textsuperscript{70}

The overall view expressed in the 1996 issues paper appears to recognise the unique
nature of multinational banks as intermediaries, which, in turn creates unique issues
in the application of the traditional source regime. Consequently, it would also
appear that the suggested solutions, aimed at ensuring that the source rules allocate
according to economic reality, reflect many of the qualities attainable under a
formulary apportionment regime. In essence, this issues paper identifies the
problems with the application of the traditional source regime to multinational
banking transactions (that the allocation does not accurately reflect economic
activity), and without explicitly stating it, infers that a solution may be found
through a formulary apportionment model. If the observations made above are
correct, the inability of any classification regime to provide objective guidance for
the classification of new and innovative financial products renders the source regime
ineffective for allocating the income of multinational banks if that allocation is to
occur based on economic activity.

The above discussion demonstrates the difficulties in applying the traditional source
regime to multinational banks, and the fact that, if it can be applied, it does not yield
a result reflecting economic activity. The next part of this chapter asks the question
why this is the case, when the source regime has been adequately applied to
traditional multinational entities.

\textbf{4.5 The Limited Alternatives Model}

It has been argued in this chapter that the traditional source regime does not apply to
multinational banks in a way that allocates income to jurisdictions according to
economic reality. The cause of this is essentially the requirement of the regime to
classify income in order to allocate that income to a particular geographic location.
As discussed earlier, the current source regime has existed for many decades and

\textsuperscript{70} Australian Commonwealth Treasury, \textit{Taxation of Financial Arrangements - An Issues Paper}
(1996) 249.
worked remarkably well for the majority of multinational entities. Why then, is it being suggested that this is no longer the case for the modern phenomena of multinational banking?

In order to answer this question in the context of modern multinational entities generally, Dianne Ring posits two possible models from which to work:

(1) The previous business world was very physical and [legislators] designed source rules to handle it, but now the world is much less physical and the old rules do not work. Or

(2) The previous world was governed by source rules, which, though not perfect, were generally acceptable because of the de facto limits imposed on taxpayer behavior by transaction costs and limited alternatives. Now that money is earned through less tangible activities, the weaknesses of the old rules have been exacerbated to the point where they no longer adequately function.71

While the distinction is a subtle one, and would seem to be unimportant, it is significant to understand the framework in which it is argued that the traditional regime is not valid for multinational banks. Dianne Ring, in stressing that it does matter which model is argued, states that 'one should be explicit because it provides a clearer sense of what is happening and why.'72 As she suggests, if the latter is the better model, it is realistic to 'contemplate a broad range of changes to the rules, because, in fact, these rules have never been perfect.'73

The arguments contained in this chapter adopt the latter model as being theoretically correct, arguing that it is because of the unique features of the multinational banks,

which no longer contain the restraints of traditional multinational entities, which make the defects in the source rules more evident. Applying by analogy to electronic commerce, the exacerbated faults in the context of financial instruments, Dianne Ring remarks, 'considering the source-based taxation of electronic commerce, one starts with source rules developed at a time when earning income was a more physical activity. At that time, the rules were tolerable, but not flawless. The major difference is that those “flaws” matter more in the taxation of electronic commerce.'\textsuperscript{74}

When the traditional source regime is applied to multinational banks, the basis of these flaws is twofold. The first basis is that there is difficulty in classifying the income earned by multinational banks. The second basis is that the highly integrated nature of the multinational bank does not lend itself to a regime which allocates to a particular geographic location. Each is examined in turn.

\subsection*{4.5.1 The Classification Quandary}

In order to determine the classification of the income of a multinational bank it must be possible to designate that income to a particular category. The fundamental problem with this classification is that these rules have already developed, as either common law or statutory principles.\textsuperscript{75} Consequently, they are a product of history. Modern financial products, however, are not a static snapshot from history, but rather evolve unabated.\textsuperscript{76} The increase in innovative instruments means not only new products coming into existence, but also products that are increasingly complex,


aided in their complexity by globalisation. Consequently, this suggests that when applied to multinational banking transactions, the traditional source rules are outdated.

Contributing to the claim that the traditional source rules are outdated, many jurisdictions do not have source rules at all that apply to many multinational banking transactions. This problem is recognised in the OECD 1998 discussion draft dealing with the taxation of global trading of financial instruments. The discussion draft provides 'many countries do not yet have rules regarding the source of income produced by notional contracts and other derivative instruments which can constitute a significant portion of the income generated in a global trading operation.'

Further compounding these issues is the lack of agreement amongst jurisdictions or consistency between domestic source laws, which makes it increasingly difficult for taxing authorities to satisfy themselves that they are taxing an appropriate portion of global trading profits. The fact that not all jurisdictions have adequate domestic laws can also lead to the taxpayer being taxed on more than the net profit earned from a particular activity. While any given taxing authority will be concerned only with getting their appropriate share of tax, it is possible to argue that in fact, where source rules are inadequate jurisdictions may be losing out on revenue.

It has been suggested that parallels can be drawn between the taxation of financial instruments and electronic commerce through mutual factors such as mobility of the activity, difficulty identifying the activity, difficulty locating the activity, rapidly

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changing transactions and activities, and importance of multi-jurisdictional co-
coordination.\textsuperscript{83} To this extent, both the OECD\textsuperscript{84} and the United States Treasury\textsuperscript{85} have recognised the inadequacy of the traditional source rules in the modern, electronic
economy. An OECD discussion paper has particularly commented on the
inadequacy of double tax agreements in the context of electronic commerce. The
discussion paper states 'since electronic commerce may allow substantial business to
be carried on with residents of a jurisdiction without the need to maintain a physical
presence therein, it has been argued that the threshold below which the source
taxation of business profits is precluded under the rules of Article 5 and 7 may be
inappropriate in the context of electronic commerce.'\textsuperscript{86}

The concerns expressed in the OECD discussion paper are amplified by the
continuous financial trading made possible by electronic commerce.\textsuperscript{87} The validity
of source rules in the present information economy environment is challenged by the
fact that the geographical location of the source of the income is not obvious.\textsuperscript{88}
Joseph Andrus discusses the implications of this in the context of global trading:

Twenty-four hour global trading in financial derivatives and securities
(businesses that rely on new technological developments in information
technology and telecommunications for their very existence) blur the lines
for determining which economic activities give rise to which income. Global
integration of the corporate management or research and development
activities of a multinational group, with 24-hour global monitoring of mutual
progress through a private 'intranet' or other shared software, raises new and
more difficult issues concerning how the resulting expense should be

\textsuperscript{83} Diane M Ring, 'Exploring the Challenges of Electronic Commerce Taxation through the


\textsuperscript{85} Office of Tax Policy, Treasury Department, Selected Tax Policy Implications of Global


\textsuperscript{87} Joseph L Andrus, 'Determining the Source of Income in a Changing World' (1997) 75 Taxes
839.

\textsuperscript{88} Joseph L Andrus, 'Determining the Source of Income in a Changing World' (1997) 75 Taxes
839, 840.
allocated among countries and whether income from those activities should be treated as arising from domestic or foreign sources. It has been suggested that when classifying income for the purposes of determining source, a substance-over-form approach should be adopted to the extent that 'the economic realities of the transaction rather than ... the tax-advantageous structure employed by the transacting parties are determinative of the source of the income. This statement is entirely correct. Adopting this approach does not, however, mean that the allocation will reflect economic activity as it is still a transactional approach. This thesis goes further to suggest that the classification process, by looking at transactions of multinational banks, rather than economic activity, is fundamentally flawed when applied to these entities.

Even where the income of multinational banks can be classified, the categorisation of income for the purposes of source has a secondary problem. Essentially, it is the fact that the source may appear to be different to the location of the economic activity. This problem can occur because source is usually where the end product is delivered. This is particularly the case with financial services as 'the new technologies enable our taxpayers to make it easily appear that transactions took place elsewhere than at their real economic home.'

The way in which multinational banking transactions are undertaken, and the inherent flexibility in fashioning those transactions undermines the traditional source rules. Taxpayers are able to take advantage of the source rules by manipulating the income to fall within the most advantageous category. This is particularly easy for

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multinational banks to undertake because the income is generated from new activities, not previously classified. These new financial products have also demonstrated the weakness of the traditional categories, with those categories failing to allocate based on economic substance. When questions are asked about the classification of financial transactions the answer may simply be that there is no one answer. Ultimately, therefore, a regime that does not require classification is congruent with an optimal regime for taxing multinational banks.

4.5.2 Integration and Geographic Locations

Consistent with the contention that the traditional source regime has been generally acceptable because of the de facto limits placed on multinational entities, it is argued that once these limits are removed traditional source rules are no longer sustainable. These limits are removed by multinational banks because of the very nature of their business. The nature of the multinational bank, providing intermediary services and servicing clients around the clock means that there is no allegiance to a particular physical location.

Source rules, however, were developed in an era where there was allegiance to a physical location, and the focus of the economy was on manufacturing and industrial efforts. The traditional concepts for determining source, which have developed into international tax concepts, evolved from a time when the dominant method of transacting involved physical and easily traceable dealings. As such, the traditional

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95 Diane M Ring, 'Exploring the Challenges of Electronic Commerce Taxation through the Experience of Financial Instruments' (1996) 51 New York University Tax Review 663, 672. Diane Ring uses the following example: 'the economic substance of a complex financial transaction could be determined by disaggregation - breaking the transaction down into smaller pieces that have an established tax treatment. But if, as is often the case with put-call parity, there is not just one way to disaggregate and if the different component transactions under disaggregation receive different tax treatment, then the disaggregation exercise has not advanced the analysis.'

source rules are primarily concerned with physical occurrences. Developments in multinational banking, however, mean that geographical locations of the control of events are different to that of the true activity.\footnote{Barry Williams, 'The Defensive Expansion Approach to Multinational Banking: Evidence to Date' (2002) 11(2) Financial Markets, Institutions and Instruments 127, 129.}

The source rules, concerned with physical occurrences were frequently based on notions regarding the location of the functions that gave rise to the income.\footnote{OECD, The Taxation of Global Trading of Financial Instruments (1998) 13(16).} This problem is recognised by the OECD 1998 discussion draft which suggests that '[g]lobal trading confounds those notions, because performance of the various functions undertaken in relation to global trading is routinely carried out in two or more locations.\footnote{OECD, The Taxation of Global Trading of Financial Instruments (1998) 13(16).}

In the context of modern transactions, it becomes difficult to associate items of income with particular geographic locations.\footnote{David G Noren, 'Commentary: The U.S. National Interest in International Tax Policy' (2001) 54 New York University Tax Review 337, 345.} This difficulty is exacerbated in the case of multinational banks due to their highly vertically integrated nature. Rather than accounting for the integration factors, the traditional source regime adopts an all-or-nothing approach to the allocation of income. The OECD 1998 discussion draft raises concerns about this very point, stating that ‘although several different jurisdictions may participate in a single transaction, domestic tax rules may not provide for the income generated by that transaction to be split between different jurisdictions.'\footnote{OECD, The Taxation of Global Trading of Financial Instruments (1998) 13(17).} If the threshold, therefore, for activity within that jurisdiction is exceeded then all of the gross income from that transaction is deemed to be sourced from that jurisdiction and included in taxable income. Conversely, if the threshold for activity is not met, none of the income from the transaction is taken into account. The OECD 1998 discussion draft explains:

If global trading is conducted through branch form, transactions may be taxed, under domestic rules, on an 'all-or-nothing' basis; if sufficient
activity takes place in a jurisdiction, then all of the gross income from the transaction is taken into account for purposes of determining taxable income; if not, then none of the income from the transaction is taken into account. Expenses, including losses from transactions entered into to hedge the risk arising from the customer transaction, may be allocated against the gross profit arising from the transaction on order to determine the net taxable income. Unless the rules regarding expense or loss allocation are clear, this approach is unlikely to produce, in practice, a result consistent with the arm's length principle.\textsuperscript{102}

This problem is recognised in the literature as one which potentially means that a result that accords with economic reality may not be achieved. For example, in the context of determining whether the traditional source regime provides an optimal one for allocating the taxing rights to the relevant jurisdictions, Reuven Avi-Yonah encapsulates the problem:

Most income comes from multiple sources, and economists have generally concluded that assigning income to a single source is a meaningless exercise (albeit a necessary one for legal and tax purposes). If so, then any generally acceptable sourcing rule is unobjectionable as an economic matter, but a concept of inter-nation equity that is based on sourcing offers no guidance in determining specifically how much income a country is 'entitled' to tax.\textsuperscript{103}

The multinational banking industry, in recent times, has produced a range of products and services previously unimaginable. Yet, the current source regime attempts to imagine that these income producing activities fall within a traditional category of income for source purposes. This is simply not possible, as no longer are the multinational entities producing this income aligned with particular geographical locations, and, as such using this traditional means of jurisdictional allocation no longer reflects economic activity. To reflect economic activity and achieve a fair allocation of income source rules need to be based on the location of that economic


reality rather than on strict legal principles.\textsuperscript{104} The use of formulas is one possible means of achieving this.\textsuperscript{105}

4.6 Conclusion

This chapter argues that the impasse to the traditional source regime when applied to multinational banks is the fact that the income from the modern transactions of these banks is particularly difficult to classify. In this thesis, it is claimed that the categorisation process is antiquated and inapplicable to modern transactions which are frequently not homogenous. Further, the categorisation problem is acutely exacerbated in light of multinational banks, which continually create new and innovative financial products. The obvious problem is the question of how to categorize these new products, when and as they are created, under the existing source-based regime.

This chapter further argues that even where the categorisation of the income of multinational banks is possible, the categorisation does not lead to a result whereby the income is allocated to the location of the economic activity giving rise to the income. Because of the nature of the multinational banks as an intermediary, rather than a manufacturer turning out a final product, the apparent source of the income can be a different geographical location to where the effort is expended to generate that income. Source rules will only provide an optimal regime where the income, regardless of its character, is allocated according to the location of the economic reality.

Consequently, a source based regime should be maintained, however, the regime should allocate the income to the place where the economic activity takes place. Chapter eight argues that unitary taxation based on global formulary apportionment


is a source based regime that achieves this result for multinational banks. A formulary apportionment system is designed so that traditional source rules no longer play a part in the allocation process. By implementing such a regime there would be the avoidance of arbitrary and predatory practices for determining source.

This thesis also maintains that there is manipulation by multinational banks through transfer price manipulation. Prior to a consideration of a unitary tax model as an alternative to the current source regime, this transfer price manipulation is examined.

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Chapter 5

Traditional Rationale of the Arm's Length Approach to Transactional Allocation

5.1 Introduction

In chapter four, it was recognised that resolving the issue of source does not mean the income of a multinational bank is being measured in each country according to economic reality. Principles of source address the issue of primary jurisdiction to tax, but it assumes that income has been measured accurately. This is only a correct assumption as to market transactions between unrelated parties, not as to related-party transactions, which are integral to the everyday functioning of a multinational entity. That is, source does not fully address the issue of apportioning income to the relevant jurisdictions where there are related party transactions. In chapter four, it was demonstrated that multinational banks have the ability to shift profits by separating intermediary economic activity from legal transactions with third parties. A further contention of this thesis is that profit shifting by multinational banks occurs by means of transfer pricing, with the result that the traditional rules fail to yield a fair interjurisdictional allocation of taxing rights.

The current solution to the problem of transfer price manipulation is the substitution of an arm's length price for related party transactions. Despite the artificial nature of the process that determines an arm's length price, using the arm's length approach to determine a plausible price for related party transactions has worked in the case of most multinational entities. This thesis argues, however, that the application of the arm's length methodologies to multinational banks, taking into account their unique

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features, results in a transfer price that fails to accord with economic reality. The premise of this chapter is that the arm's length pricing paradigm is not a theoretically sound model for allocating the profits of multinational banks.

This chapter primarily relies on the arguments presented in chapter two, which demonstrated the unique nature of multinational banks. It does this by arguing that the transactional methods of the arm's length standard fail to recognise the economic reality of the circumstances in which multinational banks are transacting. Furthermore, by arguing that the integration benefits of the multinational banking structure are not taken into account when the transactional methods are applied, the unique nature of multinational banks is exemplified, and the shortcomings of the separate entity approach are exposed. This is particularly the case due to the requirement that the branches of a multinational bank are to be treated as hypothetical and distinct separate legal entities.

The first part of this chapter considers the OECDs answer to transfer pricing manipulation – the adoption of the arm’s length price methodology. It then examines the rationale for the use of the arm’s length price, along with the arguments in favour of such a regime. This chapter refutes these justifications on the general basis that the traditional regime fails to recognise true economic activity. This is particularly relevant to multinational banks because of the intermediation services undertaken. Not only is there scope for transfer price manipulation, but the transaction may not be captured at all. This is because there may be no apparent transaction between the place of intermediation services, that is, the place of economic activity, and the place of the provision of the consequent product.

Throughout this chapter, also considered are the OECDs discussion drafts, which attempt to address the issue of the application of the current regime to multinational banking transactions. In particular, the 1998 discussion draft on The Taxation of Global Trading of Financial Instruments as updated by the 2003 Discussion Draft on the Attribution of Profits to Permanent Establishments: Part III (Enterprises

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Carrying on Global Trading of Financial Instruments)\textsuperscript{5} and the 2001 Discussion Draft on the Attribution of Profits to Permanent Establishments\textsuperscript{6} as updated by the 2003 Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)\textsuperscript{7} are examined. Also analysed is the OECDs 1984 document Transfer Pricing and Multinational Enterprises: Three Taxation Issues,\textsuperscript{8} which examines the taxation of multinational banks as a potentially difficult area in relation to transfer pricing.

This chapter argues that contrary to the very reason multinational banks exist,\textsuperscript{9} applying arm's length rules to a multinational bank involves a legal fiction of imagining transactions between unrelated parties. Multinational banks exist to operate in a way that independent banks would not, which the arm's length rules fail to take into account. As such, there is clearly an air of artificiality in applying the arm's length standard. It is recognised that this artificiality applies across all multinational entities, but it is argued that it is exacerbated with multinational banks to the point where the arm's length standard is an inappropriate transactional allocation method.

5.2 The Problem of Transfer Price Manipulation

Profits attributed to a jurisdiction may be distorted by a multinational entity, simply by the separate but related parts of that entity manipulating the prices at which goods and services are transferred internally.\textsuperscript{10} This occurs because of the different


\textsuperscript{6} OECD, Discussion draft on the Attribution of Profits to Permanent Establishments (2001).

\textsuperscript{7} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003).


motivation of the multinational entity that considers itself a whole, and the taxing authorities that recognise the separate parts of the multinational entity, rather than the whole. It is the multijurisdictional activities of the firm that provide opportunities for profit shifting through transfer pricing.\(^1\)

It is recognised globally that multinational enterprises are one economic entity, whether they operate through a branch structure or a subsidiary structure.\(^2\) As such, the aim of the entity as a whole is to maximise profits.\(^3\) This results in the multinational entity having no concern about the price paid or received for internal transactions, except in so far as the overall profits of the multinational entity is maximised.\(^4\) Consequently, the multinational entity takes advantage of different tax rates across jurisdictions by shifting profits from one jurisdiction to another through transfer price manipulation.\(^5\) In essence, profits attributed to a jurisdiction may be distorted by a multinational entity simply by the separate but related parts of that entity manipulating the prices at which goods and services are transferred. The process of charging for internal transactions is known as transfer pricing. When the price is for a non-arm’s length consideration, it is deemed a breach of the transfer pricing regime.

Jurisdictions generally adopt, in their domestic legislation, a requirement that transactions between related parties, or separate parts of the one entity, occur at an

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arm’s length consideration. The arm’s length standard is based on what is referred to as the separate accounting or separate entity approach. The separate parts of an entity are defined by reference to national boundaries, or what is commonly referred to as the ‘water’s edge’. Income and expenses are then allocated to the relevant jurisdictions on a transactional basis, that is, specific transactions are considered as if they were between distinct entities, with each entity reporting separate taxable income.

Empirical evidence suggests that multinational entities are undertaking transfer price manipulation, as well as the fact that jurisdictions are losing revenue from such activities. This evidence adds weight to the theoretical argument that the traditional regime allows for manipulation which results in an outcome that fails to allocate income according to economic reality. While studies have generally found that multinational entities are shifting profits through transfer pricing, evidence suggests that this is particularly the case with multinational banks. It is believed that multinational banks have, even more than other multinational entities, opportunities for reducing their tax burdens in high-tax countries by way of intra-firm transfer

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pricing. In their study of multinational banks Asio Demirguc-Kunt and Harry Huizinga found that taxes paid by foreign banks were relatively low in many of the major industrialised nations. By examining the relationship between the taxes paid and the statutory tax rate, they obtained further support for their profit shifting hypothesis. Their study showed a negative relationship between taxes paid and the statutory tax rate suggesting the presence of profit shifting. As additional support for the profit shifting premise Asio Demirguc-Kunt and Harry Huizinga, controlling for bank characteristics, found that foreign banks paid lower taxes in several developed countries. Further, on a cross-country basis, they found that taxes paid by foreign banks fall with the statutory tax as additional evidence of profit shifting by foreign banks.

While it is the multinational banks that undertake such behavior, it is the governments of the relevant jurisdictions that are concerned about revenue loss. As evidence of revenue losses by taxing authorities, Eugene Lester suggests that in the United States millions of dollars are being lost each year through profit shifting. Eugene Lester relies on two sources: Senator Dorgan who asserted that Internal Revenue Service studies show that the United States loses at least two billion dollars a year through tax evasion under the arm’s length principle; and James Wheeler, Professor of Accounting at the University of Michigan, who estimated that foreign multinational entity groups operating in the United States cheat the United States

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21 Asio Demirguc-Kunt and Harry Huizinga, 'The Taxation of Domestic and Foreign Banking' (2001) 79 Journal of Public Economics 429. Their estimates suggested that the relationship between the taxes paid and the statutory tax rate was positive for domestic banks, but negative for foreign banks. This was interpreted as profit shifting by foreign banks.


24 Senator Dorgan bases his claims on the studies of Professors Simon J Pak and John S Zdanowicz, Florida International University.

25 In response to Senator Dorgan's claims see Richard A Clark, 'Dorgan's Charges of Transfer Pricing Abuse Unfounded' (1999) 18 Tax Notes International 2263. Richard Clarke claims that the majority of MNEs spend considerable resources attempting to comply with the transfer pricing rules.
Treasury out of about thirty million tax dollars each year. Consequently, if these studies and assertions are correct, there is a failure of the arm's length standard to allocate profits in an optimal manner.

Manipulation of the current international tax regime is made possible for multinational banks because is very simple for a bank to establish a subsidiary or branch (permanent establishment) in a given jurisdiction and to undertake transactions through that office. While very little in the way of intermediary activity may be undertaken in a particular location, a large percentage of the source of income under the current legal source rules may be attributable to that office and hence that jurisdiction. This problem is compounded by the fact that multinational banks may distort the price at which any services are charged for internally, hence transfer price manipulation. The problem is then exacerbated by the fact that multinational banks may fail to recognise internal transactions at all. Services may be performed in one jurisdiction, with the product supplied in another, without a record of those services ever being performed and without a resultant internal charge.

Because of the potentially large revenue losses to taxing jurisdictions through transfer price manipulation, the OECD has devised a means of adjusting transactions internal to the multinational entity. The aim of these adjustments is to achieve a result that means the allocation of income purportedly reflects the location of the activities performed.

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5.3 The OECD Solution to Transfer Price Manipulation

The solution to transfer price manipulation, devised by the OECD, is arm’s length pricing. Under the arm’s length pricing model each part of the multinational entity is treated as a separate part of the economic entity (whether it is a branch or a subsidiary) and a price is substituted that would have been used in the transaction if it had been with an unrelated third party rather than a related entity within the same multinational enterprise. This solution is designed to apply to all multinational entities, and to date, the OECD does not consider that multinational banks, or any other specific type of multinational entity fall outside the bounds of the arm’s length pricing regime. Consequently, the OECD solution to transfer price manipulation by multinational banks is considered the same solution as any other multinational entity. The OECD maintains this method of transactional allocation as the theoretically superior model despite the arm’s length method being criticized for theoretical, empirical, and administrative reasons.28

The arm’s length concept, as the solution to transfer price manipulation, has been around for over 80 years, yet it is only in the past 20 years that the OECD has started articulating ways in which tax authorities can determine an arm’s length price.29 The OECD released its original guidelines as to how to determine an arm’s length price in the 1979 report on transfer pricing.30 As a response, however, to increased cross-border transactions and multinational enterprise operations, the OECD revised its international transfer pricing guidelines (OECD Guidelines) in 1995.31 The current guidelines represent a consensus among 25 OECD member countries on the approach to international transfer pricing issues. Because of the limited membership

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29 The arm’s length price was introduced in the 1920s by the League of Nations and formally adopted in 1933.


of the OECD, a caveat must be placed on the reliance on the OECD to provide a solution to the problem of transfer price manipulation.\textsuperscript{32} At present, however, the OECD is undertaking the most comprehensive investigation of this problem. As such, the OECD documents are primarily considered.

At the core of OECD policy on the application of the transfer pricing regime to multinational banks are two suppositions. The first supposition is that multinational banks should be treated the same as any other multinational entity.\textsuperscript{33} The second supposition is that branches of multinational banks should be treated the same as subsidiaries of multinational banks.\textsuperscript{34} These suppositions provide the foundation for the current application of the transfer pricing provisions and the arm’s length principle to multinational banks. It is suggested that it is these suppositions that underpin both the theoretical deficiencies and inadequacy of the comparability requirement (discussed in chapter six) to determine a distribution of the taxing rights to multinational banks between the relevant jurisdictions according to economic reality. Each is examined in turn.

\textsuperscript{32} Reuven S Avi-Yonah, ‘Commentary: Tax Issues Through Trade Regimes’ (2001) 26 Brooklyn Journal of International Law 1683, 1689. Reuven Avi-Yonah suggests that many of the OECD solutions assume that there is no significant development or growth outside the OECD. The OECD is also seen to favour the ‘Rich countries and “their” MNEs.’


\textsuperscript{34} For the most recent evidence of this see the suggested treatment of multinational bank branches in OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001), updated by OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) and OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments: Part III (Enterprises Carrying on Global Trading of Financial Instruments) (2003).
5.3.1 Analogous Treatment of Multinational Banks and Traditional Multinational Entities

The first supposition underpinning the transfer pricing regime and the arm’s length requirement, as it applies to multinational banks, is that multinational banks should be treated in the same manner as traditional multinational entities. The OECD believes that the traditional transfer pricing regime is suitable for multinational banks, yet there is, to a limited extent, recognition of some of the pertinent issues that arise with this unique multinational entity. The 1995 Guidelines produced by the OECD did not identify multinational banking as a unique type of multinational entity. It did recognise, however, that some of the traits of multinational banking were a cause of the complexities for tax authorities, specifically the increase in integration and technological progress.

Eleven years earlier the OECD released a document entitled Transfer Pricing and Multinational Enterprises: Three Taxation Issues. In this document, it did specifically recognise the need for special consideration in the treatment of international bank transactions. This document acknowledges the unique issues that arise in relation to a multinational bank branch, as contrasted with a subsidiary, and expands on the general transfer pricing guidelines to comment on some of these unique issues. In this context, while the difference between a branch and a subsidiary is immaterial if a tax regime reflects economic reality, the current transfer price regime draws a distinction, if only in its application.

The OECD also appears to recognise, at least superficially, the distinguishing and unique features of multinational banks in its 1984 document. While not explicitly stating that there are significant differences, the OECD recognises both the unique

35 It is not denied that many of these traits are also associated with other modern multinational entities.


provision of services (that of being an intermediary) and the unique organisational structure. As to the former, the OECD states that the essential feature of banking is that the funds of customers entrusted to the bank are on loaned in a manner designed to make a profit.\textsuperscript{39} This essentially provides the fundamental difference between a multinational bank and other traditional multinational entities – that of an intermediary service provider. The OECD, however, does not expand on this unique feature to acknowledge the inability of the transfer price regime to capture many of the transactions. As to the second unique feature, the OECD also recognises that the new business of these multinational banks is largely driven by governments, multinational enterprises and other very large institutions or corporations,\textsuperscript{40} thereby supporting the defensive expansion theory and internalisation theory.\textsuperscript{41} The document goes no further than to recognise these unique features, and it does not provide that it is these traits that cause the unique tax issues. It is suggested, however, that the link can be implied.

The most significant failing of the 1984 document is that it assumes that most multinational banks operate in a decentralized manner. This assumption is based on the further postulation that the main task of a bank operating multinationally, is to meet the needs of customers in the areas in which they are located.\textsuperscript{42} Based on these assumptions, the OECD concludes that 'a high proportion of all the transactions undertaken by a multinational bank, whether concluded with third parties or with the head office or other branches or subsidiaries of the bank, would be based in the “arm’s length principle”'.\textsuperscript{43} It is no longer the case, however, that the majority of


\textsuperscript{40} OECD, Transfer Pricing and Multinational Enterprises: Three Taxation Issues (1984) 47(14). See also page 49, paragraph 24, where the OECD recognises that in former time the main reason for a bank to extend its operations offshore was to service its existing clients.

\textsuperscript{41} See part 2.3.2 of chapter 2.


multinational banks operate under a decentralized organisational structure. Consequently, it is incorrect to assume that transactions are based in the arm’s length principle, especially where the organisational structure is highly integrated. Further, it is incorrect to assume that the multinational banks are primarily servicing customers within the geographical location, as this is inconsistent with the notion that banks follow existing clients abroad.

As a concession to the difficulties facing multinational banks to determine transfer prices, the OECD recognises that transactions between parts of the one entity might become complex, thereby creating considerable difficulty in the allocation process. In 1984, therefore, while conceding that multinational banks are unique, the OECD did not provide for special tax considerations or the need for different international tax rules. This stance was justified on the (albeit perhaps fallacious) basis that it is possible to reach an arm’s length price for transactions undertaken within a multinational banking entity. At this point, the OECD was not prepared to recognise the truly global nature of multinational banking.

Fourteen years later, the OECD, in its discussion draft The Taxation of Global Trading of Financial Instruments, again addressed the fact that multinational banks raise unique international tax issues. This 1998 discussion draft has subsequently been updated by the incorporation of parts of it into the 2003 update of the discussion draft on the attribution of profits to permanent establishments. Because this document has not been finalised its status is merely that of a discussion draft. It does, however, incorporate and reflect the views of some member states such as the United Kingdom and the United States of America. The discussion draft addresses the taxation of global trading, an activity undertaken by multinational banks.

48 A broader range of financial institutions also undertakes this activity.
The 1998 discussion draft adopts the view that there is consensus that issues raised by global trading should be resolved by reference to the already existing OECD guidelines, with the proviso that the generally accepted principles may require elaboration for this "relatively new and highly specialised business". While not explicitly stated, this approach has been carried through to the 2003 updates of this discussion draft. This assumption as to consensus, however, may not be accurate, as the increase in new types of multinational entities, as contrasted with traditional ones, has made jurisdictions question the adequacy of traditional arm’s length pricing principles. For example, the European Union, in the last couple of years has made substantive moves towards an acceptance that the traditional methods may no longer work.

This 1998 discussion draft aims to address the challenges facing the traditional tax system and recognises that technological change, the communications revolution, and the spread of financial deregulation and liberalization, have all contributed to these challenges. As such, it accepts that the traditional tax system is coming under increasing pressure with respect to its accurate allocation of income. Consequently, the 1998 discussion draft concedes that the transactions undertaken by multinational banks are unique, without conceding the need for any special tax rules. The conclusion, however, that any special circumstances can be dealt with through the application of the existing transfer pricing rules, suggests that very little is achieved with this discussion draft.

Most recently, the OECD, in 2001 released its Discussion Draft on the Attribution of Profits to Permanent Establishments, which has also subsequently been updated.

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50 These moves are considered in chapter eight.
53 OECD, Discussion draft on the Attribution of Profits to Permanent Establishments (2001).
While this discussion draft generally considers the attribution of profits to permanent establishments and establishes a working hypothesis for doing so, Part II specifically deals with special considerations in the attribution of profits to permanent establishments of banks. This discussion draft acknowledges the earlier 1984 report as the starting point for an analysis of the application of the working hypothesis to permanent establishments of banks, but qualifies this by recognising the changes that have occurred in the last two decades. The discussion draft states:

[T]here have been considerable changes in the global economy since 1984, which have affected the way multinational banks carry on business. There have also been changes in thinking about the application of the arm's length principle, reflected most notably in the revision of the OECD Transfer Pricing Guidelines started in 1995. This report is therefore intended not only to update the issues and situations described in the 1984 report but also to deal with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets which have been such a feature of the global economy in the late 20th Century. For example, while the risk has always been of significant concern to banks, technological developments in the late 20th Century have resulted in the willingness of banks to undertake pro-active risk management as a means of maximizing shareholder wealth and of dealing with risk-based capital adequacy requirements.

This discussion draft is recognising not only the changes per se, due to globalisation, but also the liberation of the financial markets that occurred in Australia and the world in the last two decades. The fact that this discussion draft is designed to be generally applied to permanent establishments of multinational entities, but nearly half is devoted to its application to permanent establishments of multinational banks, is alone testament to the fact that the OECD sees banking as potentially one of the most problematic of industries to apply the traditional transfer pricing regime to.

Over a two-decade period these three documents, only one of which has OECD status, all concede that unique issues arise in relation to the international taxation of multinational banks. The overall theme, however, of these three documents is that

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55 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) 3(2); OECD, Discussion draft on the Attribution of Profits to Permanent Establishments (2001) 42(2).
the traditional arm’s length pricing requirement can be applied to such banks, whether operating in subsidiary or branch form. In doing so, the OECD is attempting to maintain the stance that the traditional methods of determining the arm’s length price should be applied to any related party transactions. To this extent, it may be interpreted that the OECD is attempting to embrace the notion that the transfer pricing problem has been adequately dealt with.\textsuperscript{56} There is empirical and anecdotal evidence to suggest the contrary, and as Michael Graetz points out, this lack of controversy is ‘no doubt only a temporary lull until the next round of transfer pricing abuses captures the attention of ... policymakers.’\textsuperscript{57}

5.3.2 Analogous Treatment of Branches and Subsidiaries

The second supposition underpinning the transfer pricing regime and the arm’s length requirement, as it applies to multinational banks, is that branches and subsidiaries should be treated the same. The OECD 2001 discussion draft, using Article 9 (Associated Enterprises) to extrapolate principles to apply to the application of Article 7 (Business Profits), was clear that branches and subsidiaries should be treated the same.\textsuperscript{58} To this extent, the 2001 discussion draft provides that the requirement of Article 7(2) of the OECD Model Tax Convention on Income and on Capital, with its origins dating back to the ‘separate accounting’ approach adopted by the League of Nations in 1933, is considered the statement of arm’s length principle in the context of permanent establishments, corresponding with the arm’s length principle in Article 9.\textsuperscript{59}


\textsuperscript{58} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) as updated by the 2003 documents.

In 1998, the OECD discussion draft was a little more equivocal. It recognised that some countries believe that operations that are economically identical should produce similar results, whether conducted in branch or subsidiary form. It also recognised that other countries agree with this general principle but also believe that the legal form of the trading operations does affect economic substance, and this should be reflected in the taxation of those entities. Further, it acknowledged that legal form may affect the economic substance in a number of ways. The OECD 1998 discussion draft provides:

For example, if a branch enters into a derivative contract with a customer, the customer is able to rely for payment, not just on the capital resources allocated to the branch but on the capital resources of the whole enterprise. However, if a customer enters into the same contract with a subsidiary, it is only the capital resources of the subsidiary which are available to meet any payments due, unless there are specific legal arrangements such as guarantees which allow access to the capital resources of the parent. The difference may affect the price charged to the customer.

Under the current transfer pricing regime the question is whether a multinational banks branch should be treated the same as a multinational bank subsidiary. This thesis proposes that, rather than treat a branch and subsidiary the same, there is no place in the tax rules governing jurisdiction to tax and allocation of income of multinational banks to recognise the distinction to begin with. While the difference may appear to be a subtle one, the ramifications are significant. Under the OECD model, which recognises the difference, it is then necessary to postulate what a branch and subsidiary would look like if they were the same. Under formulary apportionment there is no need for the distinction and this hypothesising would be unnecessary.

The next part of this chapter considers the legislative approach of substituting an arm's length price under the traditional regime as applied to multinational banks – specifically the operation of the arm's length standard. This is done to determine in

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this and later chapters whether the problem of transfer price manipulation by multinational banks is dealt with under the traditional regime in a manner which reflects economic activity. It is contended that the arm’s length pricing requirement of the traditional transfer pricing regime is not optimal for taxing multinational banks and, as such, the focus of chapters six, seven and eight is to disprove the view that the arm’s length requirement is a satisfactory standard to apply.

5.4 The Traditional OECD Approach of Substituting an Arm’s Length Price

It has been established that the OECD believes that the arm’s length requirement of the traditional transfer pricing regime should be applied to multinational banks. There is, therefore, no special regime to examine in the application of transfer pricing rules to multinational banks, rather the general regime must be considered. This is done to demonstrate the less than optimal results.

In most jurisdictions, the OECD requirement for goods and services to be transferred at an arm’s length price has been adopted and has its foundation in two sources: the domestic tax law, imposed by the taxing jurisdiction unilaterally; and the double tax agreements to which the jurisdiction is a party.\(^{64}\) The domestic law generally grants the relevant taxing authority the power to substitute a consideration that is more or less than arm’s length consideration (or if there is no consideration at all) with one that is equal to an arm’s length price.\(^{65}\) The Associated Enterprises Articles\(^{66}\) and the Business Profits Articles\(^{67}\) of a jurisdiction’s double tax agreements achieve a similar result for those countries that have entered into agreements.

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\(^{64}\) For a history of this approach internationally see Joann M. Weiner, “Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level” (1996) 13 Tax Notes International 2113, 2115.

\(^{65}\) Throughout this thesis the domestic legislation of Australia is used as an example of a traditional international tax regime which adopts the OECD’s views on the distribution of taxing rights. The adoption of the OECD solution to transfer pricing manipulation is no exception.


Australia is an example of a comprehensive acceptance and adoption of the OECD views to transfer pricing and the arm’s length pricing methodologies. The requirement of an arm’s length price for related party transactions is contained both in Australia’s Income Tax Assessment Act (Cth) 1936 and the double tax agreements to which it is a party. Australia’s treatment of related party transactions has evolved over the last 20 years to a level of relative sophistication, consistent with OECD guidelines. To this extent, Australia has not disagreed with the overall OECD approach to transfer price manipulation, although it could be argued Australia has participated disproportionately in the development of OECD transfer-pricing guidelines.

Australia’s current transfer pricing regime is contained in Division 13, Part III, of the Income Tax Assessment Act 1936 (Cth) and the relevant double tax agreements. This legislation has been supplemented by numerous Taxation Rulings, which in turn have, in general, relied on the work of the OECD. As such, the Australian approach is used in this chapter to demonstrate the inadequacies of the traditional arm’s length concept when applied to multinational banks. While this analysis aids

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70 The present Division 13 was introduced by Act No. 29 of 1982, section 19(1). Section 19(3) provides that the amendments apply in respect of income of the year of income in which 28 May 1981 occurred and all subsequent years. Australia’s reform of its international transfer pricing regime commenced in 1981 with amendments to the Income Tax Assessment Act 1936 (Cth) resulting in the introduction of the present Division 13 of Part III of that Act. Prior to 1981, the former Division 13, Part III, of the Income Tax Assessment Act 1936 (Cth) dealing with transfer pricing, consisted of one section, s 136, an original provision without amendments, of the Income Tax Assessment Act 1936 (Cth). This section was based on s 28 of the Income Tax Assessment Act 1922 (Cth), which was based on s 23 of the Income Tax Assessment Act 1915-1921 (Cth), which was based on s 31 of the Income (No 2) Act 1915 (UK).


72 Public and private rulings are binding on the Commissioner provided they are favourable to a taxpayer and the arrangement to which they relate began or begins to be carried out on or after 1 July 1992.
an understanding of the operation and associated problems with the traditional regime, the caveat that Australia’s approach to transfer pricing may be viewed as heavily procedural and has very little to do with the interpretation of the law, needs to be placed on any discussion.\textsuperscript{73}

The transfer pricing regime applies to all related party transactions, whether for goods or services, and whether it is between separate legal entities or within the one legal entity. A distinction, however, is drawn between inter-entity transactions and intra-entity transactions. Different provisions apply to a subsidiary as compared a branch (permanent establishment) both under domestic legislation and the double tax agreements. This different application is one which has resulted in significant discussion in relation to multinational banks. Evidence of this is found in the fact that the OECD has concentrated on these differences in the three documents discussed earlier, with the most recent document, the OECD 2001 discussion draft, as updated in 2003, specifically dealing with the application of the Business Profits Article to branches of multinational banks.

5.4.1 Inter-Entity Transactions

Where the multinational bank operates through a parent–subsidiary structure, the subsidiaries of the multinational bank operate as independent legal entities as distinct from the head office and is separately chartered under the laws of the local country. With respect to the transfer pricing legislation that applies to this type of relationship, the critical section of the domestic legislation (\textit{Income Tax Assessment Act 1936} (Cth)) is section 136AD\textsuperscript{74} headed ‘Arm’s length consideration deemed to be received or given’. This section provides that four conditions that must be satisfied before an arm’s length price can be substituted for the consideration actually paid or received: there is the supply or acquisition of property under an international agreement; the Commissioner, having regard to any connection between any two or more of the


\textsuperscript{74} \textit{Income Tax Assessment Act 1936} (Cth) s 136AE is pivotal section in the context of single entity transactions.
parties to the agreement or to any other relevant circumstances, is satisfied that two or more parties to the agreement were not dealing at arm’s length with each other; the consideration paid or received by the taxpayer in respect of the acquisition or supply was greater or less than the arm’s length consideration in respect of the acquisition or supply, or no consideration was given; and the Commissioner determines that the section should apply in relation to the taxpayer.\textsuperscript{75} Where the Commissioner determines that the section should apply, it is necessary to consider what the arm’s length price is that may be substituted.

Where there is a double tax agreement the domestic legislation is complemented by the Associated Enterprises Article in those agreements,\textsuperscript{76} which generally follow the approach of Article 9 of the OECD Model Tax Convention. The Model Tax Convention provides:\textsuperscript{77}

Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The provisions of Article 9 only apply where the enterprises are associated, that is, there is a parent-subsidiary relationship or the companies are under common control, and commercial or financial relations between the enterprises differ from normal

\textsuperscript{75} The fact that the Australian Commissioner of Taxation must determine that the section should apply means that the transfer pricing regime is discretionary rather than self-executing.

\textsuperscript{76} Taxation Ruling TR 94/14, paragraph 18: In considering the application of Division 13, the terms of any relevant double taxation agreement must be considered. The Commissioner may apply the provisions of Division 13 and/or the treaty provisions. In the event of any inconsistency, the treaty provisions will prevail unless the treaty itself gives precedence to the domestic law.

\textsuperscript{77} OECD, Model Tax Convention on Income and on Capital (1992).
market terms. As with the domestic legislation, the Commissioner may then include in the profits of the enterprise any amount that would have accrued under normal market terms. If the Article is applicable, again the question arises as to the method used to determine the normal market terms or, in other words the arm’s length price.\textsuperscript{78}

5.4.2 Intra-Entity Transactions

Where there is a permanent establishment (branch) of a multinational bank, the legislation also requires an arm’s length price for internal transactions. In Australia, internal transactions are generally ignored for domestic tax purposes. Although, in 1981 special rules were incorporated into the transfer pricing provisions, in the form of section 136AE of the Income Tax Assessment Act 1936 (Cth), permitting the commissioner of taxation to participate in the determination of the source of income attributable to both inbound, and outbound permanent establishments.\textsuperscript{79}

Further, due to a statutory exception, contained in Part IIIB of the Income Tax Assessment Act 1936 (Cth), introduced with effect from 28 November 1994,\textsuperscript{80} Australian branches of foreign banks are treated exactly the same as Australian subsidiaries of foreign banks.\textsuperscript{81} This measure was introduced, at the same time legislation was passed to allow foreign bank entry into Australia in branch form. It was introduced to eliminate any perceived taxation advantages of Australian branches over subsidiaries of foreign banks. By virtue of the statutory exception, the

\textsuperscript{78} Paragraph 2 of Article 9 allows an adjustment to be made where there is economic double taxation by virtue of an assessment under para 1. The right to an adjustment is not automatic and the other Contracting State need only make an adjustment where it considers that the adjustment is justified both in principle and regards the amount.


\textsuperscript{80} A statutory exception has also been provided for offshore banking units to the extent that they are treated similarly, that is, they are treated as separate legal units for the purposes of the transfer pricing provisions: Income Tax Assessment Act 1936 (Cth) Division 9A.

Australian branch is treated as if it were a separate legal entity. This results in any transactions between a branch and its head office being treated as true dealings for the purposes of taxation. For example, the two most frequent types of financial transactions between a branch and head office - derivative transactions and foreign exchange transactions - are treated for tax purposes as if they were between separate legal entities, which results in the different status between a branch and a subsidiary being removed.

The separate entity approach is extended to Division 13 of Part III of the *Income Tax Assessment Act 1936* (Cth). In particular, section 160ZZW(5) ensures that section 136AD, which allows the Commissioner to substitute an arm’s length price in relation to any international dealings between associated parties, applies to transactions between a branch and head office. Normally section 136AD could not apply to any internal profit shifting. Section 160ZZW(5) provides that for the purposes of Division 13 of Part III, the branch is taken not to be, and not to have been at any time since its establishment, a permanent establishment in Australia of the bank. This provision is necessary as section 136AD can only apply where there is an international agreement as defined. Without this provision, transactions between a permanent establishment (branch) and a non-resident parent do not fall within the definition of an international agreement for the purposes of section 136AD.

While these statutory provisions apply to Australian branches of foreign banks, they do not extend to internal dealings between an Australian bank and its foreign branches or dealings between foreign branches of an Australian bank. This fact alone, prima facie, results in an inequitable taxing of like entities. This problem is

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82 *Income Tax Assessment Act 1936* (Cth) s 160ZZVA(2).

83 *Income Tax Assessment Act 1936* (Cth) s 160ZZV defines a ‘derivative transaction’ as a transaction entered into for the purpose of eliminating, reducing or altering the risk of adverse financial consequences that might result from changes in rates of interest or changes in rates of exchange between currencies, or for the purpose of making a profit from such changes, but does not include a transaction for the provision of finance or a foreign exchange transaction.

84 *Income Tax Assessment Act 1936* (Cth) s 160ZZV defines a ‘foreign exchange transaction’ as a transaction by which different currencies are exchanged.
one that has been acknowledged by the Australian Government, but not addressed.\(^{85}\) The Australian Treasury Department recognises that, without legislative provision for the recognition of cross-border financial arrangements, a gain corresponding to a loss in another part of the entity may permanently escape the tax net.\(^{86}\) It also recognises that there is potentially a result of double taxation where a gain is recognised for tax purposes without the corresponding loss allowed as a deduction.\(^{87}\)

Where a double tax agreement applies and a more favourable result ensues, a foreign bank may elect to apply not these concessionary measures of Part IIIB in the calculation of its taxable income. Section 160ZZVB(2) provides that where there is an agreement within the meaning of the *Income Tax (International Agreements) Act 1953* that has the force of law and applies in relation to the bank, the bank may elect that Part IIIB is not to apply in the calculation of its taxable income where one of three situations arises. The first situation is where the taxable income of a foreign bank, attributable to activities carried on by the Australian branch, is greater when calculated under Part IIIB than when calculated without the assistance of Part IIIB. The second situation is where, if a foreign bank would be taken not to incur a loss in a year of income in respect of activities carried on by the bank through its Australian branch that it would be taken to have incurred if Part IIIB did not apply. The third situation is where the amount of a loss that a foreign bank incurred in a year of income in respect of activities carried on by the Australian branch under Part IIIB is less than the amount of the loss if Part IIIB does not apply.\(^{88}\)

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\(^{88}\) Regardless of whether the income of the foreign branch is determined under Part IIIB of the *Income Tax Assessment Act 1936* (Cth) or under the double tax agreements, a foreign bank branch will not be able to utilize the Australian foreign tax credit system for any foreign tax paid. The reason for this is twofold. First, the foreign tax credit system is available only to residents whereas by virtue of section 160ZZW, the foreign bank branch is deemed a non-resident. Second, even if the foreign bank branch were a resident for tax purposes, the income would be considered Australian sourced because of section 160ZZY. The inability of a foreign bank branch to avail itself of the foreign tax credit system may potentially lead to double taxation. In order to ensure there is no double taxation, the *Income Tax Assessment Act 1936* (Cth) provides that foreign tax paid during a year of income by a foreign bank on
Where a double tax agreement is relevant, the Business Profits Article applies to attribute profits to a permanent establishment. Australia’s Business Profits Articles in the double tax agreements to which they are a party generally follow Article 7 of the OECD Model Tax Convention. Paragraph 1 of that article provides:

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Article 7(2) aims to prevent any distortion of the profits or losses of the permanent establishment by deeming the amount of the transaction to be that of an arms length transaction. It provides:

Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits of which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

Paragraph 3 of Article 7 is a continuation of this, as it allows expenses to be taken into account and, reading the paragraphs together, to be calculated at an arm’s length price. Article 7(3) provides that ‘in determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere’.

The 2001 OECD discussion draft specifically deals with the application of Article 7 to permanent establishments, and, in particular, Part II, as updated in 2003, deals with the application of Article 7 to permanent establishments of multinational banks.

interest received by its Australian branch from a place outside Australia is an allowable deduction for that year of income.
The discussion draft concentrates on determining the profits to be allocated to a permanent establishment by virtue of a working hypothesis. The working hypothesis provides "that the profits to be attributed to a permanent establishment are the profits that the permanent establishment would have earned at arm's length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2)."  

The application of the transfer price regime, therefore, depends on a number of factors: whether the related party transaction involves a subsidiary or a permanent establishment; and whether a double tax agreement is relevant or it is merely a case of applying the domestic laws of a jurisdiction. In essence, before the determination of an arm's length price, an unnecessarily complicated legal process ensues. The following diagram summarises the relevant regime applicable under Australian legislation to the possible scenarios:

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The application of this process then leads to the necessity of determining an arm’s length price.

5.4.3 Determining the Arm’s Length Price

Whether the multinational bank operates through branches or subsidiaries, and whether or not a double tax agreement applies, once it is established that related party transactions have occurred at a non-arm’s length price there may be a substitution of that price for one that represents an arm’s length price. Whether it is the domestic legislation that applies, or a double tax agreement, and whether the related party transactions are inter-entity or intra-entity, to determine that an arm’s length substitution is warranted, all provisions lead back to the matter of determining an appropriate arm’s length price. This determination is the crux of the traditional transfer pricing regime and has caused the most debate.

The legislation and double tax agreements, while they provide for the substitution of an arm’s length price where one is not paid or given, offer no further assistance in the determination of that arm’s length price. Further guidance is sought from the OECD Guidelines, and domestically, Australia’s Taxation Rulings (which have followed the approach of the OECD). To establish this arm’s length price certain methodologies have been determined to ascertain the substituted price. Both sources support the use of the arm’s length method for determining the substituted price, with five methods suggested as appropriate.

The five arm’s length methodologies, recognised both internationally and by the Australian Taxation Office, can be categorised into two basic divisions: the traditional methods; and the profit methods. The first category consists of the comparable uncontrolled price, the resale price and the cost plus methods. It is the view of both the OECD and the Australian Commissioner of Taxation that these are to be preferred over the alternative profit methods. The second category includes, but is not limited to, valuation procedures such as the profit split and the profit
comparison methods. While both the Commissioner and the OECD have stated that the traditional methods are preferred over the profit methods, it has been recognised that highly comparable data is required in order to apply the former. Where there is adequate highly comparable data the preferred traditional approach is the comparable uncontrolled price method.

It can be seen from the five methods that the obvious and preferred method of determining the arm's length price is to simply look at similar transactions between unrelated parties. This, however, is not always possible. To overcome this limitation the OECD has devised the other four methods and suggested when they should be used. Again, Australia has followed this procedure and issued rulings explaining how it understands the OECDs guidelines to work.

By providing alternative guidelines in addition to the obvious one (comparable uncontrolled price) the OECD is in effect conceding that certain multinational entities are unique. The parts of the enterprise operate together to create a synergy individual enterprises cannot replicate. As a consequence, in many cases there will be no comparable transaction between unrelated parties. It is then necessary to go

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90 It should be noted that the transactional profit methods are different to unitary taxation. Taxing authorities generally believe that an allocation based on profit split is consistent with the arm's length principle on the basis that it 'takes into account the facts and circumstances of each particular taxpayer's situation and seeks to achieve the best estimation of what independent parties might have reasonably expected to have agreed to in a joint venture relationship.' See eg, Australian Treasury Department, Taxation of Financial Arrangements — An Issues Paper (1996) 16.52.

91 Australian Treasury Department, Taxation of Financial Arrangements — An Issues Paper (1996) 2.3.


94 The application of each of these methods is examined in chapters six and seven.

through the fiction of pretending it is possible, and then use OECD proposed procedures to determine what the price would have been had there been a transaction between unrelated parties. Nevertheless, the OECD argues that it is possible and the comparable uncontrolled price method can be used to allocate income between parts of a multinational entity. A closer look suggests the rules may not be optimal for taxing multinational banks and the alleged benefits are at best exaggerated and at worst wrong.

The question then is, if there is an air of artificiality about applying the arm's length rules then why is this method used? The OECD claims that the transfer pricing regime, imposing the requirement of an arm's length price for related party transactions, is an optimal model for determining the price of transfers between different parts of a multinational entity. While the OECD maintains this argument for all types of multinational entities, this thesis asserts that the arm’s length model is not optimal for multinational banks.

In the next part of this chapter, the theoretical rationale for maintaining the arm’s length requirement is examined to demonstrate that while it may be reasonable to maintain this standard for traditional multinational entities, such logic does not transpose to multinational banks.

5.5 Rationale for the use of the Arm’s Length Price

The attention given to transfer price manipulation by international tax policymakers in recent times has focused on difficulties in enforcing the requirement that related-company prices be equivalent to those that would occur in arm’s length transactions between unrelated companies. Very little has been done, therefore, by bodies such

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as the OECD to determine whether the arm’s length standard for determining transfer prices should be retained. As such, it must be assumed that the original rationale for adopting the arm’s length price is maintained.

The rationale for maintaining the arm’s length requirement for multinational banks is that the current regime is an optimal one for distributing the taxing rights of all multinational enterprises. While the 1984 OECD document, and the more recent discussion drafts dealing with international banking, specifically acknowledge that unique taxation issues arise in relation to multinational banking transactions, they fail to acknowledge the cause of these issues being the unique features of multinational banks as contrasted with their more traditional counterparts.

The consequence of this acceptance by the OECD that multinational banks are essentially the same as traditional multinational entities means that it is assumed the rationale for maintaining the use of the arm’s length standard for traditional multinational entities is transposed to multinational banks. This is also the view of some authors who believe that the existing rules are adequate to deal with new means of delivering goods and services.\textsuperscript{99} Based on the conclusion that multinational banks are unique, it is the proposition of this thesis that the arm’s length approach fails to correlate with economic reality when applied to these entities. As a consequence, the rationale for the use of the arm’s length price for all multinational entities is considered to determine whether the same rationale is true for multinational banks.

Current literature advocates the arm’s length requirement of the transfer pricing regime based on four perceived theoretical advantages: it is the internationally recognised standard,\textsuperscript{100} it is an objective and determinate standard; it creates neutrality between affiliated and unaffiliated firms; and the allocation of income is


\textsuperscript{100} Although this could be viewed as a practical argument for the maintenance of the arm’s length standard. See eg, Hubert Hamackers, ‘Arm’s Length – How Long?’ in Paul Kirchhof, Moris Lechner, Arndt Raupach, and Michael Rodi (eds) International and Comparative Taxation: Essays in Honour of Klaus Vogel (English version edited by Kees van Raad) (2002) 29, 39.
based on economic reality. It is also argued that, at a practical level, the arm’s length principle has been successfully applied in the majority of cases. This practical application does not, however, translate into an accurate allocation of income. Each of the purported theoretical advantages is considered in turn.

5.5.1 International Acceptance

The most compelling argument in favour of the arm’s length requirement is that it is one which has gained international acceptance through its objective and determinate standard. The arm’s length standard has both longevity and international adoption. It is also argued that it has been remarkably successful over the years, accurately reflecting, when first developed, the income earned by various parts of the multinational entity. Further, it is undisputed that globally it is the more commonly used method.

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Some defenders of the arm’s length price model argue that it has the force of customary international law, while others argue that treaties allow the adoption of formulary apportionment. While the fact that most jurisdictions adopt the arm’s length standard can be construed as the standard gaining international acceptance, it can also be interpreted as consequence of history. It is this proposition that Stanley Langbein puts forward. The arm’s length standard is a product of history with its foundations laid in a report commissioned by the League of Nations and delivered in 1933. The Carroll report advocated the separate accounting approach as the preferred model for the allocation of profits under the model conventions.


112 Stanley I Langbein, ‘The Unitary Method and the Myth of Arm’s Length’ (1986) 30 Tax Notes 625. For a comprehensive rebuttal of Stanley Langbein’s claim see Chantal Thomas, ‘Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method’ 14 (1996) Berkeley Journal of International Law 99. Chantal Thomas states ‘Langbein’s arguments are ultimately aimed less at demonstrating that countries do not believe the method to be an international norm and more at laying the groundwork from which to argue that they should not adhere to that norm. That is, Langbein asserts that weaknesses in the empirical data supporting the separate accounting method’s normative status exist in order to buttress his own normative argument for the formulary apportionment method. Thus, while Langbein points to valid and indisputable problems with the separate accounting method, these problems do not speak to the actual status of the method as an international norm.’: Chantal Thomas, ‘Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method’ 14 (1996) Berkeley Journal of International Law 99, 127-128.


114 M B Carroll, Taxation of Foreign and National Enterprises – Methods of Allocating Taxable Income (Volume IV), League of Nations Document No. C.425(b),M.217(b),1933.11A, September 1933. ‘Fractional’ (formulary) apportionment was raised as an alternative to the separate accounting approach. However, the Committee rejected this approach for practical reasons: see Joann M Weiner, ‘Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level’ (1999) OTA Paper 83, 4-5.

115 For a complete history of the arm’s length standard, see Stanley I Langbein, ‘The Unitary Method and the Myth of Arm’s Length’ (1986) 30 Tax Notes 625. Langbein, however,
Relative to today’s multinational entities, there was very little activity undertaken by such entities, prior to the 1960s. The multinational entity, as a concept, is a relatively new phenomenon, with multinational banking only becoming prominent in the 1980s. As such, prior to the 1960s very little attention was paid to transfer pricing issues and the arm’s length pricing requirement. While the arm’s length pricing requirement existed in OECD Model Tax Conventions and domestic legislation, the methods for determining this arm’s length price had not been considered in any detail. In 1979, the OECD released its first report into transfer pricing,\(^{116}\) and has continued to actively examine transfer pricing issues ever since. As a response to increased cross border-transactions and multinational entity operations, the OECD revised its international transfer pricing guidelines in 1995. The revised guidelines, issued on 13 July 1995, replace those contained in the OECDs 1979 report on transfer pricing.

Both the United States and Australia are domestic examples of this relative lateness in the consideration of methods to determine the arm’s length price. In 1968, the US Treasury, for the first time, considered the methods for determining the arm’s length price. It has continued to refine the methods ever since.

In Australia, prior to 1981, the former Division 13, Part III, of the **Income Tax Assessment Act 1936 (Cth)** dealing with transfer pricing, consisted of one section, section 136, an original provision without amendments, of the **Income Tax Assessment Act 1936 (Cth)**.\(^{117}\) Australia’s reform of its international transfer pricing regime commenced in 1981 with amendments to the **Income Tax Assessment Act 1936 (Cth)**, resulting in the introduction of the present Division 13 of Part III of that Act. It has not been until the 1990s, however, that the Australian Taxation Office has taken an active interest in the operation of the transfer pricing provisions. Since


\(^{117}\) This section was based on s28 of the **Income Tax Assessment Act 1922 (Cth)**, which was based on s23 of the **Income Tax Assessment Act 1915-1921 (Cth)**, which was based on s31 of the **Income (No 2) Act 1915 (UK)**.
1992 the Commissioner of Taxation has issued numerous rulings directly relating to international transfer pricing.\textsuperscript{118} The Australian Taxation Office has issued these comprehensive rulings outlining not only the selection and application of transfer pricing methodologies, but also documentation requirements and penalties for non-compliance.

Adoption of the arm's length standard at a domestic level, along with the supposed international acceptance, appears to generally stem from the belief that the OECD Model Tax Convention requires it. This, however, can be disputed. The standard required by the Associated Enterprise Article of the OECD Model Tax Convention\textsuperscript{119} is that the parties deal with each other as independent parties would. This Article does not contain a requirement for an arm's length price.

The OECD interpretation of this Article, however, is that there is a compulsory requirement for the use of the arm’s length principle, which has become stronger in recent times. While the OECD, in its 1979 report, indicates that the arm’s length principle is 'the underlying assumption behind Article 9', the 1995 report provides that it is 'the authoritative statement of the arm’s length principle'.\textsuperscript{120} The 1998 OECD discussion draft also refers to the view expressed in the guidelines that multinational entity 'groups retain the freedom to apply methods not described in this

\textsuperscript{118} Taxation Ruling TR 92/11 income tax: application of the division 13 transfer pricing provisions to loan arrangements and credit balances; Taxation Ruling TR 95/23 income tax: transfer pricing -- procedures for bilateral and unilateral advance pricing arrangements; Taxation Ruling TR 94/14 income tax: application of division 13 of part III (international profit shifting) -- some basic concepts underlying the operation of division 13 and some circumstances in which section 136AD will be applied; Taxation Ruling TR 97/20 income tax: arm’s length transfer pricing methodologies for international dealings; Taxation Ruling TR 98/11 income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings; Taxation Ruling TR 98/16 income tax: international transfer pricing -- penalty tax guidelines; Taxation Ruling TR 1999/1 income tax: international transfer pricing for intra-group services; TR 1999/8 income tax: international transfer pricing: the effects of determinations made under division 13 of part III, including consequential adjustments under section 136AF; Taxation Ruling TR 2000/16 income tax: international transfer pricing -- transfer pricing and profit reallocation adjustments, relief from double taxation and the mutual agreement procedure; Taxation Ruling TR 2001/11 income tax: international transfer pricing -- operation of Australia's permanent establishment attribution rules.

\textsuperscript{119} OECD, Model Tax Convention on Income and on Capital (1992) Article 9.

Report to establish prices provided those prices satisfy the arm’s length principle in accordance with these Guidelines.\textsuperscript{121} This statement again focuses on the use of the arm’s length standard as the only available method for transactional allocation.

This acceptance of the arm’s length standard, both domestically and internationally, appears to stem from the fact that there is a general belief that to determine how independent parties would deal with each other, the arm’s length standard must be applied. This assumption, however, necessarily assumes that prices must be determined for transactions. Yet, as Dale Wickham and Charles Kerester point out \textquoteleft[a]llotting or apportioning taxable income among countries is the task to be accomplished; that is quite different from allocating or apportioning taxable income among internal units of a business enterprise.'\textsuperscript{122} Essentially, the purpose of Article 9 is to determine how the profits of an enterprise should be split between the relevant jurisdictions. So long as that split is according to how unrelated parties would split the profits, there is no reason why a method other than the arm’s length method could be used. To this extent, commentators have started to question whether the current interpretation of Article 9 of the OECD Model, requiring strict use of the comparable transactional pricing approach, is warranted.\textsuperscript{123}

There is similar discussion in relation to internal transactions where there is an branches of the multinational entity. In relation to Article 7, the 2001 OECD discussion draft, in the context of attributing profits to permanent establishments, comments on the wording of paragraph 4 which states:

\begin{quote}
Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such
\end{quote}


that the result shall be in accordance with the principles contained in this Article.\textsuperscript{124}

The 2001 OECD discussion draft addresses the issue of whether this paragraph allows a method other than purely transactional profit methods to be used to determine the profits to be attributed to a permanent establishment. While the 2001 OECD discussion draft suggests that this paragraph does not allow the use of other methods, there are two arguments which support such use. The first argument is that the wording is wide enough to allow the use of other methods where it is customary to do so. The second argument is that the paragraph itself talks about an ‘apportionment of the total profits’ thereby opening the door to a profit split method or global formulary apportionment. The 2001 OECD discussion draft attempts to refute the possibility of the paragraph allowing the use of global formulary apportionment, stating that it is distinguishable on the basis of the last sentence which provides that the result should be in accordance with the principles contained in the Article.\textsuperscript{125} This document does, however, recognise that the fact that an attribution under this paragraph is one applying to total profits thereby making it difficult to achieve such a result in practice.\textsuperscript{126}

Contrary to the view expressed in the 2001 OECD discussion draft, there is a suggestion that the related-party articles of the treaties do not prohibit formulary apportionment.\textsuperscript{127} The standard required by the treaties is that the related parties must deal with each other, as independent parties would, not at an arm’s length price.\textsuperscript{128} To this extent, it is suggested that ‘[a]n arm’s-length price is only one


\textsuperscript{125} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishment} (2001) 49(179).

\textsuperscript{126} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishment} (2001) 49(179).


means of satisfying an arm's-length standard. It is not the only means.\textsuperscript{129} The most obvious alternative means of determining how independent parties would act is to consider the joint venture relationship. 'Many unrelated parties enter into joint ventures with each other under which the combined taxable income (or loss) from the joint venture's activities with unrelated third parties must be allocated between the members of the joint venture.'\textsuperscript{130}

It appears, therefore, that rather than being the internationally accepted standard, the arm's length requirement is merely a product of history, with domestic jurisdictions simply following OECD interpretations. Further, the methods that determine the arm's length price are a relatively new area of exploration. The transfer pricing guidelines of 1995 were seen as an important achievement heralding new international consensus.\textsuperscript{131} It has been suggested, however, that international consensus on the arm's length principle is superficial.\textsuperscript{132} Evidence of the late consideration of the application of the arm's length principles supports this claim. Rather than accepting that the traditional methods have also become the internationally accepted norm, it is more likely that jurisdictions have had very little time to consider in detail, both theoretically and practically, whether these methods are, in fact, optimal for taxing even traditional multinational entities. Because of the relative 'recency' of multinational banking, there has been even less time to consider the appropriateness of the five methods to determining an arm's length price for related party transactions.

It is not suggested that at the time when the arm's length method was formulated it was neither sensible nor practical. Quite the contrary, in an era where transactions involved tangible goods, related parties were relatively autonomous and only a small


amount of international trade occurred, rendering it both possible and practical to find genuine arm's length prices for comparable transactions. Because of the changes in recent times, however, the arm's length formula has ceased to have any real meaning in many situations involving multinational entities, particularly multinational banks.

The OECD is now recognising the unique issues facing taxing authorities in the current global economy. While they have adopted the position that the traditional transfer pricing regime can be adequately adapted to apply the modern multinational banking industry, the inference is that it is difficult to do this.

5.5.2 Objective and Determinate Standard

The second argument in favour of the arm's length standard is that it has gained international acceptance through its objective and determinative nature. Proponents of this argument base their line of reasoning on the fundamental concept of 'comparability' underpinning the traditional arm's length methodologies. This concept of comparability relies on the market forces of supply and demand being the best way to allocate resources and reward effort. Part of the economic rationale for the arm’s length principle is that an unrelated party would consider the available alternatives to a prospective transaction and enter into the alternative which provides the most profitable outcome.

The five methodologies considered acceptable generally rely on the concept of comparability. The three preferred traditional methods rely particularly heavily on this requirement. The comparable uncontrolled price method relies on a comparison between ‘the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances’. The resale price method relies on the comparability of functions between the taxpayer and an independent dealer to determine an appropriate resale price margin. The cost plus method also relies on comparable independent dealings. The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.

It is demonstrated in chapter six that, while it may be possible to find comparables for transactions undertaken by traditional multinational entities, it is unlikely to be possible to do the same for multinational banks. While these issues are dealt with in detail later, it is worth noting at this point that this is contrary to the view of the OECD. In 1984 the OECD was of the view that:

The widespread existence of markets for the borrowing and lending of money in various forms, the fact that banks frequently borrow and lend large sums to each other on inter-banks markets and the common phenomenon of recognised inter-bank lending rates indicates that it would normally be possible to derive arm’s length interest rates for transactions between the various parts of a banking enterprise from the rates charged in comparable transactions between independent parties.

There will often therefore be evidence for arm’s length prices on the comparable uncontrolled price basis and the cost plus or resale minus basis will be of much less importance in the context of bank interest than in other

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138 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) II-2 (2.6); examples of the method appear in paragraphs 2.10 to 2.13; also TR 94/14, paragraphs 88 to 93 and 353 to 358. This definition is adopted by *Taxation Ruling* TR 97/20 paragraph 3.10.

139 *Taxation Ruling* TR 97/20 paragraph 3.20. (1995 OECD Report Glossary). Examples of the method are found in the 1995 OECD Report at paras 2.29 to 2.31 (also *Taxation Ruling* TR 94/14, paragraphs 94, 95 and 359 to 362).

contexts. It has to be recognised, however, that usable evidence is likely to be more freely available for short-term borrowing than for longer-term borrowing. Normally the transactions to be used for comparison should be arm's length transactions between unrelated banks where the amount lent, the term of the loan, the currency involved and the other conditions are the same or similar to those in question.\textsuperscript{141}

Very little has changed over the period between this report and the recently updated 2001 discussion draft. In the 2003 updated version of this discussion draft on the attribution of profits to permanent establishments it is still maintained that the methods in the Guidelines can be applied to branches of multinational banks, with that document stressing that comparability can be made between the 'reward earned from dealings within the bank with comparable transactions between independent enterprises'.\textsuperscript{142}

It is suggested, however, that multinational banks are involved in activities that cannot be allocated to separate parts of the enterprise with any certainty.\textsuperscript{143} Richard Bird believes that because of the very nature of the multinational entity, an objective and determinative standard is not possible. He states '[t]he very essence of a multinational enterprise in a sense is thus its ability to achieve higher revenues (or lower costs) from its different subsidiaries as a whole compared to the results that would be achieved under separate management on an arm's length basis. The allocation of profits within a multinational enterprise is thus inherently and unavoidably arbitrary since such businesses are, as a rule, inevitably 'unitary' in character.'\textsuperscript{144} As demonstrated later, this is particularly true for multinational banks.

It may be possible to argue that the arm's length standard is theoretically objective and determinate, but this does not transpose into an economically rational argument


\textsuperscript{143} Richard M Bird, 'The Interjurisdictional Allocation of Income' (1986) 3 (3) \textit{Australian Tax Forum} 333, 334.

\textsuperscript{144} Richard M Bird, 'The Interjurisdictional Allocation of Income' (1986) 3 (3) \textit{Australian Tax Forum} 333, 334. Richard Bird uses the example of technology and management services, which may be applied to a division of a firm without detracting from their value elsewhere.
for maintaining the standard for multinational banks as a theoretically superior model. This issue is explored further, in a practical application setting, in chapter six.

5.5.3 Removal of Economic Incentives

A third argument in favour of the arm's length standard is that it removes economic incentives to enter a foreign market through foreign direct investment, compared with transacting with an unrelated foreign based entity. The OECD provides that this is a major reason why member countries have accepted the arm's length principle, as it 'provides broad parity of tax treatment for MNEs [multinational entities] and independent enterprises'. This argument is based on the premise that the current tax regime provides a tax neutral environment. That is, the multinational entity's choices are not affected by tax consequences, but rather are made based purely on commercial reasoning. This argument in favour of the arm's length price is that the decision of whether to become a multinational entity or to transact with an unrelated party will not be distorted by perceived tax advantages, through profit shifting and tax minimisation. Rather, a decision would be based on an analysis of the economic costs associated with the two alternatives. The arm's length standard provides similar treatment between multinational entities and independent enterprises. In doing so, there is the avoidance of the creation of tax advantages by the concentration of economic power in large multinational entity groups.


The OECD believes that this is one of the main reasons why member countries and other countries have adopted the arm’s length principle. It argues that the arm’s length principle provides broad parity of tax treatment for multinational entities and independent enterprises. Further, because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment. Charles Berry et al, explain:

The appeal of the arm’s-length standard is that it purports to place, in each taxing jurisdiction, the commonly controlled firm on the same footing as an equivalent uncontrolled firm, thereby providing no competitive advantage or disadvantage to commonly controlled firms, and hence no incentive to alter the ownership structure of corporations as a consequence of the way in which tax liability is defined. Ideally applied, the tax liability of a given firm would be unaffected were it to be totally controlled, dealing only with its corporate parent, or were it to be sold and operated totally independently.

Proponents of this argument believe that any increased efficiency gained through foreign direct investment, which results in decreased costs associated with the multinational entity, should not be taken into account for taxation purposes. Savings, which allow a product or service to be transferred to another part of the entity at a price less than arm’s length, should be ignored. Any costs associated with the external market, which can be avoided through the establishment of a multinational entity should be ignored according to this argument. Such costs include: brokerage costs; costs of defining the obligations of the contracting parties; the risk of scheduling and the related input costs; and the taxes paid on the transactions.

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There is, however, a counter argument, that to reflect economic reality, these cost savings should be taken into account. The cost savings associated with multinational banks are caused by two factors. The first factor is the cost savings due to external market failure. The second factor relates to the synergistic advantages of being a multinational bank. Each is examined in turn.

5.5.3.1 Internalisation of Market Inefficiencies

Where intercompany transactions could be carried out with approximately equal (or greater) efficiency by unrelated firms, the neutrality rationale provides a cogent reason for applying the arm's length standard to those multinational entities.\(^{152}\) There are, however, very few multinational entities in existence where transactions can be carried out with approximately equal or greater efficiency by unrelated firms. Economic reality is that there is increased efficiency gained through foreign direct investment, resulting in decreased costs associated with the multinational entity.\(^{153}\) The arm's length principle does not recognise these efficiencies within the multinational entity.\(^{154}\) Consequently, the arm's length price fails to reflect the economic reality of a multinational entity that achieves such efficiencies. The multinational bank is one such multinational entity that exhibits these efficiencies.

Multinational banks are profit driven entities and banks are internalising a market failure - information asymmetry,\(^ {155}\) which means that there is greater efficiency for the banks by operating as multinationals. Internalisation - which is about the imperfections in the intermediate market - explains how the multinational bank achieves the goal of cost reduction. Banks follow their customers overseas because

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the knowledge advantage they possess, born of the client-banking relationship, which becomes a public good within the firm that can be best exploited by expanding offshore. The imperfections in the open market create transaction costs, which can be minimised or avoided by operating in the international market through foreign direct investment.\(^{156}\)

Stanley Langbein is one supporter of the argument that these factors should be taken into account, and maintains that at the heart of the objection to the arm’s length standard is that it is deficient in theory based on this internalising of market failure.\(^{157}\) He bases this argument on the fact that ‘[m]ultinational enterprises are integrated for substantial economic reasons; they do not behave or govern themselves “as if” their various components were separate.’\(^{158}\) Relying on this internalisation of market failure argument, it can be maintained that the current approach is conceptually inconsistent with the economic purpose of a multinational enterprise,\(^{159}\) which results in the arm’s length requirement being economically illogical.\(^{160}\) Essentially, it is suggested that the theory of the arm’s length standard does not correspond with the theory of the multinational entity as it disregards the fact that related parties may be economically different from unrelated parties.\(^{161}\)

In this context of multinational banking, this economic difference is a result of banks entering foreign markets through foreign direct investment. It is only when a bank enters a foreign market through foreign direct investment, thereby creating a multinational bank, that transfer pricing becomes an issue. There are, however, then


efficiency gains through foreign direct investment which can be explained by internalisation theory.\footnote{Mark Casson, *The Organisation of International Business* (1995) 22; K R Cho, 'Determinants of Multi-national Banks' (1986) 26(1) *Management International Review* 10, 13; Barry Williams, 'Positive Theories of Multinational Banking: Eclectic Theory versus Internalisation Theory' (1997) 11(1) *Journal of Economic Surveys* 71.} Internalisation is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimised for the sector as a whole by bringing interdependent activities under common ownership and control.\footnote{Mark Casson, *The Organization of International Business* (1995) 22.} Implicit in the internalisation theory are the assumptions that: (1) the primary goal of any capitalist entity is to maximise profit, and as part of achieving that goal, minimise expense; and (2) there is an imperfect market.\footnote{Mark Casson, *The Organization of International Business* (1995) 22.} Internalisation explains how the multinational entity achieves this reduction in cost. Costs associated with the external market, which can be avoided through the establishment of a multinational entity are: brokerage costs; costs of defining the obligations of the contracting parties; the risk of scheduling and the related input costs; and the taxes paid on the transactions.\footnote{Barry Williams, 'Positive theories of Multi-national Banking: Eclectic Theory versus Internalisation Theory' (1997) 11(1) *Journal of Economic Surveys* 71, 74.} There is an argument that the reduction of these costs should be reflected in the transfer price. Referring to internalization, Stanley Langbein maintains:

This exegesis of the origin of multinational firms, and of the 'integration economies' they effect, suggests the futility of constructing a transfer pricing regime based on the identification of 'inputs' to the productive process and the association of profit with particular inputs. It suggests, rather, that allocations seek to divide profits among the components of a multinational group according to the relative contributions of the components of the group profit.\footnote{Stanley I Langbein, 'A Modified Fractional Apportionment Proposal for Tax Transfer Pricing' (1992) 54 *Tax Notes* 719, 724.}

It is asserted that the arm's length approach ignores the interdependence and integration of the multinational entity by treating the various parts as if they were

While the internalisation of market inefficiencies argument may apply to multinational entities besides multinational banks, it is of greater significance for these banks because of the unique services provided and they way they are provided. In particular, multinational banks are internalising information that is client specific, resulting in reduced transaction costs.

\subsection*{5.5.3.2 Synergistic Benefits}

It is further arguable that, also from a theoretical perspective, the arm's length pricing model fails to take into account the synergies arguably inherent in a multinational enterprise.\footnote{D Kevin Dolan, 'Intercompany Transfer Pricing for the Layman' (1990) 49 Tax Notes 211, 214.} This failing has been described as follows:
The major theoretical criticism of the arm’s length principle is that it is inherently flawed because it adopts the separate entity approach. Consequently, the arm’s length principle cannot account -- at least comprehensively -- for the economies of scale or other benefits of integration that accrue to integrated businesses.172

Multinational banks generally function as one economic unit, unlike unrelated parties. As such, there are synergistic benefits to the integrated entity as a whole.173 It may be argued, however, that the arm’s length approach fails to take these benefits into account. This is because the arm’s length approach ignores the answer to the question of why multinational banks come into existence and structure themselves in a particular fashion. The simple answer to this question is that usually multinational entities come into existence because it is more cost effective than contracting with arm’s length parties.174 Further, when they do come into existence, they structure themselves in a manner that maximises profits.175 ‘Internal organization economizes on uncertainty and opportunism by allowing for adaptive, sequential decision making; by facilitating the development of internal codes concerning idiosyncratic knowledge; and by promoting convergent expectations, which attenuate uncertainties generated when interdependent parties make independent decisions.’176

Multinational banks operating on a global basis will benefit from these economies of scale as they will have the ability to minimise their risk, cost effectively obtain technical expertise and information, and preserve their value.177

The 1998 OECD discussion draft on The Taxation of Global Trading of Financial Instruments acknowledges ‘the co-operation between the marketers and traders


which is essential to produce the profits from global trading.\textsuperscript{178} The discussion draft also states that two problematic issues arise because the current tax model may not fully reflect this co-operation. The first issue is the question of how to allocate the benefits of integration. The response to this is found in the guidelines which provide ‘[t]here are, however, no widely accepted objective criteria for allocating the economies of scale or the benefits of integration between associated enterprises.’\textsuperscript{179}

The second issue is the question of how to evaluate the level of integration of functions in respect of a particular transaction or transactions.\textsuperscript{180} The discussion draft suggests that, in many cases it is still possible to undertake a comparability analysis to determine a comparable uncontrolled price. It is recognised, however, that a number of tax authorities believe that in some global trading cases there is such a high level of integration between locations and functions that traditional transaction methods could not reliably be applied.\textsuperscript{181} That is, it is not possible to make reasonably accurate adjustments.

Where it is not possible to use a traditional transactional method, the OECD refers to its guidelines that state: ‘[u]nder similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split.’\textsuperscript{182} This would appear to be an admission by the OECD that where there are synergies in global trading, it is unlikely to be possible to use traditional methods. Further, it is often because of the integration that there is an absence of arm’s length markets to be used as comparables.\textsuperscript{183} Even where there are such comparisons, which is highly


\textsuperscript{179} OECD, \textit{The Taxation of Global Trading of Financial Instruments} (1998) 42(167) quoting from the Guidelines, paragraph 1.9.


\textsuperscript{182} OECD, \textit{The Taxation of Global Trading of Financial Instruments} (1998) 42(172), referring to paragraph 3.5 of the Guidelines.

unlikely, the use of the traditional methods will not take account of the integration economies, as non-associated parties have not undertaken such integration.  

It has already been established that multinational banks are highly integrated. It is this highly integrated nature that sets apart multinational banks from their traditional counterparts and provides larger profits. As Jinyan Li explains '[a]n integrated business offers the advantage of increased efficiency, through economies of scale, the internalisation of transaction costs, or synergies that earn profits for the MNE that are greater than the aggregate profits earned by separate enterprises.' The separate entity approach requires the taxpayer to act as if there were no synergies, treating parts of the multinational as if they were distinct.

It is not disputed that the neutrality rationale provides a coherent reason to apply the arm's length standard to multinational entities where intercompany transactions can be undertaken just as efficiently by an unrelated entity. Many multinational entities, however, enter the market through foreign direct investment because those market transactions are not economically viable - multinational banks are one such example.

It is argued that the discussions above, and in chapter two, clearly demonstrates that multinational banks are one such group of multinational entities that enter a foreign market because of the advantages of internalising the transactions undertaken. It is generally understood that the income allocated to each jurisdiction should reflect the economic activities carried on in that jurisdiction.  

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accepted, however, that ‘... the manner in which parties express their transactions and account for them based upon principles of separate entity accounting may not, in fact, be a reliable reflection of the extent to which economic activity will have taken place in a jurisdiction.' In the case of multinational banks, an accurate allocation may not be achieved through an application of the traditional arm’s length regime. As such, the neutrality rationale is outweighed by the failure to take into account economic reality.

The criticism that the arm’s length standard fails to take into account economic reality is qualified by the fact that it is possible, if the arm’s length standard were replaced by a different methodology to allocate income, inefficient multinationals would come into existence for tax-driven reasons. This thesis, however, proposes a unitary tax regime, based on global formulary apportionment. As such, it may be argued that the contributions of each of the parts of the entity are recognised, while at the same time the internal benefits are inherently factored in.

The attainment of an appropriate replacement which would provide a tax neutral environment (a difficulty this author believes can be overcome), has its potential difficulties. It may be argued, however, that the neutrality argument is clearly flawed in circumstances where multinational banks are born due to market inefficiencies. If this were correct, it would appear that multinational banks are then essentially punished by their election of foreign direct investment. It is suggested that this certainly is the case with most multinational banks, as their decision to become multinational is usually based on their compulsion to follow clients, both to take advantage of existing knowledge and for fear of competitors. This decision to become multinational means that there are synergistic benefits to the multinational bank, which the traditional transfer pricing regime also fails to take into account.


5.5.4 An Accurate Allocation of Income

The fourth argument in support of the arm’s length requirement is that it accurately allocates income among affiliates of a multinational entity in proportion to each affiliate’s economic activity.\textsuperscript{191} The theoretical justification\textsuperscript{192} of this rationale is that it is the most accurate solution because of its ‘bottom up’ approach.\textsuperscript{193} The separate accounting approach attempts to determine the origin of the income,\textsuperscript{194} and evaluates individual transactions rather than assessing them as a whole.\textsuperscript{195} The OECD Guidelines also list this as an advantage of the separate entity approach.\textsuperscript{196} Jinyan Li explains that this perceived advantage is that ‘the comparable transactional pricing approach provides the most accurate measurement of the fair market value of the true economic contribution of members of a [multinational entity] group.’\textsuperscript{197}

There are two substantive objections to this rationale. The first objection is that it ignores the industrial organisation theory of the multinational enterprise\textsuperscript{198} as previously discussed. Because this theory argues that the sum is greater than the


parts, and the consequential income cannot be allocated to the parts in any principled manner.\textsuperscript{199} The result does not accurately allocate income. There are efficiencies which 'generate value for the whole enterprise that is greater than the sum of the parts, and it is this value that cannot be meaningfully divided among separate activities conducted by separate legal entities as the arm's length system attempts to do.'\textsuperscript{200} This is particularly relevant to multinational banks due to the integrated nature of global trading as it is difficult to allocate profits among trading jurisdictions.\textsuperscript{201} 'Global trading involves large amounts of highly mobile capital which would suggest it is relatively easy to transfer expected profit or loss from one jurisdiction to another. The complex and innovative nature of the financial products being dealt with makes the tracing of such transfers more difficult...'\textsuperscript{202}

The second objection to this rationale that the arm's length standard is desirable because it accurately allocates income to source is that this argument rests on the underlying premise that the current source regime is justified.\textsuperscript{205}

There are sound reasons to support a source based regime over one based on residency, as despite its imperfections, there are advantages to such a regime.\textsuperscript{204} In the previous chapter this thesis supported the argument for a pure source based regime. It was also argued, however, that the current source regime does not provide an optimal result for multinational banks due to their unique attribute of being an


intermediary, thereby allowing manipulation of the source of income. The proposed unitary tax regime is also a source based regime. It, however, allocates income to the relevant jurisdictions based on economic factors rather than legal principles, thereby it provides a tax regime which replicates economic reality.

The current source based regime is not optimal for taxing multinational banks as it does not accurately allocate income among affiliates of the banks in proportion to each bank subsidiary or branch’s economic activity. If the propositions in chapter four are correct, given the current transfer pricing regime’s reliance on source, it is naïve to suggest that the current arm’s length standard achieves a result which does accurately allocates income among the relevant jurisdictions.

Finally, there is an argument that the arm’s length approach does not in fact resolve the issue of allocating income among countries of source.205 Dale Wickham and Charles Kerester argue that ‘it focuses only on allocating revenues and costs among the legally separate but commonly controlled legal entities.’206 Further, it will ‘increase the revenues of the country requiring the reallocation to an entity taxed on the basis of the taxpayer’s nationality or residence, rather than the source of the income.’207

Also used as the basis for arguing that the arm’s length price results in an accurate allocation of income is that, assuming there is an arm’s length price for a product or service,208 it should be used as the transfer price, not because there is one for that product or service, but that self-interest dictates.209 Charles Berry et al, argue that the ‘self-interest of any independent firm would dictate that such a firm would never pay


208 Chapter six argues that very rarely is there one.

more for any product than the price at which the same product could be obtained from an alternative seller, and that no independent firm would ever accept less, in selling that product, than the price it could obtain from an alternative buyer."\textsuperscript{210}

What this argument fails to take into account (besides the obvious one of the need for comparables to exist), is that separate parts of a multinational entity are not motivated by self-interest; rather they are motivated by the economic interest of the group as a whole. A multinational entity will arrange its affairs to maximise the overall profits.\textsuperscript{211}

Tax considerations aside, the structure adopted will, in turn, affect the choice of transfer pricing methodology adopted by the multinational entity; whether this is established by reference to market based transfer prices, cost based transfer prices or negotiated transfer prices. The transfer pricing methodology chosen should lead management to make optimal decisions for the organisation as a whole.\textsuperscript{212} An organisation chooses an appropriate method according to the criteria of promotion of goal congruence and promotion of a sustained high level of management motivation.\textsuperscript{213} The promotion of goal congruence is achieved where divisional managers make decisions consistent with goals set by group management. The promotion of a sustained high level of management effort is achieved where management is motivated to attain set goals.

Setting an appropriate transfer price by reference to market-based (traditional transactional) methodologies are most appropriate where there is a competitive market to provide a price. In these circumstances there is little advantage in dealing with an associated enterprise as compared with an independent one and as such the market price will meet an entity’s goals. However problems may arise, for example,


where there is excess capacity which results in a price drop that may be either short or long term. Essentially this highlights two problems for multinational banks. The first problem is that there must be a competitive market to provide the price (transactional comparability). The second problem is one of excess capacity, as it is a very real possibility in that a multinational bank may have excess funds which it can loan at a rate lower than an independent third party simply because it is excess.

While it is not possible to establish a general rule to determine the appropriate transfer price applicable to all multinational enterprises it is possible to determine a general guide. As a general guide the following formula is useful in the context of a traditional multinational entity:

\[
\text{Additional outlay costs per unit incurred to the point of transfer} + \text{Opportunity costs per unit to the supply division} = \text{Minimum transfer price}^{214}
\]

In its application to multinational entities generally, the additional outlay costs per unit incurred to the point of transfer are the variable costs associated with the production of goods, while the opportunity costs per unit to the supply division will be the negotiated portion of fixed costs. This formula can be adapted for multinational banks and the service they provide of operating as an intermediary in the borrowing and lending of money.

This determination of the transfer price, appropriate from a managerial accounting perspective, is very different to that of the arm’s length requirement. Rather than examining opportunity costs, the question that a firm is required to answer for tax purposes, or in other words to determine the arm’s length price, is ‘what would have happened if the ownership link had been severed and the enterprise was motivated by its own economic interest?’\(^{215}\) Relying on industrial organisation theory, this


\(^{215}\) Taxation Ruling TR 97/20, paragraph 2.5. While this question is taken from an Australian Taxation Ruling it will be asked by all taxing authorities adopting the arm’s length approach.
question does not accord with the general purpose behind the establishment of a multinational enterprise. As already pointed out, this theory essentially postulates that multinational entities are established so that the group performs better than they would as non-associated enterprises.

To answer the question required by the taxing authorities, by adopting the arm’s length requirement, it would appear that these taxing authorities generally conclude that an enterprise would have sold the goods to a non-associated party at market value and therefore the arm’s length consideration should also be market value. If this is the case then the purpose of establishing a multinational entity is defeated. That is, if you can buy or sell goods from a non-associated party for the same consideration to that of an associated party, the incentive to have related enterprises is severely undermined.

5.6 Conclusion

The fundamental theoretical failing of the traditional transfer pricing approach, when applied to multinational banks, is that it does not take into account the unique features of these banks when allocating profits. Yet, it is these unique features, particularly entering the market through foreign direct investment to avoid market externalities, which make the multinational bank is so successful. The separate entity paradigm adopted by the traditional transfer pricing regime is incongruous with the economic theory of multinational enterprises.

Consequently, it has been demonstrated in this chapter that the traditional OECD approach to the problem of transfer price manipulation of substituting an arm’s length price may not be optimal for multinational banks. Further, it was demonstrated that the rationale for the use of the arm’s length price for traditional multinational entities do not carry over to the enterprise of multinational banking. Despite this, the OECD continues to insist upon the traditional application of the transfer pricing regime. It is necessary, therefore, to consider the application of this
traditional regime to multinational banks to demonstrate the inadequacies of such a regime.

While this chapter concludes that the arm’s length pricing model is theoretically flawed when applied to multinational banks, chapter six considers the flaws in its application to these entities. Chapter six demonstrates that the arm’s length pricing model also fails to work in practice.
Chapter 6

The Fundamental Failing of the Traditional Transfer Pricing Regime – Conceptual and Transactional Comparability

6.1 Introduction

Separate accounting as applied to a unitary business thus suffers from the inherent defect that ... it operates in a universe of pretense. As in 'Alice in Wonderland,' it turns reality into fancy, and then pretends it is in the real world. The essence of the separate accounting technique of dividing the income of a unitary business is to ignore the interdependence and integration of the business operations conducted in the various states and treat them instead as if they were separate, independent, and nonintegrated.1

(Emphasis added)

While it may appear trite to refer to a children's fairytale written in 18652 to analyse the transfer pricing regime as it applies to multinational banks in 2003, nothing could be further from the truth. The above quote succinctly states the fundamental problem with the application of the current transfer pricing regime – it ignores the economic reality of the multinational enterprise. The reality is ignored through the separate entity approach, which requires comparisons to be drawn between parts of a multinational entity and unrelated entities. The arm's length principle 'starts from the fiscal myth that every subsidiary and permanent establishment within a group is a separate entity which conducts trade under free-market conditions with other entities in the group'.3 Chapter six contends that the current OECD approach does turn reality into fancy, and then pretend it is in the real world. This chapter proposes that OECD does this by pretending that integrated parts of an entity are in fact separate, and then pretending that those separate parts transact as if they were wholly independent.

2 Lewis Carroll, Alice in Wonderland (1865).
Chapter five raised the concept of ‘comparability’ that underpins the traditional arm’s length methodologies required by the current transfer pricing regime. Both of the steps that must be undertaken to achieve the OECDs desired outcome utilise this concept. This chapter considers the two-step process suggested by the OECD to determine the allocation of profits to each of the part of a multinational bank. The first step is to determine the hypothetical distinct and separate enterprise through conceptual comparability. Once this is done, the second step is to attribute profits to that hypothetical entity through transactional comparability. At present, the only way a multinational financial institution can ensure compliance with the current regime is a clear articulation of the economic activities taking place within a jurisdiction (a functional analysis) and a sound means of attributing profits to those activities (a transfer pricing methodology), that is, undertaking the two step process.

This chapter examines the concept of comparability in the context of multinational banking transactions to establish that having such a requirement in a regime which applies to multinational banks may result in an outcome which is economically flawed. This is primarily due to the fictional nature of the arm’s length requirement and the unique nature of multinational banking. Very simply, there may be no comparables with which to determine the separate and distinct entity and to set the arm’s length price.

This chapter concludes that it may be arguable in some circumstances that the comparability requirement works in practice and may provide an objective and determinative standard. This is only the case, however, where comparables actually exist; otherwise there is a fiction. It appears that this fiction is aggravated by the practice of multinational banking. The first step of conceptual comparability attempts to equate a multinational banking branch or subsidiary to that of a local bank not affected by globalisation or international demand of existing clients. The second step becomes even more far fetched, as it requires comparisons with independent transactions when they do not exist. The suggested fiction of each step

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is examined in turn.

6.2 **Step 1: Conceptual Comparability – Determining the Hypothetical Distinct and Separate Banking Enterprise**

The fundamental concept of ‘comparability’ underpins the traditional transfer pricing regime and arm’s length methodologies. Under the traditional regime, to arrive at an arm’s length price the question being asked is, ‘what would have happened if the ownership link had been severed and the enterprise was motivated by its own economic interest?’ The relevant question, therefore, is how the terms of that firm’s transactions would have been affected had that common ownership been absent.

Determining what the entity would *look like* if the ownership link were severed is the first step in the comparability process, or what this thesis refers to as conceptual comparability. This step necessitates the consideration of a bank branch or subsidiary as a separate entity, wholly independent of the remaining parts of the enterprise. Further, where the entity in question involves a branch, it requires the hypothesising of that branch equating to a subsidiary that is then treated as wholly independent. This step is undertaken through the process of comparisons with such separate and distinct entities.

While most commentary on the comparability requirement of the transfer pricing regime relates to individual transactions and determining an arm’s length price for those transactions, the analysis of this step, undertaken in the OECD 2001 discussion draft suggests that this preliminary step requires significant examination. The discussion draft states that it is necessary at the outset to undertake a

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5 *Taxation Ruling TR 97/20* paragraph 2.5.


7 See eg, literature referred to in part 6.3.

comparability analysis to determine what a distinct and separate enterprise would look like.\textsuperscript{9}

The overall approach to determining comparability, through a functional analysis is based on the belief that 'compensation will usually reflect the functions that each enterprise performs'.\textsuperscript{10} It is believed that this functional analysis allows a comparison to be drawn between the functions performed by the subsidiary or branch of the multinational bank and an unrelated party. The purpose of the functional analysis is to reveal the contributions made by the different parts of the entity so that the performance of those functions can be rewarded in accordance with the arm's length principle.\textsuperscript{11}

A functional analysis is described by the OECD, in its 1995 Transfer Pricing Guidelines, as 'an analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions.'\textsuperscript{12} It stresses that particular attention should be paid to the structure and organisation of the group,\textsuperscript{13} and elaborates in a general context, factors that should be considered.

The process of a functional analysis requires the taxpayer to consider the relevant characteristics of the branch or subsidiary. The 2001 OECD discussion draft recognises that, in undertaking this consideration 'it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal

\textsuperscript{9} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 14(44).


entity. This would appear to be a measure which attempts to align the current tax model with economic reality. It is suggested, however, that merely recognising economic activity does not equate to an allocation based on economic activity.

In both the 1998 discussion draft and the 2001 discussion draft, as updated, released by the OECD the importance of a functional analysis is stressed. The 1998 discussion draft provides, 'in the global trading context, the carrying out of a careful functional analysis will be particularly important because of the wide range of significant functions potentially involved, the variety of risks that can be assumed or transferred, the global dispersal of the performance of many functions and the wide variation in business structures and organisation'. This statement is also made in the 2003 update. Further, similar statements are made in part II of the 2001 discussion draft. For example, it states that the functional and factual analysis allows for the appropriate hypothesizing of the permanent establishment and the rest of the bank as associated enterprises. This statement is also included in the 2003 update to part II.

Under the current regime where there is a subsidiary of a multinational bank, it is necessary to undertake a functional analysis to determine the tasks performed by that subsidiary. While the subsidiary is a legal entity in its own right, it is not distinct from the entity as a whole. The first step, therefore, is to imagine that subsidiary as if it was an independent bank undertaking arm's length transactions with a foreign bank. Where the multinational bank operates through a web of subsidiaries, this process is still necessary but relatively straightforward.

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17 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (2001) 60(95).

18 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 29(131).
Where there is a branch of the multinational bank, it is necessary to go a step further as there is the issue of hypothesising a separate enterprise where one does not exist. In this sense, it is necessary to imagine what a subsidiary might look like and then imagine that subsidiary to be unrelated to the group. The first step to determine the profits to be attributed to that permanent establishment is to determine the activities and conditions of the hypothesised separate enterprise, that is, assuming it to have a separate legal personality. The 2001 discussion draft provides that the 'first step of the working hypothesis will apply a functional and factual analysis to the permanent establishment in order to determine the functions of the hypothesised distinct and separate enterprise and the economically relevant characteristics relating to the performance of those functions.'

The outcome of this requirement is that where the multinational banking structure involves branches, it is not simply the case of undertaking a functional analysis to determine what the entity would look like were it not a related entity. Rather, it is necessary to take a further step in imagining a separate legal entity where one does not exist. Consequently, when applied to subsidiaries, the separate entity approach follows legal form but ignores economic reality. When applied to branches, both legal form and economic reality are ignored.

While this step is required for all multinational entities, it is suggested that the problems are exacerbated for multinational banks because the types of transactions undertaken by these banks are ones that only a multinational could undertake. As such, it is not possible to determine what the hypothetical distinct and separate enterprise would look like by comparison. The discussion drafts released by the OECD, however, do purport to identify the key economic functions of the entity in order to undertake this functional analysis.

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6.2.1 The Functional Analysis

The first part of the functional analysis is the ascertainment of the economically significant functions undertaken by the bank as a whole. When a functional analysis is undertaken for multinational banks, given the differences in management philosophies, investment technology, market strategy, and other factors, few generalisations are possible regarding the way financial intermediaries organise global trading operations.\(^\text{20}\) This is particularly relevant where the multinational bank undertakes global trading business. The difficulty in making such generalisations, because of the wide range of potentially significant functions, is recognised in the OECD 1998 discussion draft,\(^\text{21}\) and the 2003 update.\(^\text{22}\) Certain broad categories of activities can, however, be ascertained. The operations of a financial institution generally comprise of four elements: trading; sales; management and support; and capital,\(^\text{23}\) with the activities that give rise to transfer pricing issues generally being categorised as funding activities, services, and trading.\(^\text{24}\) These activities, in the OECDs discussion drafts, are considered relevant to the business of banking, and therefore, are taken into account as significant functions for the purposes of a functional analysis.

Both the original 1998 OECD discussion draft and the original 2001 OECD discussion draft provide detail on what are considered the significant functions undertaken in the banking business generally, and the specific business of global trading. The 2001 discussion draft provides greater detail as to what are considered the economically significant functions of the business of multinational banking in general. The earlier document does not provide this detail, however, it considers that


in the context of global trading there are two functions considered to be of consequence: first, the people functions; and second, the use of capital. The 1998 approach can be summarised as follows:

The first category, people functions, is divided into sales and marketing, trading and risk management, and support. The sales and marketing personnel, usually assigned to a particular geographical area, deal directly with the clients, and as such are the face of the enterprise. Trading and risk management on the other hand, depends on how the enterprise chooses to spread its risk. Finally, support personnel are usually centrally located in order to reduce costs. The location of the last two functions, while both being centralised, may be in different locations.

The second category of functions relating to global trading is the role of capital and the assumption of risk. The multinational banking entity needs this attribute of capital to fund its cash needs and assume risks. The 1998 discussion draft identifies credit risk and market risk as the most common of the risks, however, it also recognises legal risk as one that is attached to global trading.

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Part II of the original 2001 discussion draft, which deals with special considerations for applying the working hypothesis to permanent establishments of banks, goes into greater detail to determine what are the significant functions of the business of multinational banking. The discussion draft stresses that to do this it is necessary to undertake a 'functional and factual analysis to identify the economically significant activities and responsibilities undertaken by the enterprise as a whole, before going on to identify which of those economically significant activities and responsibilities are undertaken by the PE, and to what extent'.\textsuperscript{30} (Emphasis added) As such, not only is it the significant functions of the branch (or subsidiary) that need to be considered but rather the economically significant functions of the whole multinational entity.

The 2001 discussion draft again outlines what are considered the important functions undertaken in the traditional business of banking, dividing such functions into three categories: functions performed; assets used; and risks assumed. The functions performed can be divided into the functions involved in creating a new financial asset and the functions involved in managing an existing financial asset.

The approach of the 2001 discussion draft in its original form can be summarised as follows:

Where there is the creation of a financial asset, the multinational bank as a whole would undertake the following: sales/marketing; sales/support; sales/trading; trading/treasury; and sales/support.\footnote{OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 43(5).} Where there is the management of an existing financial asset the following functions would be performed: loans support; monitoring risks assumed as a result of entering into the loan; managing risks assumed as a result of entering into the loan; treasury; and sales/trading.\footnote{OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 44(6).} Ancillary functions performed by the multinational bank as a whole, generally called back
office functions, would include the infrastructure necessary to support the above functions.\textsuperscript{33}

A functional analysis also requires a consideration of the assets used by the multinational bank as a whole. There are three general categories of assets: first, physical assets such as premises and computers;\textsuperscript{34} second, intangible assets such as the marketing of the name and reputation;\textsuperscript{35} and third, capital.\textsuperscript{36}

The third element of a functional and factual analysis of a multinational bank is to consider the risks assumed. The three most important risks for tax purposes are considered to be credit risk, market interest rate risk, and market foreign exchange risk.\textsuperscript{37} The 2001 discussion draft, in its original form, stated that a banks credit rating, capital adequacy requirements, other regulatory requirements, and ‘free’ capital also need to be taken into account.\textsuperscript{38} Emphasis was not placed on these risks as being of undue significance.

The newly released updates to the 2001 discussion draft, which also encompass updates to the 1998 discussion draft, have further developed what are considered the economically significant functions. Of particular interest is the inclusion of a separate category of capital and funding. The update to part II of the 2001 discussion draft suggests that, while a functional analysis should be undertaken in the same manner for banks and financial institutions as would be undertaken for non-financial institutions, capital plays a further important role in assessing the economically

\textsuperscript{33} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 44(7).

\textsuperscript{34} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 44(9).

\textsuperscript{35} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 44(10).

\textsuperscript{36} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 44(11).

\textsuperscript{37} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 45(12).

\textsuperscript{38} OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 45-47.
significant functions where the business of banking is undertaken. Consequently, under the category of capital and funding, an examination of capital adequacy and attribution of capital is required. Free capital is also stressed to be a significant factor, especially for branches of multinational banks.

Also new in the updates to the 2001 draft discussion, is the inclusion of part III which specifically deals with the global trading of financial instruments. The significance of this update is the fact that the functional analysis and the ascertainment of the economically significant functions for global trading has been brought into line with what are considered to be the economically significant functions for multinational banking generally. It was stated earlier, that the 2001 discussion draft provides greater detail than the 1998 discussion draft. The updates mean that this is no longer the case, nor is it the case that there is a divergence in what are considered the economically significant functions.

Once a functional and factual analysis of the multinational bank as a whole has been undertaken, it is necessary to attribute the relevant factors to the bank’s permanent establishment. The working hypothesis provides that the next part of the process is to determine which of those functions the permanent establishment performs, what assets are used, and what risks are assumed as a result of performing those functions. This process is difficult for a multinational bank, particularly the allocation of capital and risk to a branch.

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39 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) 8(26).

40 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) 8(26).


42 OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks) (2003) 14(57); OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 49(31).
The update to the OECD 2001 discussion draft recognises that capital and risks are not segregated from each other within a single entity. Yet, the discussion draft maintains that a functional analysis can be used to attribute assets and risks to a branch, with capital allocated that supports the attributed risk. Free capital is also allocated based on the amount needed to support the functions performed. The 2001 OECD discussion draft stresses that the attribution of capital is a pivotal step in the process of profit attribution to branches of multinational banks. While this document acknowledges the difficulties in doing so, it maintains that an arm’s length result can be achieved, thereby conforming to the traditional approach to the problem of transactional allocation.

The overall approach of the functional analysis assumes that it is possible to allocate to the various parts of the multinational bank, whether subsidiary or branch, the economically significant functions perform. That is, the functions can be separated into distinct parts. It needs to be questioned, however, whether this is actually the case.

6.2.2 The Fiction of Step One

The multinational entity is a business which trades in joint products and intermediate goods. The multinational bank, whether undertaking traditional banking business, or global trading, is one such multinational where the business is that of intermediate

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44 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 15(60).

45 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 18(79).


47 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 27(121).

services and products which are not traded on the open market. Consequently, it is a fiction to suggest that the activities undertaken by these multinational banks can be allocated with any certainty or precision to the separate parts of the entity.  

The identification of the economically significant functions performed by the multinational bank as a whole is relatively easy to identify. The OECD discussion drafts have attempted to do this. Even then, this identification is an evolving process with the relative degree of complexity increasing dramatically between 1998 and the updated discussion draft of 2003. This in itself poses problems, as multinational banks continue to evolve and develop new and innovative products and ways of doing business. Identification of economically significant functions, however, is not the most difficult issue.

The difficult issue to overcome, once the economically significant functions of the entity as a whole are determined, is allocation of those functions to the different parts of the multinational bank. By allocating functions to the separate parts of the entity, the transactions between the parts of the entity become obvious. Often, however, the line cannot be drawn on this allocation. The reason that activities typically cannot be allocated with certainty to the various branches, divisions, affiliates, or subsidiaries of a multinational bank is threefold: their highly integrated nature; their existence because of market failure; and the differences in related and non-related relationships.

The first reason that the economically significant activities cannot be allocated with any certainty to the separate parts of the multinational bank, is that one of the unique features of the bank is that they offer intermediary services. Because of these intermediary services, the multinational bank is highly integrated on a worldwide basis. Where the integrated trading model is adopted by multinational banks the problem is exacerbated. Compounding this high level of integration is the economic interdependence created through vertical integration adopted by the multinational

banks. It is this interdependence that is the very nature of the multinational entity, especially multinational banks. As such, it is increasingly difficult to separate the multinational banks into component parts. Consequently, this process of allocation, and the untangling of profits of integrated activities 'becomes an artificial exercise and rules-of-thumb measures often have to be adopted.'

The obvious solution would be to not untangle the activities. Global trading, the most integrated activity undertaken by multinational banks, would seem to fall within the category of being an artificial exercise and, as such, not warrant the untangling. The 1998 discussion draft, however, rejected this possibility, stating that anything done on a consolidated level failed to meet the arm's length requirement.

The second reason that it is difficult to allocate activities to the different parts of the multinational bank is because of the very reason for the existence of multinational banks. Internalisation theory suggests that multinational banks exist because of market imperfections. The first step, requiring the functional analysis, is to determine the economically significant functions and then allocate those functions to the parts of the entity based on a comparison with distinct and separate enterprises. Yet, where multinational banks exist because of market imperfections, these distinct and separate enterprises will simply not exist because the successful multinational banks will have driven non-multinational competitors out of the market. Reuven Avi-Yonah explains the consequences of this:

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Therefore, allocating economically significant activities to a part of a multinational bank based on the economically significant activities of a distinct and separate enterprise is a fiction because this distinct and separate enterprise does not exist.

The third reason that it is difficult to allocate activities to the different parts of the multinational bank is that the relationship between related parties is one of control, whereas the relationship between non-related parties is one of contract. Economically significant activities of a separate and distinct entity would reveal the functions undertaken in the negotiations between non-related parties. An investigation of related party functions will not reveal similar activities. Parties within the multinational bank are not dealing in the open market so there are no open market negotiations. Activities, therefore, are different, and transactions are based on different terms. Robert Green explains this in terms of expectations using intangibles as an example:

[U]nrelated firms dealing at arm's length often determine prices on the basis of expectations. In the case of transfers of intangible property, the transferee generally will use the property over a period of time as part of a productive process, and therefore will value the property based on projections of how much it will contribute to future earnings. Any approach to determining arm's length prices that is not based on expectations at the time of the transfer will be difficult to defend as being consistent with the arm's length principle. The alternative, an approach to determining arm's length prices that is based on such expectations, will inevitably be indeterminate and difficult to administer.

The first step of comparability requires an analysis of the multinational bank to
determine what it would look like if it were divided into its component parts and
those parts operated independently. Yet, this is not how multinational banks operate.
Multinational banks operate as highly integrated businesses, taking advantage of
market imperfections and their intermediary role, to operate as a whole, which
cannot be divided without a high degree of hypothesising. Consequently, while it
may be possible to determine the economically significant functions undertaken by
the bank as a whole, it is not possible to allocate these functions with any degree of
accuracy. As such, the first step of conceptual comparability becomes a fiction for
multinational banks. Despite this fiction, the arm’s length standard requires a
second step of transactional comparability, which determines the profits to be
allocated to the hypothetical distinct and separate entity, based on what are
considered the economically significant activities undertaken by the branch or
subsidiary.

6.3 Step 2: Transactional Comparability - Determining the Profits of
the Hypothesised Distinct and Separate Entity

The second step in the arm’s length process is to determine the actual profits
attributable to the subsidiary or branch of the multinational bank. Underpinning this
determination is the supposition that multinational banks should be treated the same
as traditional multinational entities. Therefore, the traditional arm’s length rules
applicable to multinational entities in general are applied to multinational banks.
This requires an analysis of the application of the traditional arm’s length pricing
methodologies. Where the multinational bank operates through subsidiaries in
foreign jurisdictions the process will involve the determination of whether the related
party transactions have occurred at an arm’s length price through a comparison with
arm’s length transactions. This is a difficult process in itself. Where, however, the
multinational bank operates through branches in foreign jurisdictions there is the
added fictional step of imagining transactions to exist where they may not.

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59 See chapter five, part 5.3.1.
In addition, underpinning the step of transactional comparability is the supposition that branches and subsidiaries are to be treated the same.\textsuperscript{60} By recognising the structural differences adopted by multinational banks, the traditional regime then encounters problems when applying the same principles to branches as subsidiaries. Prior to an examination of the application of the traditional arm’s length methodologies, and the fiction of the second step, the difficulties associated with the application to permanent establishments are addressed.

6.3.1 Issues Specific to Permanent Establishments

The 2001 OECD discussion draft provides the strongest evidence of the desire to treat branches and subsidiaries the same, while recognising problems unique to the branch format. The discussion draft summarises its transfer pricing position for permanent establishments by stating:

\begin{quote}
Where inter-branch dealings take place, the factual and comparability analysis will attribute profit in respect of the dealings by reference to comparable transactions between independent enterprises. The guidance in the Guidelines in undertaking such analysis is applied, by analogy, in light of the particular factual circumstances of a permanent establishment and as a result of testing the working hypothesis.\textsuperscript{61}
\end{quote}

The Guidelines are an interpretation and application process for Article 9 of the OECD Model Tax Convention dealing with related party transactions, not internal transactions. Consequently, before this analogy can be drawn several preliminary matters need to be addressed.

\textsuperscript{60} See chapter five, part 5.3.2.

\textsuperscript{61} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 23(90).
6.3.1.1 The Profits of an Enterprise

To determine the profits attributable to the permanent establishment it is first necessary to establish the profits of an enterprise. While most contention relates to the determination of the attributable profits, the 2001 OECD discussion draft addresses the issue of the question that needs to be addressed first: what are the ‘profits of an enterprise’? There are two possible approaches to this question. The first method is the relevant business activity approach, which defines the profits to include only those in which the permanent establishment has some participation. The second method is the functionally separate entity approach, which attributes profits to the permanent establishment that it would have earned at arm’s length as if it were a ‘distinct and separate’ enterprise.

The 2001 OECD discussion draft maintains consistency with its traditional approach to transfer pricing, concluding that the ‘functionally separate entity’ approach is the more sound method, and as such, preferred. It states the reason for this is threefold. The first reason is that the functionally separate entity approach does not impose a profit limitation on those profits which are attributable to the permanent establishment, thereby not affecting the application of the arm’s length principle. The relevant business activity approach may impose a profit limitation on the permanent establishment, as the attributable profits could not exceed the profits of the enterprise as a whole, including taking into account losses.

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64. OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments (2001) 10(22).
It is argued that the second reason for adopting the ‘functionally separate entity’ approach is that it is also more desirable administratively as it does not require the host country to determine the enterprise’s total profits from the relevant business activity.\textsuperscript{68} The 2001 OECD discussion draft provides that third reason for adopting the functionally separate entity approach is that the ‘functionally separate entity’ approach meets the criteria of consistency, as it mirrors the analysis undertaken where there is a subsidiary involved. In support of the ‘functionally separate entity’ approach the discussion draft states:

The WH [working hypothesis] is that the profits to be attributed to a PE [permanent establishment] are the profits that the PE would have earned at arm’s length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). The phrase ‘profits of an enterprise’ in Article 7(1) should not be interpreted as affecting the determination of the quantum of profits that are to be attributed to the PE, other than providing specific confirmation that ‘the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.’\textsuperscript{69}

While this approach is consistent with the OECD views on the application of the traditional transfer pricing regime and arm’s length requirement, it fails to recognise the fact that multinational bank branches do not operate as functionally separate entities. Consequently, it may be argued that the failure of this approach is that of the failure of the arm’s length principle in general.

6.3.1.2 A ‘Real and Identifiable’ Event

Where the transactions in question are within a multinational entity with a parent-subsidiary structure, these transactions will generally be clearly defined because of the separate legal identity of the individual parts. Where, however, the transactions in question are internal to the entity, there may not be clearly defined transactions.

As a result, where there are branches of a multinational bank, it is first necessary to

\textsuperscript{68} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 12(29).

determine whether there are dealings in relation to that branch. That is, prior to the allocation of profits, the threshold question is whether inter-branch dealings have taken place, and therefore should be recognised for taxation purposes.\textsuperscript{70}

In order for a transaction to be recognised for taxation purposes there must be a real and identifiable event. A functional analysis determines whether such an event occurred and whether it should be taken into account as an economically significant dealing.\textsuperscript{71} This is distinguished from the functional analysis of step one, used to determine economically significant functions.

Once the dealings are identified, it is necessary to consider whether they are a real and identifiable event. A functional analysis is again used to determine whether the event should be taken into account as an inter-branch dealing of economic significance.\textsuperscript{72} If it is established that an event is to be taken into account, the profit to be attributed to the permanent establishment can be determined by considering the arm's length price. Again, the working hypothesis provided by the 2001 OECD discussion draft is to undertake a comparison of dealings between the permanent establishment and the enterprise of which it is a part, with transactions between independent enterprises.\textsuperscript{73}

The failing of this process is the fact that there simply may be no internal transactions to recognise. The multinational bank operates as an intermediary, often providing services in one jurisdiction, but borrowing and on-lending money (product) in another. While there is substantial economic activity undertaken in the service location, there may be no real and identifiable event that occurs between the service location and the product location. By requiring the separation into the

\textsuperscript{70} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 19(68).

\textsuperscript{71} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 19(69).

\textsuperscript{72} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)} (2003) 30(134); OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 61(98).

\textsuperscript{73} OECD, \textit{Discussion Draft on the Attribution of Profits to Permanent Establishments} (2001) 19(67).
component parts, the arm’s length requirement fails to recognise the interrelated nature of the intermediary services.

Despite the inherent difficulties, the 2001 OECD discussion draft believes that, in the context of internal transactions, there are several key areas that warrant special attention in the allocation process as potentially significant events. The 2001 OECD discussion draft recognises that special factors need to be taken into account to accurately reflect the use by the permanent establishment of group resources. Where there is a subsidiary all transactions for items such as the use of capital and intangibles are recognised as true transactions. Where, however, there is a branch, the issue of recognising internal transactions become more complex as often there will be no internal recognition. Where the arm’s length standard is applied, there are particular circumstances that must be taken into account in light of the branch status. These factors are the use of capital assets, the use of intangible assets, the provision of internal services, capital allocation, and the funding of the permanent establishment’s operations.

Capital Assets

Where there is the use of a capital asset, such use will normally be exclusive to the permanent establishment. Further, if there is a payment made for the contribution to the cost of capital, a deduction is consistent with the arm’s length approach.  

Difficulties may arise, however, where there is a change in the use of the capital asset, or there is the temporary use of a capital asset. Where there is a change in use of a capital asset, where that asset now contributes to the profits of the permanent establishment, the question arises as to how to account for the acquisition and use by the permanent establishment. It is difficult to apply, by analogy, the independent enterprises comparison, as such a transaction would involve a legally binding contractual arrangement specifying the terms of the transfer. The 2001 OECD discussion draft suggests that one way to determine the transfer price is fair market

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value, but recognises that there are problems associated with this.\textsuperscript{75} The 2001 OECD discussion draft believes that that a temporary change in the use of an asset should be treated in the same manner.\textsuperscript{76}

**Intangible Assets**

Where there is the use of intangible assets, it is possible that the asset will attach to one part of the entity through a purchase. Again, a deduction for a payment made as a contribution to the cost of intangibles, and a deduction for the costs associated with the permanent establishment is considered consistent with the arm's length standard.\textsuperscript{77} The common type of intangible asset, however, is a result of research and development, marketing, and advertising activities and it will commonly be used simultaneously by different parts of the enterprise.\textsuperscript{78} Thus, the ascertainment of the permanent establishment's contribution and costs is a formidable exercise.

The working hypothesis of the 2001 OECD discussion draft requires that 'the decision about attribution of profits based upon an inter-branch dealing in relation to intangible property would be fully dependent on an analysis of the facts and circumstances'.\textsuperscript{79} The discussion draft suggests that there are a number of possible outcomes from this analysis. For instance, the intangible property could be considered to have been bought, a licence could have been granted, or there could be a type of cost contribution arrangement.\textsuperscript{80} There is also the question of whether the permanent establishment contributed to the creation of the intangible asset, and, in


\textsuperscript{78} OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (2001) 27(109).

\textsuperscript{79} OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (2001) 27(113).

\textsuperscript{80} OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments* (2001) 27(113).
that case, profits would also be attributable to the permanent establishment. The notional right to use an intangible also provides unique problems for the determination of attribution, as does the simultaneous use of intangible property. Further, the 1998 discussion draft argues that any payments made for the use of intangible rights - such as payment of royalties - should not be recognised for taxation purposes under the arm's length principle, as legal ownership of an intangible cannot be attributed to any particular part of the enterprise.

The OECD discussion drafts offer little in the way of solutions to each of these potentially difficult areas, except suggest that a comparability analysis is necessary to determine attribution.

Internal Services

Where there is the provision of internal services the OECD discussion drafts provide little guidance except to state that the 1995 Transfer Pricing Guidelines should be relied on and any internal services should be treated as arm's length dealings. The 1998 discussion draft does provide more detail than the 2001 discussion draft stating that where the provision of services is the main activity of the permanent establishment and the services provided are the same type of services performed for third parties, a mark-up over cost is accepted as appropriate.

Capital Allocation

The working hypothesis requires an appropriate amount of capital to be allocated to the permanent establishment. The appropriate amount will reflect that required to

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support the functions performed, assets used and risks assumed. This requires an allocation of both free capital and capital other than free capital. Where multinational banks operate through a head office-branch structure, only the capital adequacy requirements of the home country need to be met. Where there is a parent-subsidiary relationship, the capital adequacy requirements for the subsidiary need to be met in its own jurisdiction. As a result, to equate a branch with a subsidiary a degree of free capital needs to be allocated to the branch. The 2001 OECD discussion draft suggests that the free capital should be allocated based on the risks accepted, and a higher risk would require greater capital. Part III, dealing with the global trading of financial instruments maintains the same measure of free capital allocation.

Once the risk associated with the permanent establishment have been determined, it is necessary to allocate the free capital to those risks. Capital, other than free capital, also needs to be allocated to the permanent establishment. The 2001 OECD discussion draft lists several ways to determine this allocation but is not decisive in its recommendation. This document concludes:

[The consultation process has also shown that it will not be possible to develop a single internationally accepted approach for making that attribution of capital, including free capital. Further, a review of the domestic law of OECD Member countries shows that there are different views on the preferred approach to capital attribution, and so it will not be possible to develop an internationally accepted hierarchy of approaches.]

Despite the recognition of these potentially difficult areas of allocation to determine the significant events that occur between the various parts of multinational banks, the

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85 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 18(79).

86 'Free Capital' refers to retained profits or equity. That is, money on which no dividends or interest are payable.


89 OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments Part II (Banks)* (2003) 27(120).
OECD still requires the use of the recognised arm's length methodologies to determine the transactional allocation of income to the relevant jurisdictions. These traditional arm's length methodologies are examined in turn.

6.3.2 Arm's Length Methodologies

Currently, the 1995 Transfer Pricing Guidelines is the only authoritative OECD document for the application of the arm's length standard to multinational entities. Furthermore, the discussion drafts maintain that this document provides the guidance necessary for the application of the arm's length standard to multinational banks, whether undertaking the business of traditional banking or global trading. Because there is no authoritative statement on the use of a method other than arm's length for allocating the profits of multinational banks, it is necessary to consider the suggested traditional methodologies.

The Australian adoption of the standard arm's length methodologies provides a useful example of their operation. There are various arm's length methodologies, recognised both internationally and by the Australian Taxation Office. The Australian Taxation Office has issued two rulings specifically dealing with the suitable arm's length pricing methods. The first is Taxation Ruling TR 94/14, which provides the foundation to determine the most appropriate arm's length methodology for a given transaction. Taxation Ruling TR 97/20 - Income tax: arm’s length transfer pricing methodologies for international dealings, expands on Taxation Ruling TR 94/14 and provides the practical guidance that Taxation Ruling TR 94/14 lacks. The ruling considers the factors that the Commissioner believes should be taken into account in selecting a particular methodology, along with the circumstances in which the various methods are considered the most appropriate. The ruling also considers various definition issues pertaining to the different methodologies. As with Taxation Ruling TR 94/14, Taxation Ruling TR 97/20 is also limited to transactions between separate legal entities and as such does not address transactions entered into between branch offices, divisions, and permanent
establishments of a single entity.\textsuperscript{90}

Specifically, \textit{Taxation Ruling TR 97/20} closely reflects many of the views expressed in the 1995 OECD Transfer Pricing Report, relying on most of its definitions and practical examples. Further, the ruling provides ‘... when applying Division 13 and the Associated Enterprises Articles of Australia’s double tax agreements, the Australian Taxation Office follows as closely as practicable the OECD guidelines on transfer pricing methodologies for the application of the Associated Enterprises Article of the OECD Model, being the considered view of many tax administrations with extensive experience on transfer pricing.’\textsuperscript{91}

As stated in chapter five, the recognised arm’s length methodologies can be categorised into two basic divisions: the traditional methods; and the profit methods. The first category consists of the comparable uncontrolled price, the resale price and the cost plus methods. It is the view of the OECD and the Australian Commissioner of Taxation that these are to be preferred over the alternative profit methods. The second category includes, but is not limited to, valuation procedures such as the profit split and the profit comparison methods.\textsuperscript{92} While both the Commissioner and the OECD have stated that the traditional methods are preferred over the profit methods,\textsuperscript{93} it has been recognised that highly comparable data is required in order to apply the former.\textsuperscript{94} Where there is adequate highly comparable data the preferred traditional approach is the comparable uncontrolled price method.\textsuperscript{95} The traditional methods are considered in turn. The non-traditional methods are considered in

\textsuperscript{90} \textit{Taxation Ruling TR 97/20} paragraph 2.

\textsuperscript{91} \textit{Taxation Ruling TR 97/20} paragraph 1.13.

\textsuperscript{92} It should be noted that the transactional profit methods are different to unitary taxation. Taxing authorities generally believe that an allocation based on profit split is consistent with the arm’s length principle on the basis that it ‘takes into account the facts and circumstances of each particular taxpayer’s situation and seeks to achieve the best estimation of what independent parties might have reasonably expected to have agreed to in a joint venture relationship.’ See for example: \textit{Taxation of Financial Arrangements - An Issue Paper}, Commonwealth Treasury December 1996 (16.52).

\textsuperscript{93} \textit{Taxation Ruling TR 97/20} paragraph 2.3.

\textsuperscript{94} \textit{Taxation Ruling TR 97/20} paragraph 2.27.

\textsuperscript{95} \textit{Taxation Ruling TR 97/20} paragraph 3.15.
6.3.2.1 Using the Comparable Uncontrolled Transaction Method

The comparable uncontrolled price method is defined as a method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. Essentially, the comparable uncontrolled price method determines an arm's length price by reference to comparable transfers between unrelated parties in comparable markets. The arm's length price is then set by reference to these comparable transfers. This is the only objective way to determine the arm's length price using a traditional method, but seldom is it possible.

In 1984 the OECD believed that the widespread existence of markets for the borrowing and lending of money in various forms, the fact that banks frequently borrow and lend large sums to each other on inter-bank markets, and the common phenomenon of recognised inter-bank lending rates means that a comparable arm's length price can be easily derived. The OECD believed that this resulted in the comparable uncontrolled price being the most suitable, especially where there is short term borrowing and there are transactions which are between unrelated banks for the same amount lent, the same term and the currency involved, along with other terms are the same or similar. This 1984 document is the only OECD document relating to multinational banking that is in final form. All later relevant documents are merely drafts, which to date, have not been agreed to.

96 OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995) II-2 (2.6); examples of the method appear in paras 2.10 to 2.13; also TR 94/14, paragraphs 88 to 93 and 353 to 358. This definition is adopted by Taxation Ruling TR 97/20 paragraph 3.10.


Where the transactions do not involve interest on loans, but rather are intra-group services, the OECD believes that the arm’s length standard could also be adequately applied.\textsuperscript{100} This thesis refutes this proposition on the basis that it is not possible to find comparables.

To determine whether there is a comparable product ‘[t]he most important comparability factors are similarity of product, contract terms and economic/market conditions.’\textsuperscript{101} While these factors have the greatest bearing on comparability, other factors such as business strategies, and the relative bargaining power of the parties may influence the comparability factor.\textsuperscript{102}

As with all of the traditional methods, the primary limitation of the comparable uncontrolled price method is the comparability factor. The initial problem is how to determine a comparable product, or in the case of multinational banks, finding a comparable service. For example, where the transfer is specialised or unique there may be no comparable service or product in existence. Further, because of the nature of the service there may not be an unrelated market. For example, where the transfer involves work in progress there is no external market.

Problems with the comparable uncontrolled price method also arise where the transfer involved is intangible or involves the provision of services, as issues such quality come into play. This may clearly be the case with a multinational bank due to the different risk associated with different banks. Alternatively, while there may be a comparable service, it may not be possible to obtain a competitor’s prices. All of this means there is opportunity for the taxpayer to manipulate the transfer price and there is no way for the taxing authority to check its appropriateness. If any of these scenarios, considered in detail below is the case, the comparable uncontrolled price method will not be workable and an alternative method will need be


\textsuperscript{101} \textit{Taxation Ruling TR 97/20} paragraph 3.14.

\textsuperscript{102} \textit{Taxation Ruling TR 97/20} paragraph 3.14.
considered.

While there may not be a directly comparable product, it may be possible to still use the comparable uncontrolled price method, however, this would involve an adjustment of the comparable price to result in an adjusted comparable uncontrolled price. This is a less objective approach where unrelated firms that engage in similar, though not identical, transactions under similar circumstances, are considered.\footnote{Robert A Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Cornell Law Review 18, 37.} Inherent in this approach is the problem of the subjectivity of the valuation of the differences, which, in turn, will affect the reliability of the adjusted comparable uncontrolled price. Despite difficulties associated with any adjustments necessary the Australian Commissioner of Taxation has stated that the comparable uncontrolled price method should not be routinely dismissed.\footnote{Taxation Ruling TR 97/20 paragraph 3.15.}

The 1998 OECD discussion draft provides one such example for the use of this method in relation to multinational banks. It provides where there are sales and marketing functions undertaken and the transactions occur between unrelated parties, the amount and type of reward depends on the level of service provided.\footnote{OECD, The Taxation of Global Trading of Financial Instruments (1998) 36(140) as updated by OECD, Discussion Draft on the Attribution of Profits to Permanent Establishments: Part III (Enterprises Carrying on Global Trading of Financial Instruments) (2003) 26(113).} The service may range from general sales personnel to highly specialised marketers providing benefits. When the controlled transaction is compared with the uncontrolled data, it is likely only to be possible to draw direct comparisons where the service provided is at a relatively low level of sophistication. Where, however, the services are highly specialised reasonably accurate adjustments need to be made by looking at further independent data.

If, however, differences cannot be measured and allowed for with any certainty then alternative methods should be considered.\footnote{Taxation Ruling TR 97/20 paragraph 3.15.} The 1998 OECD discussion draft recognises this potential problem and suggests that where this is the case
consideration should be given to the profit methods. It suggests that one possibility would be to add some share of the profit of the transaction to the basic commission payment. It also suggests that a profit split method may be justified where there is evidence of such a method is used by independent parties.\textsuperscript{107}

With these limitations impacting on the suitability of the comparable uncontrolled price method it is the most appropriate method where an uncontrolled enterprise sells an identical product to that sold by the taxpayer to an associated party. It is unlikely to be suitable where services are involved such as those undertaken by a multinational bank.

6.3.2.2 Using the Alternative Traditional Methods

When comparable uncontrolled transactions do not exist it is necessary to consider alternative models to determine what an unrelated entity would have charged had they engaged in the same transaction as the related multinational entity.\textsuperscript{108} Two further methods are considered traditional and appropriate alternatives to the comparable uncontrolled price method. These are the resale price method and the cost plus method.

The first of the alternative traditional methods, the resale price method, is defined in the 1995 OECD Transfer Pricing Report and Taxation Ruling TR 97/20 as:

A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g., customs duties), as an arm's length price of the original transfer of property between the associated enterprises.\textsuperscript{109}


The resale price margin is:

A margin representing the amount out of which a reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.\textsuperscript{110}

The arm's length price under the resale price method is determined by looking backwards, that is, by deducting from the sale price of the goods, when sold to an arm's length buyer, the taxpayer's costs, and an appropriate profit margin.

The resale price method can be set out in the following equation:

\[
\text{Resale price to an independent enterprise} - \text{gross margin} = \text{arm's length price}
\]

As with the comparable uncontrolled price method the primary limitation of the resale price method is the need for comparable independent dealings. Calculating the gross margin by reference to a percentage of the resale price where that percentage has not been determined by reference to a comparable uncontrolled dealing will not be acceptable except in extreme cases.

In addition to the difficulty associated with the concept of 'comparability', the resale price method has the further problem of placing a value on the gross margin. This gross margin, usually measured at the gross profit level,\textsuperscript{111} will vary according to the value added by the reseller. This amount should reflect two components; the costs incurred by the reseller in relation to the particular property and an appropriate profit. Factors affecting the relevant margin include the functions undertaken, assets employed, and risks assumed.


\textsuperscript{111} Taxation Ruling TR 97/20 paragraph 3.26.
The resale price method is most suitable where the reseller does little in the way of value enhancement to the property and there are independent parties who undertake comparable dealings. Where the reseller further processes the goods or incorporates them with other products, thereby creating a new one, it is more difficult to determine an arm's length price. Likewise, where the reseller is the owner of intangible property which relates to the product and hence adds value the resale price method may not be suitable.

The difficulties associated with the application of this method to the services provided by multinational banks are compounded by the fact that a bank may repackage money deposited by a lender in a financial product to suit a borrower.

The second of the alternative traditional methods is the cost plus method. The cost plus method is defined in the 1995 OECD Transfer Pricing Report and *Taxation Ruling TR 97/20* as follows:

Cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful if semi-finished goods are sold between related parties, related parties have concluded joint facility agreements or long-term buy-and-supply arrangements or if the controlled transaction is the provision of services.112

The cost plus method arrives at an arm's length price by looking forward, that is, it determines an appropriate mark-up of profit to be added to the cost of the property to the supplier.

The cost plus method can be set out in the following equation:

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112 *Taxation Ruling TR 97/20* paragraph 3.31. Examples of the method are found in the OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) 2.46 to 2.48 (also TR 94/14, paragraphs 97, 98 and 363 to 365).
Cost of property to supplier + cost mark-up = arm's length price

The cost base, upon which the mark-up is added, will consist of both the direct and indirect costs associated with the production of the property, that is, absorption costing\textsuperscript{113} is used to determine the cost of the property to the supplier.\textsuperscript{114} Indirect costs should be allocated on the basis of ordinary accounting principles, as the Australian Taxation Office evaluates the proportioning of indirect costs using these principles.

The appropriate profit mark-up, measured at gross profit level,\textsuperscript{115} is usually determined by reference to the profit margin added by the supplier in independent dealings. Where however the supplier does not engage in any independent dealings it may be necessary to determine the cost plus mark-up by reference to uncontrolled dealings of wholly independent parties.\textsuperscript{116} Calculating the profit mark-up by reference to a percentage of the cost price where that percentage has not been determined by reference to a comparable uncontrolled dealing will not be acceptable except in extreme cases.

The 1998 OECD discussion draft provides an example of where it is believed that the cost plus method is suitable for the use by multinational banks. It is recognised that there are difficulties in finding comparable uncontrolled prices when the comparability analysis is undertaken for support and back office functions.\textsuperscript{117} The discussion draft suggests that, where this is the case, it may be possible to use as a measure the contribution of back office activities, the compensation paid to key staff, especially where their compensation is performance related.\textsuperscript{118} The discussion draft

\textsuperscript{113} For further information on absorption costing see Income Tax Ruling IT 2350.

\textsuperscript{114} Taxation Ruling TR 97/20 paragraph 3.40.

\textsuperscript{115} Taxation Ruling TR 97/20 paragraph 3.49.

\textsuperscript{116} Taxation Ruling TR 97/20 paragraph 3.48.


suggests the use of the cost plus method in these circumstances.\textsuperscript{119} As with the previous methods, however, this method is designed for the transfer of goods between associated enterprises and will not work well when applied to multinational banks.

\subsection{6.3.3 The Fiction of Step two}

For the purposes of computing the taxable income of the separate parts of the multinational bank, a hypothetical price for inter and intra company transfers must be constructed for each transaction.\textsuperscript{120} To do this under the traditional method comparables must be found. This chapter suggests that it is this concept of ‘comparability’ that is the primary limiting factor associated with the traditional methods. In \textit{Taxation Ruling TR 97/20} the Australian Commissioner of Taxation provides greater practical guidance as to the meaning of ‘comparability’, remarking:

\begin{quote}
To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g., price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.\textsuperscript{121}
\end{quote}

The ultimate aim of applying the arm’s length methodologies under the traditional regime is to purportedly produce an arm’s length price which most closely reflects commercial and economic reality. The Australian Commissioner of Taxation provides when selecting an arm’s length methodology:

\begin{quote}
The choice of the most appropriate transfer pricing method or methods should be based on a practical weighing of the evidence having regard to the nature of the activities being examined; the availability, coverage, and reliability of the data; the degree of comparability that exists between the controlled and uncontrolled dealings or between enterprises undertaking the dealings including all the circumstances in which the dealings took place; and the nature and extent of any assumptions.\textsuperscript{122}
\end{quote}


\textsuperscript{121} \textit{Taxation Ruling TR 97/20} paragraph 2.3.

\textsuperscript{122} \textit{Taxation Ruling TR 97/20} paragraph 3.6.
This thesis suggests that, because of the fiction of the arm's length standard, where the multinational entity involved is a bank, this notion of commercial and economic reality will not be achieved. There are three interrelated fictions in applying the second step of transactional comparability. The first fiction relates to the unique organisational structure and the highly integrated nature of multinational banks, which means that often there is no direct evidence of comparisons in an uncontrolled situation. The second fiction is that there is frequently an absence of comparables because of the unique services provided by multinational banks. The third fiction is that the type of inter and intra entity dealings for multinational banks are highly specialised and frequently intangible. Each is examined in turn.

**6.3.3.1 The Unique Organisational Structure**

The traditional arm’s length methodologies rely on the presence of direct evidence of uncontrolled comparisons. Without such evidence, it becomes impossible to apply a method that is reliant on comparability. Yet, multinational banks, because of their unique nature may be one such multinational entity where comparables do not exist. Multinational banks are unique because of the structure adopted to provide the intermediary services which are marketed. The structure adopted is primarily a vertically integrated one.

Where the multinational bank adopts a vertically integrated structure, seldom are there direct comparisons in existence.\(^{123}\) This is because of the success of the multinational entities in driving out any competitors undertaking arm’s length transactions that could be used as comparables.\(^{124}\) Multinational banks are able to internalise market failure, which means that they can service the market more cost

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effectively than purely domestic banks. As such, domestic banks cease to compete with multinational banks in their range of products.

The ease of finding comparables for multinational banks will also largely depend on the organisational structure adopted. Multinational banks may operate on a separate enterprise basis, central product management basis, or fully integrated basis. The higher the level of integration, the harder it becomes to find comparisons for internal transactions. Further, even where the multinational bank operates on a separate enterprise model, which is the best suited of models to the use of traditional methodologies, the result may not accurately reflect the economic activity undertaken by the various banking locations.

The 1998 OECD discussion draft, as updated, provides the view that that when controlled and uncontrolled trading and risk management activities are considered, and the trading is organised on a separate enterprise model, the traditional transaction methods are the most appropriate. This is based on the supposition that it is possible to apply the comparable uncontrolled price method without the need for any adjustments as there are no material differences. The separate enterprise model is the easiest structure to apply to the traditional methods. The fact that these methodologies may be easily applied, however, this does not mean that all of the economic activity is brought into account through internal transactions. Furthermore, despite operating on a separate enterprise model, some activities undertaken by multinational banks may be so highly specialised that there are no true comparable.


At the other end of the spectrum is the centralised trading model. The 1998 OECD discussion draft also provides the view that the application of the traditional transactional methods should provide little difficulty for this model. The rationale for this view is that all of the trading and hedging is undertaken at a central location, with the income attributable to that location. Under this model, the trading, risk management and capital functions may all be centralised in one location. The profit attributable to those functions is largely produced from transactions with independents and most controlled transactions are in respect of simpler functions, such as support, and sales and marketing, for which comparable market data may be readily available. The discussion draft, however, notes that where more complex trading activities issues arise, the structure is more accurately reflected as an integrated trading model rather than the centralised product model, and consequently allocation problems arise. Again, reasonably accurate adjustments may need to be made to reflect an appropriate arm’s length price. The centralised product management model, however, is less suited to traditional methods than the pure separate enterprise model.

While there are difficulties applying the traditional arm’s length methodologies to the separate enterprise model and the centralised product model, assuming there are arm’s length competitors in the market place, it may be possible to meet the OECD criteria by making reasonably accurate adjustments. Where, however, the multinational banks organisational structure is based on a fully integrated trading

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model, there may be real difficulty reliably applying traditional transaction methods.\textsuperscript{133}

Because of the obvious fiction of dividing an entity that operates as one into component parts, the 1998 OECD discussion draft does not maintain that it is possible to determine comparables and make reasonably accurate adjustments to determine an arm’s length price.\textsuperscript{134} Instead it advocates the use of the transactional profit methods as a means of determining an arm’s length split.\textsuperscript{135} The discussion draft then qualifies the use of the profit split methods to circumstances where paragraph 4 of Article 7 of the OECD Model Tax Convention is satisfied. To use a non-traditional method the following conditions must therefore be satisfied:

(i) Such apportionment is customary in the jurisdiction\textsuperscript{136};

(ii) The result from such an apportionment is in accordance with the arm’s length principle contained in Article 7.\textsuperscript{137}

The 1998 OECD discussion draft, at least tacitly, recognises the fact that it is a fiction to attempt to use traditional arm’s length methodologies where multinational banks adopt a fully integrated trading model. This discussion draft recognises that there simply will not be a comparable trading structure amongst independent enterprises. It states:

The arrangement can be made in a variety of legal forms, e.g. a joint venture, a partnership, or an incorporated body. However, under such arrangements,


\textsuperscript{136} That is, the statutory domestic rules allow such apportionment and it is customary to do so in that jurisdiction.

\textsuperscript{137} OECD, The Taxation of Global Trading of Financial Instruments (1998) 60(238). This section has not been replicated in the 2003 updates.
the independent parties may well not attempt to divide the profits from each transaction but instead may well attempt to determine the overall profits for each party. For example, where the legal form is that of an incorporated body or a partnership, the arrangement may divide the rewards from the venture at the shareholder or partnership level respectively.\footnote{138}

The 1998 OECD discussion draft goes on to recognise that, at times, it is necessary to use a profit split because of the high level of integration and co-operation between and within different functions and locations. It provides ‘where transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split.’\footnote{139} Consequently, taxpayers have often chosen to adopt profit methods as the most reliable way of approximating arm’s length conditions in difficult cases such as ‘when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all.’\footnote{140}

A transfer pricing methodology that reflects the economic activity undertaken in the relevant jurisdictions is one which parallels the decisions of the entity’s management to maximise profits.\footnote{141} Consequently, an optimal allocation model will take into account the unique organisational structure of multinational banks thereby reflecting these features in the ultimate allocation. Where multinational banks operate on a separate enterprise model or a centralised product model there may be some correspondence between the traditional methods and managements operation of the bank. The inability of the traditional methodologies to ‘pick up’ intermediary services, however, must not be dismissed.


Further, where multinational banks operate on a fully integrated trading model with vertical integration, the best transfer pricing methodology will not be reflected in any of the traditional approaches. These multinational banks have a unique organisational structure which does not lend itself to the arm’s length approach. The arm’s length concept is not workable for highly integrated businesses, as they do not operate in a manner that resembles the arm’s length intercompany pricing model. Compounding the fiction of comparing the transactions of a highly integrated multinational entity is the fact that, because of the unique nature of the services and consequent products supplied by multinational banks, seldom are there comparables in existence to undertake such a comparison. This leads us to the next fiction.

6.3.3.2 The Absence of Comparables

The most obvious failing of the arm’s length requirement, when applied in practice, is that seldom can identical comparisons be drawn. Consequently, comparisons are made where there are similar transactions by similar entities, in similar circumstances, with the price being adjusted accordingly. This is particularly the case for multinational banks as the unique nature of these entities means that direct comparisons do not exist. Compounding this problem is the ability of these multinational entities to identify such comparisons at all. This identification is becoming increasingly difficult as multinational banks grow and increasingly operate on a global scale. These multinational banks come into existence because of the demand driven by traditional multinational entities.

Defensive expansion has meant that already existing clients are followed into the international arena with their financial needs met by the new and innovate financial services and products offered by the banks. The reason why the banks have expanded via foreign direct investment is that there are economies of scale and scope, that is, it is more cost effective to do so. Consequently, these multinational banks exist in a market where it is inefficient to operate in another manner. Non-related party transactions may not exist simply because it would be inefficient for

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banks other than multinationals to operate in the particular market.\footnote{143}

The consequence of this economic fact is that multinational entities are increasingly engaging in transactions for which there are no uncontrolled comparisons.\footnote{144} Where multinational banks are offering new services and creating new products to meet the changing needs of existing clients this problem will only continue to grow.\footnote{145} While this problem is one applicable to all modern multinational entities, banks provide the most common example of this is the provision of highly specialised services.\footnote{146} While the transfer pricing rules provide that a hypothetical arm’s length price should be constructed for non arm’s length intercompany transfers, often there are no real prices set in the marketplace.\footnote{147} The reality of the failure of the arm’s length principle in its application is primarily the lack of comparables, and as a result, the lack of ability to determine what is comparable and suitable rules where there simply are no comparables.\footnote{148}

Despite the lack of direct comparables, the 1998 OECD discussion draft provides that transactions may still be comparable where ‘reasonably accurate adjustments can be made to eliminate the material effects of such differences.’\footnote{149} The discussion draft goes on to provide that the guidelines are designed to be applied flexibly, but does


recognise the fact that because the only independent data is likely to be routine, it may be difficult to adjust for considerable differences in functions performed, economic circumstances, and business strategies. A solution, however, is not offered.

The underlying fiction with step two is that the arm's length standard requires the hypothesising of a transaction between unrelated parties when, in fact, the parties are related. This is dichotomous with the theory of the firm which suggests the existence and growth of multinational entities is due to the synergies gained. These synergies mean that transactions will not be carried out under the same terms.

While highly fictional, making an adjustment may be possible where there are similar transactions. The arm's length principle, however, does not provide a solution where associated enterprises engage in transactions that independent enterprises would not undertake. These transactions may occur as a consequence of the commercial differences between multinational entities and independent enterprises. Where this is the case, there simply is no direct evidence of the terms and conditions of transactions on the open market. The arm's length standard requires the entity to determine comparables for transactions which are unique, and to determine the value of the internal advantages which are immeasurable against non-related parties. Consequently, it is a fiction to suggest that this can be done.

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This inability becomes apparent where there are no market counterparts. For example, the transfer of intangible property, such as patents, trademarks and know-how, will not be traded on the open market. Therefore, there is no comparable transaction.\textsuperscript{156} One of the most valuable assets for multinational banks is know-how, or people skills. This leads us to the final fiction.

6.3.3.3 \textit{The Intangible Nature of Internal Transactions of Multinational Banks}

The traditional arm’s length principle no doubt effectively provides a suitable arm’s length price for traditional commodity type, or tangible goods.\textsuperscript{157} Such a result is possible because tangible goods are standard.\textsuperscript{158} Where, however, multinational entities deal internally in non-standard goods the arm’s length standard may not provide a suitable price, as there may be no comparable transactions.\textsuperscript{159} These intangibles are seldom transferred to an arm’s length party, and consequently, remain inside the multinational entity.\textsuperscript{160}

Where the multinational entity is a bank, it may be the case that it is not possible to find a comparable transaction due to the unique nature of the transaction.\textsuperscript{161} Many internal transactions relate to know-how, borne from client information and trading


skills. These intangible assets are proprietary to the individual multinational bank.\textsuperscript{162} Banks become multinational because of the compulsion to follow clients. To become a successful multinational bank the information unique to the bank must then be used to its advantage. Consequently, information and skills are transferred between parts of the bank to avoid the failure of the arm’s length market to hold this information or skills needed to be successful.\textsuperscript{163} Where this is the case there is no arm’s length comparable transaction precisely for the reason that the information exists within the multinational – to avoid market failure.

The OECD, in its 1995 guidelines on transfer pricing recognises the significance of the problem in relation to intangibles. It states:

A practical difficulty in applying the arm’s length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of a multinational entity group face different commercial circumstances than would independent enterprises. For example, an independent enterprise may not be willing to sell an intangible (e.g., the right to exploit the fruits of all future research) for a fixed price if the profit potential of the intangible cannot be adequately estimated and there are other means of exploiting the intangible. In such a case, an independent enterprise may not want to risk an outright sale because the price might not reflect the potential for the intangible to become extremely profitable. Similarly, the owner of an intangible may be hesitant to enter into licensing arrangements with independent enterprises for fear of the value of the intangible being degraded. In contrast, the intangible owner may be prepared to offer terms to associated enterprises that are less restrictive because the use of the intangible can be more closely monitored. There is no risk to the overall group’s profit from a transaction of this kind between members of a multinational entity group. When independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises.\textsuperscript{164}


Where intra group transactions involve goods, third party transactions are usually available. However, were there are services and group generated intangibles, there may be no third party equivalent.\textsuperscript{165} It may then become impossible to determine the true profits of the separate entity under the transactional approach.

\textbf{6.4 Conclusion}

While it may be possible to argue that arm's-length-pricing is optimal (or, at least workable) for traditional multinational entities, multinational banks are an exceptional case. This is a product of their unique nature, derived from both the nature of the service provided (and consequent financial products) and their organisational structure. Simply put, there are no comparable arm's length prices for the transactions of multinational banks. Everything a multinational bank does is unique to that multinational bank, which means that it is impossible to find separate unrelated taxpayers entering similar transactions. For example, it is not possible to enter the local unrelated bank to find the comparable price. Further contributing to the problem is the fact that none of the other indirect ways of calculating comparable or arm's length price work for a multinational bank because they are such unique characters.

This chapter has argued that it is unrealistic to expect step one to accurately determine what a hypothetical distinct and separate enterprise would look like, just as it is unrealistic to expect to determine what an appropriate arm's length price would be using comparable data. Consequently, a functional analysis will not achieve the desired result.\textsuperscript{166} If this is correct, it would appear that the fiction exists.


The proposed alternative of formulary apportionment has the benefit that transfer prices are no longer necessary.\textsuperscript{167} Comparable uncontrolled transactions are, therefore, unnecessary.\textsuperscript{168} Prior to a consideration of unitary taxation based on global formulary apportionment, the consequences of the failings of the traditional approach to the problem of transfer pricing are considered.

\textsuperscript{167} Joann Martens Weiner, "The European Union and Formula Apportionment: Caveat Emptor" (2001) 41 (10) \textit{European Taxation}.

Chapter 7

Implications of the Failure to Address the Inconsistencies between the Separate Entity Paradigm and Economic Reality

7.1 Introduction

In chapter six the fundamental deficiency of the traditional transfer pricing regime was examined to argue that both conceptual and transactional comparability are fictional concepts, which cannot be applied to multinational banks in the real world. Chapter seven addresses the implications of this, and considers the multinational banks' response to these difficulties in the application of the arm's length method to transactions within the entity.

The first part of this chapter considers the use of non-traditional arm's length pricing methods. In particular, the use of the profit split method as a means of moving towards a more equitable measure of transactional allocation is examined.

The second part of this chapter examines the advance pricing arrangement regime as evidence that the current international tax rules governing jurisdiction and allocation are unworkable for multinational banks. This infeasibility results in the adoption of advance pricing arrangements, whereby multinational banks implement a system by agreement that effectively equates to formulary apportionment. By looking at the advance pricing arrangement regime it is possible to argue not only that the current regime is administratively unworkable, but also that unitary taxation based on global formulary apportionment more closely reflects economic reality for multinational banks.

This chapter concludes that there is a furtive move towards the use of formulary apportionment by multinational banks. As such, tax authorities should consider being proactive in their solution to the problem of transfer price manipulation by these banks, and consider a move towards a unitary tax model.
7.2 The Use of Non Traditional Pricing Methods

In practice, it is recognised in certain circumstances that the traditional arm's length pricing methods may not be the most suitable to determine the arm's length price. Where this is the case, it is necessary to consider the use of non-traditional methodologies. These methods, while still considered transactional based, rely less on the notion of comparability.

These non-traditional methods are usually relied on to determine an arm's length price where the economically significant functions of a multinational entity are highly integrated. In this case, it becomes impossible to apply the traditional transactional methods, and the profit allocation methods become the only appropriate basis for the allocation of profits under the current regime.\(^1\) This is particularly the case where the multinational entity in question is a multinational bank, especially where the multinational bank is undertaking global trading, business is based on highly sophisticated technology, business involves valuable production, there is the distribution or marketing intangibles, and the business is generally vertically integrated. Consequently, in practice, to stay within the bounds of the existing model, a non-traditional method may be more appropriate.\(^2\)

There are two generally accepted non-traditional methods: the profit split method; and the profit comparison method. The former is the more widely used non-traditional method, with its appropriateness recognised for the use of profit allocation for global trading business. Each is examined in turn.

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\(^2\) *Taxation Ruling TR 97/20* paragraph 3.52.
7.2.1 Profit Split Method

The profit split method determines the combined profit and loss of the associated parties, and then splits this amount between those parties by reference to an economically valid basis, according to a profit split expected if parties were dealing at arm's length. The OECD describes profit split methods as follows:

Profit split methods are transfer pricing methods that identify the combined profit to be split for the associated enterprises from a controlled transaction or controlled transactions, and then split those profits between the associated enterprises according to an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length between independent parties. The profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles.

The acceptance of profit split methods as being a valid methodology for determining an arm’s length price is a recent development in transfer pricing. To this extent, taxing authorities are generally wary of its use, offering two broad cautions. The first caution is that profit split methods and global formulary apportionment are two different things and should not be confused. The second caution is that the profit split methods should only be used as methods of last resort.

The OECD, in its transfer pricing guidelines, explains the difference between profit split methods and global formulary apportionment. It makes it clear that the profit split methods are still methods which use comparable independent data. The global

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3 For a general discussion of the profit split methods see Thomas Horst, ‘Profit Split Methods’ (1993) 60 Tax Notes 335.


formulary apportionment method uses a predetermined formula that applies to all taxpayers to allocate profits, while the profit split methods compare on a case-by-case basis the profits of the associated enterprises with those of comparable independent enterprises. Global formulary apportionment allows profits from an entire line to be allocated via a formula, whereas profit split still focuses on separate transactions. The key difference, therefore, between the profit split method and formulary apportionment is that the former is used to establish transfer prices for specific transactions, whereas the latter adopts a unitary approach.

The Australian Taxation Office approach to the profit split method provides an example of the reluctance of taxing authorities’ acceptance of this method, and the type of issues facing a taxpayer where this method is used. The Australian Commissioner of Taxation holds the view that this method may be used by a taxpayer to establish a system in order to ensure that the transfer pricing requirements of the Act are satisfied, that is, to determine an appropriate split based on projected profits. Alternatively, the taxpayer may apply the profit split method to actual profits to determine whether the transfer pricing requirements of the Act have been satisfied.

The Australian Commissioner of Taxation specifies a range of scenarios where he believes the profit split method may need to be used as a method of last resort. The first scenario in which the profit split method may be used is where there is insufficient reliable comparable data. The second scenario is where the product or service in question is unique or contains out of the ordinary intangibles. The third scenario is where the traditional methods are not practicable because of the

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11 *Taxation Ruling* TR 97/20 paragraph 3.62.

12 *Taxation Ruling* TR 97/20 paragraph 3.62.

13 *Taxation Ruling* TR 97/20 paragraph 3.52.
complexity and diversity of the multinational entity. The fourth scenario is where there simply are no comparables for the types of transactions being undertaken, particularly where transactions flow both ways.

It may be argued that the unique features of multinational banks means that these criteria are met, allowing the use of the profit split method. This, however, does not provide a solution to the practical difficulties associated with determining an arm's length price. There are several problems related to this method, which make difficult to apply. Further, the result may still fail to accord with economic reality. The main difficulty, which once again incorporates the notion of comparability, is determining the split of profits had the parties been dealing at arm’s length. The two most common approaches used to determine an appropriate profit split are the contribution analysis and the residual analysis. Other approaches such as return on capital\textsuperscript{14} and profit split based on comparable transactions\textsuperscript{15} may be appropriate alternatives but tend not to be used.

The contribution analysis operates in such a way as to divide the profits in question based on the value of the functions performed by the respective parties. The value of the functions performed is measured either directly where possible, or is an estimation based on market data indicating the profit split between independent parties.\textsuperscript{16}

The residual analysis involves a two-stage process. In the first stage, the respective parties are allocated an appropriate amount of profit equivalent to a basic amount determined in accordance with the market. In the second stage, the residual profit is allocated amongst the respective parties according to the expected division between independent parties. It is at this second stage that an examination of intangible property and relative bargaining positions would be undertaken. This method uses two principal determinants, 'the participants' relative amounts of routine, or

\textsuperscript{14} Taxation Ruling TR 97/20 paragraph 3.69.

\textsuperscript{15} Taxation Ruling TR 97/20 paragraph 3.70.

\textsuperscript{16} Taxation Ruling TR 97/20 paragraph 3.63-3.64.
(primarily) tangible assets, and their relative amounts of entrepreneurial or (primarily) intangible assets. The obvious problem with this method being the requirement of comparable data with a further issue arising where the first stage results in a loss to be allocated at the second stage.

Apart from the problems associated with the determination of the split of profits if the parties were dealing at arm’s length, there are at least three other material difficulties associates with this method. The first problem is determining the scope of the profit split, that is, should it apply to the whole business or to a single product. The second problem is identifying the profits to be allocated to various dealings, for example, where there are several associated parties dealing with each other. The third problem is determining the appropriate accounting standards applicable to the consolidation of accounts. These problems are similar to those confronting a formulary apportionment regime, which are discussed in chapter eight.

### 7.2.2 Profit Comparison Method

The second non-traditional methodology is known as the profit comparison method. It is defined as:

> [The profit comparison method] is a transfer pricing methodology based on comparisons at the net profit level between the taxpayer and independent parties dealing wholly independently in relation to a comparable transaction or dealings. Comparisons at the net profit level can be made on a single transaction or in relation to some aggregation of dealings between associated enterprises.

The profit comparison method determines an appropriate net profit margin relative to a specified base such as costs or sales. This is a variation on the cost plus method in the sense that this method considers an appropriate gross profit margin, whereas the

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18 *Taxation Ruling* TR 97/20 paragraph 3.65-3.68.

19 *Taxation Ruling* TR 97/20 paragraph 3.73. The profit comparison method is identical to that of ‘transactional net margin method’ used by the OECD (1995 OECD Report, Glossary, paragraph 3.26).
profit comparison method involves a net profit margin. The mark-up is determined by reference to transactions entered into with independent parties and the net profit margins of independent parties in the market place.

One of the problems associated with the cost plus method is the lack of independent industry data available to determine the appropriate gross profit mark-up. Thus, the profit comparison method may overcome the unreliability and subjectivity associated with the cost plus method. The profit comparison method may also allow for greater accuracy when adjusting for differing functions undertaken by various enterprises. This, however, may not transpose to multinational banks.

The 1998 OECD discussion draft, as updated in 2003, in relation to the use of this final method has stated that the 'sheer diversity of the organisation, business strategies, products, and functions of global trading businesses, has meant that to date taxpayers and tax authorities have been very reluctant in global trading cases, to use the other acceptable profit method ... the transactions net margin method.' It is the diversity of global trading which makes this method unsuitable, as it still requires comparability yet it is difficult to be sure that the net margins of the controlled transactions are comparable to the uncontrolled transactions. As such, this method is not widely used.

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7.2.3 Evidence of Support for the Non-Traditional Methods

The profit based transfer pricing methods are becoming increasingly popular.\(^2\) Whether this is seen as a regrettable trend,\(^3\) or a necessity for modern multinational entities, such as multinational banks, this move is explicable. Profit split methods are both consistent with the notion of business-judgement, and the inability to find comparables for highly integrated multinational entities.\(^4\)

In the context of global trading there are supporters of both the profit split and the profit comparison method. Supporters of the profit split method (usually the residual profit split approach) believe that it is particularly applicable to the case of global trading because of its ability to use comparable data for routine functions and leave the more complex functions to share in the residual profit.\(^5\) Those who believe that the contribution method is more suitable do so because it is thought that the residual method does not adequately capture the integration of the functions found in global trading operations.\(^6\)

The strongest evidence of support for the profit split method is found in the United States. In the United States Internal Revenue Service Notice 94-40\(^7\) the United States taxing authority discusses the use of profit split for global trading. The Notice discusses the use of this method as part of an advance pricing arrangement, which is discussed in the next part of this chapter. The OECD uses the experience of the Internal Revenue Service as an example of the application of the profit split approach

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based on a contribution method. Stressing two principles factors applicable to the equitable taxation of multinational banks (economic activity and overall profitability), the OECD provides ‘[t]he APAs [advance pricing arrangements] described in the Notice used a profit split method based on the contribution method that utilised factors intended to ensure that profits were divided according to the economic activity of each location and its contribution to the overall profitability of the world-wide business.’ Economic activity is seen as the underlying factor in the rationale for the use of this method. But further, it is recognised that the question is one of the contribution to the overall profitability, rather than individual profits earned.

Notice 94-40 provides guidance as to when it is seen as acceptable to use a profit split method specifically for global trading. It recognises that many financial intermediaries undertake global trading, with the integration of the trading, sales, management and support resulting in operations that are functionally fully integrated. As such, it applies to ‘functionally fully integrated operations in the global trading of commodities and derivative financial products.’ Where there are functionally fully integrated operations there is the centralised management of risk and personnel, and the business being managed as one global position. By using the profit split method of allocation the profits are then allocated according to the contribution of each location to the profits attributable to the book as a whole.

The purpose of Notice 94-40 adopting the use of the profit split method for allocating profits between the jurisdictions is 'to measure the economic activity of each trading

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29 Its biggest limitation is that it does not provide general guidance on the taxation of derivative financial products; Marc M Levey and Gregg A Grauer, 'IRS Indicates a Preference for Profit- split Method in Global Trading' (1994) 5 Journal of International Taxation 300, 300.

30 Its biggest limitation is that it does not provide general guidance on the taxation of derivative financial products; Marc M Levey and Gregg A Grauer, 'IRS Indicates a Preference for Profit- split Method in Global Trading' (1994) 5 Journal of International Taxation 300, 300.

location and its contribution to the overall profitability of the worldwide business.\textsuperscript{32} The Internal Revenue Service identified three critical factors in the allocation process: the relative value of the trading location; the risk associated with the trading location; and the extent of the activity of each trading location.\textsuperscript{33} The factors taken into account are the value factor, risk factor and activity factor.

The value factor is a measure of the contribution of a trading location to the worldwide profits of the entity; the best measure of this factor being the compensation of the traders at a trading location.\textsuperscript{34} The risk factor is a measure of the potential risk to which a trading location exposes the worldwide capital of the entity.\textsuperscript{35} The activity factor is also a measure of the contribution of a trading location to the worldwide profits of the entity, which takes into account key support staff.\textsuperscript{36}

These factors superficially appear to be suitable factors for a generic global trading formula under a global formulary apportionment model (and are, in fact, the suggested factors in chapter eight). It would also seem that there is very little difference between this application of the profit split method and global formulary apportionment. The rationale for arguing that this is still an arm's length methodology is the weighting of the factors on a case-by-case basis.

The Internal Revenue Service considered these factors in 1994, and the 1998 OECD discussion draft expands on these, taking into account the Transfer Pricing Guidelines of 1995. The 1998 OECD discussion draft also divides the factors into the three core areas of front office (value factor), risk or capital (risk factor), and


back office (activity factor), and but raises the possibility of other factors such as a measure of volume, capital, and management.\textsuperscript{37}

In relation to the front office factor, the usual measure is according to the compensation paid to the traders, provided there is a high correlation between the profits of the firm and compensation awarded. A similar approach can be adopted for the marketing function.\textsuperscript{38} The OECD discussion draft raises two potential problems with determining this factor via compensation. The first potential problem is how to allocate where there has been an overall loss.\textsuperscript{39} The second potential problem is how to adjust for geographical differences in the level of average compensation.\textsuperscript{40} These issues mean that the factor may have to be altered accordingly, for example, to take into account the cost of living.

The 1998 OECD discussion draft suggests that the second factor, that of risk, is the most difficult global trading issue to resolve.\textsuperscript{41} The discussion draft does not express a view on whether and how a risk factor should be incorporated into the equation. Rather, it elects to illustrate the arguments both for and against such an inclusion.

Arguments against the inclusion of risk as an allocation factor are that it is difficult to determine which location really bears the risk and to determine risk exposure.\textsuperscript{42} Furthermore, large risk exposure does not necessarily entitle that part of the entity to a large share in the realised profits.\textsuperscript{43} Arguments for the inclusion of risk as an allocation factor are that in most cases it is possible to determine who is bearing the risk of a particular transaction and that measuring the various types of risk inherent

\textsuperscript{40} OECD, \textit{The Taxation of Global Trading of Financial Instruments} (1998) 46(186).
in a particular derivative transaction is not an insurmountable task, also there is a correlation between risk exposure and expected profit.44

The 1998 OECD discussion draft states that the third factor of back office or support functions can normally be rewarded via one of the traditional transaction methods. It is only where there is key middle level staff that play a role in the profitability of the whole operation that it would be necessary to include a factor in the profit split.45 In a similar manner to the measure attributed to traders and marketers, the contribution would be measured in accordance with compensation for activities essential to global trading.

Once all of the factors are determined, there is the necessary weighting of each factor to take into account their relative contribution to the profits as a whole. The 1998 OECD discussion draft suggests that the weight should be determined on a case-by-case basis to ensure that the profit split method still results in an arm’s length allocation.46 This ensures the justification of the use of the profit split method under the arm’s length approach and allows taxing authorities to argue it is distinct from global formulary apportionment.

Once the relative factors have been established, it is still necessary to determine the profit to be split from global trading. The real question to be addressed is the amount of revenue to be included. The 1998 OECD discussion draft provides that revenues unrelated to global trading are to be excluded from the scope of the profit split method,47 with the most common problem being the question of the inclusion of revenues from a treasury book, that is, revenues from such things as interest earned on surplus cash, or capital gains or losses on hedging transactions. The OECD discussion draft does not provide a definitive view on the treatment of these revenues

except to emphasise the need for any transactions to be at an arm’s length price.\textsuperscript{48} On the issue of whether there should be a net profit split or a gross profit split, the OECD discussion draft refers to the guidelines which suggest that it is the net profits which should be allocated, except in exceptional circumstances.\textsuperscript{49}

While the problems outlined above with respect to the profit split method are not insurmountable, such an approach would appear to continue to labour under the burden of the arm’s length approach of comparability. Yet, it adopts the implementation problems associated with a formulary apportionment model, but at the individual taxpayer level, rather than resolving these issues at a broad policy level. This approach, therefore, rather than offering a solution, in many situations will contribute to the problem. The use of this method, however, is a product of the lack of acceptability of a true global formulary apportionment method as being a valid means of transactional allocation for multinational banks.

\section*{7.3 The use of Advance Pricing Arrangements}

Where the taxpayer is a multinational bank, and it is difficult, if not impossible, to apply the traditional arm’s length pricing methodologies, the use of advance pricing arrangements provides a practical solution to the employment of a non-traditional methodology. An advance pricing arrangement is an agreement whereby future transfer pricing methodology to be used is agreed to by the taxpayer and the relevant tax authority or authorities. The OECD guidelines define an advance pricing arrangement as follows:

An advance pricing arrangement (‘APA’) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs


are intended to supplement the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues.\textsuperscript{50}

An advance pricing arrangement is designed to establish the transfer pricing methodology or methodologies to be used in any future transactions, agreements, or arrangements in order to ensure that the arm's length transfer pricing requirement of the double tax agreement or domestic legislation is met. A transfer pricing methodology will be determined that is acceptable to the parties to the agreement to be used in any future apportionment or allocation of income, deductions, credits or allowances.

The use of an advance pricing arrangement allows the taxpayer to implement a profit split method of allocation as well as avoid many of the administrative burdens associated with the traditional transfer price regime.

### 7.3.1 Implementing a Profit Split Method

Many of the taxation issues involved in global trading are being resolved by way of an advance pricing arrangement.\textsuperscript{51} The United States Internal Revenue Service believes that the advance pricing arrangement 'process has proven to be a useful vehicle to allocate income of a functionally fully integrated global trading business between taxing jurisdictions.'\textsuperscript{52} The United States also provides an example of where multinational entities involved in global trading are entering into these arrangements.


The first four advance pricing arrangements entered into in the United States involved global trading issues;\textsuperscript{53} with the first two of these, dealing with international derivative products establishing a formulary methodology for the allocation of income and expenses attributable to their dealings.\textsuperscript{54} Both Sumitomo Bank Capital Markets Inc and Barclays Bank PLC entered into these arrangements, with Barclays believing that the approach of treating the international affairs as one global business was a businessmen’s approach.\textsuperscript{55} The Internal Revenue Service concludes that, ‘the Service, treaty partners, and taxpayers found that the use of a profit split method to allocate the income of these functionally fully integrated global trading businesses was appropriate because of the volume and nature of the transactions involved in these APAs [advance pricing arrangements].\textsuperscript{56}

In the context of advance pricing arrangements, the OECD again stresses that the selected application of a formula agreed to by taxing authorities and taxpayers should not be confused with global formulary apportionment.\textsuperscript{57} This is because an arrangement involves the careful analysis of the particular facts and circumstances of the taxpayer, rather than being a pre-determined formula.\textsuperscript{58} While the method prescribed, however, for the advance pricing arrangements is classified as a profit split method, it would appear that formulary apportionment underlies many of the advance pricing arrangements being entered into.\textsuperscript{59} This is certainly the case where


the advance pricing arrangements are entered into by functionally fully integrated financial services firms involved in global trading of derivatives and commodities.\(^6^9\)

The 1998 OECD discussion draft recognises that advance pricing arrangements provide a useful 'safety valve' in the absence of clear consensus on the concrete application of general principles.\(^6^1\) The discussion draft, however, also recognises that many countries have little experience with advance pricing arrangements or fail to have domestic legislation allowing for such arrangements, and as such, fail to provide a complete solution.\(^6^2\)

Where an advance pricing arrangement is available to the parties, the 1998 OECD discussion draft believes that it may help both the taxpayer and taxing authorities 'save time and resources and provide the benefit of certainty in the otherwise difficult assessment of tax liability of global trading operations'.\(^6^3\) This discussion draft, however, does recognise that while the benefits of entering into an advance pricing arrangement may provide incentive for taxpayers to request such agreements, the costs sometimes outweigh the benefits. In particular, it recognises that the opportunity costs of disclosure to the taxing authority may mean that the advance pricing arrangement approach is insufficient to deal with global trading issues.\(^6^4\)

There is no doubt that advance pricing arrangements provide a valuable practical tool for multinational banks facing the challenges of the taxation of global trading under the current transfer pricing regime.\(^6^5\) It is the case that financial institutions involved

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in global trading should consider these arrangements. It, however, does not provide a long term solution. Further, "the integrity of the system will be called into question if a "private law" track is permitted to develop." Despite this, the use of such an arrangement also aids the taxpayer to circumvent many of the administrative costs associated with the traditional regime.

7.3.2 Circumventing Administrative Burdens

The administrative burdens placed on taxpayers by virtue of the current transfer pricing regime are onerous. The successful functioning of any tax regime requires taxpayers to be clearly informed of the expectations of the taxing authority in computing their taxable income. This, however, is not necessarily the case under the current regime. For example, in Australia, at a domestic level, the vagueness of the legislation itself, accompanied by a dearth of rulings, leads to confusion and uncertainty. Further complicating this are the double tax agreements, with the accompanying OECD material. As such, it may be argued that transfer pricing rules are vague rules, which invite litigation because of their openness to interpretation. While some commentators suggest that facilitating certainty in the current regime is the answer, it is proposed that this is not possible. It can be argued that the

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excessive administrative burden of the current approach to transfer pricing is one of
the principle problem areas in taxing modern foreign direct investment.\textsuperscript{72}

Where there is a highly vertically integrated multinational entity such as the
multinational bank, it is administratively difficult to demonstrate that there has not
been a transfer price manipulation.\textsuperscript{73} This problem is exacerbated where there are no
uncontrolled market prices for the vertical transactions.\textsuperscript{74} In practical terms,
multinational banks are turning to advance pricing arrangements to avoid the
problems associated with the application of the arm’s length standard to related party
and internal transactions.

An advance pricing arrangement allows the taxpayer to address any transfer pricing
issues on a prospective basis, thereby circumventing a possible audit. It may provide
solutions to situations where there is no realistic alternative way of both avoiding
double tax and of ensuring that all profits are correctly attributed and taxed. Further,
it provides certainty on an appropriate transfer pricing methodology for the taxpayer.
Therefore, it enhances the predictability of tax treatment of international
transactions.\textsuperscript{75}

Advance pricing arrangements circumvent administrative burdens, along with the
risk of an audit.\textsuperscript{76} Advance pricing arrangements themselves, however, add to the
administrative burden together with high compliance costs. The fees that

\textsuperscript{72} Alex J Easson, Taxation of Foreign Direct Investment (1999), 177.

\textsuperscript{73} Charles E McLure Jr, ‘Defining a Unitary Business: An Economist’s View’ in Charles E

\textsuperscript{74} Charles E McLure Jr, ‘Defining a Unitary Business: An Economist’s View’ in Charles E
‘Replacing Separate Entity Accounting and the Arm’s Length Principle with Formulary

\textsuperscript{75} Taxation Ruling TR 95/23 paragraph 65. See also OECD, Transfer Pricing Guidelines for

\textsuperscript{76} For the advantages and disadvantages of entering into an advanced pricing agreement by
financial intermediaries see Andrew Snyder, ‘Taxation of Global Trading Operations: Use of
multinational entities must pay professionals for work on a large transfer pricing tax issues can be enormous.  

While tax authorities are marketing advance pricing arrangements as a solution to difficult transfer pricing issues, it may not be the answer. There is no doubt that the advance pricing arrangement is a procedural innovation in international tax. It is an administrative approach, however, that attempts to prevent transfer pricing disputes from arising, by being proactive to determine an agreed methodology, rather than a solution to the underlying theoretical and practical problems of the arm's length pricing requirement. An advance pricing arrangement is a practical solution, but does not address the underlying failure of the arm's length principle to allocate income to jurisdictions according to the economic reality of multinational banking. While it has improved the administrability of transfer pricing for participants, the advance pricing arrangement regime is a procedural solution to the transfer pricing dilemma.

The need for advance pricing arrangements may constitute evidence alone that the current regime is not working for multinational banks. Further, the number of multinational entities in general applying for advance pricing arrangements is steadily growing. In addition to the fact that advance pricing arrangements are

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being entered into by multinational banks, many are using an approach very close to a formulary apportionment model to determine the allocation of taxable profits to the relevant jurisdictions - further evidence that the current regime is unworkable for this industry.

It may be argued that many of the advantages to an advance pricing arrangement are also found in a formulary apportionment regime. Formulary apportionment reduces the administrative burden on taxpayers because only one set of accounts is necessary for tax purposes. \(^84\) 'It also decreases the uncertainty of an audit and improves tax compliance.' \(^85\)

Entering into an advance pricing arrangement is not a long term solution to the problems facing multinational banks to determine transfer prices. The advance pricing arrangement regime may itself contribute to the fact that prices may reflect tax considerations rather than business and economic considerations, due to the advantages associated with such an agreement. \(^86\) To vary from the traditional methods, however, multinational banks are forced into advance pricing arrangements to ensure compliance with the regime.

The use of an advance pricing agreement is seen at present, as the only acceptable means of using a transfer pricing methodology that is not entirely consistent with the generally understood notion of arm's length and comparability. It is also a means used by multinational banks to adopt a transfer pricing approach that more closely reflects economic reality. In doing so, however, there is also a trend towards formulary apportionment.


7.4 The Current Trend - Moving Towards Global Formulary Apportionment

This thesis proposes unitary taxation based on global formulary apportionment as a more economically sound basis for distributing the taxing rights to multinational banks. The profit split approach is a conservative move towards this model for taxing these modern multinational entities. This may be seen as a trend to encourage formulary apportionment on a different level through ‘comparable profits’ and ‘profit split’ pricing methodologies. There is an argument, however, that this move towards profit split methods for multinational banks is merely a move along the continuum towards formulary apportionment.

Contrary to the generally accepted view that formulary apportionment is an alternate model, Reuven Avi-Yonah describes arm’s length methodologies as being on a continuum, with traditional arm’s length methodologies at one end and formulary apportionment at the other. Such a continuum model then suggests that it is not clear where the traditional methods end and formulary apportionment begins. It is clear, however, that the profit split method is placed on that continuum next to global formulary apportionment. Reuven Avi-Yonah explains the relationship:

The profit split method is very close to the pure formulary apportionment end of the transfer pricing continuum, because it starts with the enterprise as a whole and allocates the profits in a formulary fashion. The only differences are that some of the profits are allocated on the basis of comparables, and that the formula used to split the rest is more flexible than the traditional assets, payroll, and sales-based formula used by the states.

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In support of the view that formulary apportionment is part of the traditional arm's length pricing regime, Stanley Langbein opines that the separate enterprise model 'is not the polar antithesis of formula apportionment; rather, it (i) uses fractional apportionment for expense allocations; (ii) uses it as a backup method; and (iii) tolerates it as a primary or exclusive method where 'customary.' As such, he argues that the traditional regime is not one limited to using comparable prices, but rather, a system which utilises the available comparable data and then relies on fractional methods as the 'true descriptive, prescriptive, and theoretically desirable substantive international norm.' It would appear that multinational banks, for practical reasons, are adopting a stance that methods closely resembling formulary apportionment are part of the current regime.

There is also a move by the OECD to recognise the difficulties associated with the application of the traditional arm's length pricing methodologies and an acceptance of the use of non-traditional methods. In the context of global trading of financial instruments, the OECD recognises that there may be a need for profit split methods as a last resort. The 1998 OECD discussion draft, along with its 2003 update, however, clearly rejects any method based on global formulary apportionment. It then endeavours to place a restriction on the use of profit split methods, such that use is only acceptable if the factors used to allocate the combined profits or loses from global trading activities produces a result consistent with what would have been realised between independent parties.

The move towards global formulary apportionment is also evidenced by the United States Internal Revenue Service signing advance pricing arrangements with

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multinational entities undertaking global trading, using a conservative type of formulary approach to allocate income from global trading.\textsuperscript{95} This may demonstrate a trend towards an acceptance of unitary taxation as an appropriate method of allocating profits between the relevant jurisdictions in certain industries. Some taxing jurisdictions do provide that in certain cases, a formula developed by both tax authorities in co-operation with a specific enterprise after careful analysis of the particular facts and circumstances, such as might be used in an advance pricing arrangement, would be appropriate to determine a fair allocation of revenue to the countries involved. It continues to be argued, however, that these formulas are not instances of global formulary apportionment because they have regard to the particular facts.

What has been stressed throughout this chapter is that profit split is very close to formulary apportionment, but it is still a transactional method because any formula is determined on a case-by-case basis. This, however, it is not necessarily advantageous. Under the current regime, formulas are used when there are difficulties applying the traditional arm’s length methodology. They are then determined not according to any established criteria but rather on indeterminate factors.\textsuperscript{96} Formulary apportionment, on the other hand, provides ‘determinate, universally acceptable criteria which leave little for conjecture or manipulation. And its terms are authored by statute, not by administrative or judicial discretion.'\textsuperscript{97} Thus, where formulas are being used on an ad hoc basis, the tax regime is not optimal for many reasons such as its potential inequity, inconsistency and uncertainty. A move towards global formulary apportionment would address many of the suboptimal characteristics of the current trend.


7.5 Conclusion

This chapter concludes that there are insurmountable problems associated with the application of the arm's length pricing standard to multinational banks if the taxation model is to achieve a regime that reflects economic reality. The reasons for the deficiency stem both from the flaw in theory and the practical burden of the compliance with the regime. Because of these problems, multinational banks are having to turn to practical solutions. These practical solutions are in the form of the non-traditional arm's length pricing methods, particularly the profit split method, which is implemented via an advance pricing arrangement. This is not a long term solution to the problems facing the taxation of mutational banks. For this reason, it is necessary to consider an alternative regime.

At a time when the business of multinational banks is rapidly expanding, and changing, a viable alternative to the current regime is formulary apportionment.98 Despite opposition from taxing authorities, there would appear that there is already a furtive move towards this approach by the banks.99 Consequently, it is timely that taxing authorities consider an overt move towards formulary apportionment, and, if it is considered a theoretically superior model for taxing multinational banks, embrace it as such. By considering this possibility, tax authorities will ensure their participation in any discussion relating to the developments of globalisation and internationalisation and their consequent tax affects.100

Many of the problems, which arise under the current jurisdiction and allocation rules when applied to multinational banks, are overcome with global formulary apportionment. Comparable uncontrolled transactions are no longer necessary. It takes into account the reasons for entities operating internationally through foreign direct investment and recognises the synergistic benefits in doing so. It also


eliminates any need to distinguish between a subsidiary and a branch. Further, administrative burdens, uncertainty, and tax evasion can be reduced by the unitary approach. Also, the risk of double taxation under formulary apportionment is no greater than the risk of double taxation under the arm's length principle.\textsuperscript{101}

This thesis argues that, not only does formulary apportionment avoid many of the problems associated with arm's length pricing, but that the unitary taxation model based on global formulary apportionment has several advantages over the existing model. The first advantage is that where multinational entities are highly integrated, unitary taxation has greater consistency with economic reality. The second advantage is that it conforms to the aim of efficient operations within the multinational entity. The third advantage is that the aim of unitary taxation, to find an equitable split of profits between the jurisdictions, should ultimately be the overall aim of any taxation regime.\textsuperscript{102} It is the theoretical advantages of this alternative regime that chapter eight examines.


Chapter 8

Alternative Apportionment through a Unitary Taxation Regime
Aligning with Economic Reality

8.1 Introduction

This thesis argues that the traditional international tax rules governing jurisdiction to
tax and allocation of income, when applied to multinational banks, do not produce a
result which is optimal, as that result does not reflect economic reality. The
suggested alternative is unitary taxation using global formulary apportionment.
Chapter eight considers formulary apportionment as an alternative that reflects
economic reality by recognising the unique nature of multinational banks and
allocating the income to the location of the economic activity.

The unique nature of multinational banking is recognised in the fact that formulary
apportionment does not attempt to undertake a transactional division of a highly
integrated multinational entity; rather it allocates income to the jurisdictions based on
an economically justifiable formula. Based on this recognition, the purpose of this
chapter is to demonstrate that formulary apportionment is a theoretically superior
model for the taxation of multinational banks.

Most of the concern about formulary apportionment focuses not on its theoretical
soundness, but gaining the acceptance needed to implement the model. In particular,
there needs to be international acceptance as the theoretically superior model for
formulary apportionment to be successful. This general agreement then needs to be
converted into international agreement of the key economic components and
administration of the regime.

Opposition to formulary apportionment is generally based on the argument that it is
not a theoretically superior model because of the implementation difficulties. Yet
these are two separate issues. As such, this chapter is divided into two core
components. The first component examines the theoretical soundness of the
formulary apportionment model concluding that it is theoretically superior to the arm’s length pricing requirement of the traditional transfer pricing regime. The second component examines the practical implications of accepting formulary apportionment as an optimal model with a view to disclosing the issues that arise when a formulary apportionment regime is adopted.

This chapter concludes that, while there are significant implementation, compliance, and enforcement issues to overcome, the unitary taxation model is theoretically superior to the current arm’s length model, which applies to multinational banks, given their unique features.

8.2 The ‘Big Bang’ Approach

Given the previous conclusion that the current tax rules governing jurisdiction and allocation, do not accurately allocate the income of multinational banks according to economic reality, it is necessary to consider a solution. It cannot, however, be assumed that a ‘new’ tax model for multinational banks is the only answer. There are two approaches to the way forward: first, the ‘big bang’ or the ‘holy grail approach’ of radical change; or second, an incremental step-by-step approach, building on the current regime.1 In other words, a solution to the current problems may be sought ‘within the ambit of the arm’s length principle’ or ‘in alternative methods of profit allocation’.2 These solutions are posited in a general multinational entity setting but apply equally to the subcategory of multinational banks.

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8.2.1 Alternative Solutions

Seeking a solution to the current problems associated with the taxation of multinational banks within the ambit of the arm’s length principle does have its support. The OECD has made it clear that it believes that any problems, which arise in relation to the taxing of multinational banks, can be solved within the domain of the already existing rules. Furthermore, whilst most unitary taxation model proposals are aimed at multinational entities generally, it may be unreasonable to expect the relevant stakeholders to agree on a radical new regime that applies at this broad level. Despite the fact that nation’s views are slowly changing, as evidenced recently by the European Union position, a general adoption of a unitary taxation model would not appear currently realistic. This is especially the case given the OECD is one body that is vehemently opposed to such a proposal.\footnote{OECD, \textit{Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations} (1995) 3.63. The OECD provides ‘OECD Member countries do not accept these propositions and do not consider global formulaic apportionment a realistic alternative to the arm’s length principle.’}

This thesis, however, proposes that a ‘new’ approach is the answer to the problems associated with taxing multinational banks, and not multinational entities in general. A global solution is needed in relation to multinational banking transactions if the tax regime is to keep pace with the economic reality of the multinational banks undertaking such transactions.\footnote{Ian Spence, ‘Globalization of Transnational Business: the Challenge for International Tax Policy’ (1997) 25 (4) \textit{Intertax} 143, 146.} The ‘big bang’ approach, which has the support of leading academic scholars,\footnote{See eg, the writings of Reuven Avi-Yonah, Jerome Hellerstein and Louis Kauder.} is the suggested solution to the international tax problems associated with multinational banking as a step-by-step approach would not resolve many of the theoretical deficiencies associated with the arm’s length pricing model.

Adopting the incremental step-by-step approach to the problems associated with the current jurisdiction and allocation rules would mean that out of date fundamental principles, established in the 1920s, would remain part of the international tax
regime\(^6\) that applies to multinational banks. The very reason these principles have been made out of date is because of many of the features associated with multinational banks, such as the mobile capital market and the integrated nature of their business.\(^7\)

A step-by-step approach would also retain a model which asks the wrong question and continues to rely on hypothetical arm’s length prices for which there are no prices in the market place.\(^8\) The current regime asks the question ‘[w]hat price is right for intercompany transfers?’\(^9\) Whereas, the question that should be asked is ‘[w]hat portion of the combined profit or loss derived by all participating units of an enterprise from an international transaction should be geographically sourced to each of the countries claiming jurisdiction to tax part of that income?’\(^10\) The purpose of the international tax regime is to allocate taxable income of a multinational entity to the relevant jurisdictions, not to allocate taxable income to the separate parts of the multinational entity.\(^11\) The traditional regime allocates prices, yet the aim is to allocate profits, and these are two different things.\(^12\) While the result may generally equate to an allocation based on economic activity for traditional multinational entities, it will not do so for multinational banks. As such, retaining a regime for multinational entities in general may not pose the problems it does for multinational entities.

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banks, which have unique features that make the traditional rules unworkable, and
distinguish them from their traditional counterparts.

It has been suggested that in the past "we have been blinded by adherence to
inadequate principles and remain wedded to outdated concepts." Currenty there is
the opportunity to change this blind adherence in an industry where the inadequacy
of the principles and the outcome of the outdated concepts are exacerbated to a point
where they no longer adequately function. While the OECD attempts to hold onto
the belief that the current regime should be maintained for multinational banks, there
is an argument supporting the 'big-bang' approach.  

The 'big bang' approach that asks the right question, and allocates profits according
to economic activity, is unitary taxation based on global formulary apportionment.
The question remains, however, whether formulary apportionment really is a 'big-
bang' approach, or whether it too is part of the step-by-step approach to the problems
associated with the traditional arm's length model. There are two views as to where
formulary apportionment sits within the international tax regime. One view is that
arm's length pricing and global formulary apportionment are 'effectively, two
competing and fundamentally different theories for the basis of taxation of
international business.' This view is based on the premise that the models
fundamentally contradict each other as one allocates profits based on a consolidated
approach, while the other operates on a transactional basis.

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13 Michael J Graetz, ‘Taxing International Income: Inadequate Principles, Outdated Concepts,

14 The OECD states '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, Transfer Pricing

15 See eg, Daniel Sandler, ‘Slicing the Shadow – The Continuing Debate over Unitary Taxation

16 Diane Hay, Frances Horner and Jeffrey Owens, 'Past and Present Work in the OECD on
An alternative view is that 'separate accounting and formula apportionment are not so much alternatives as points on a continuum.' This view is premised on the fact that the separate accounting model uses methods which closely resemble formulary apportionment when the more traditional methods fail to accurately allocate income. The obvious example is profit split. It may be argued that this adoption of formulary apportionment already occurs for multinational banks.

Whether formulary apportionment is seen as a competing theory or a modern adaptation of traditional arm’s length methods, it is a departure from the possible maintenance of the existing model. In this context, there is the opportunity for formulary apportionment to replace the current source rules and transfer pricing regime for multinational banks, eliminating the problems associated with the application of both.

8.2.2 Formulary Apportionment Defined

The OECD describes global formulary apportionment:

A global formulary apportionment method would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. There would be three essential components to applying a global formulary apportionment method: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales.

Unitary taxation is the taxation of the worldwide income of a multinational entity, and is normally based on a formulary apportionment method, which allocates income to the relevant jurisdictions based on a percentage of the worldwide profits of the

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multinational entity. Formulary apportionment and unitary taxation are regularly treated as being interchangeable terms. However, this is not accurate. As Joann Weiner explains:

Formula apportionment is often referred to as unitary taxation, but the terms are not entirely equivalent. Apportionment refers to the process of using a formula to assign a portion of the total income of a company and its branches that operate in several locations to each individual location. Unitary taxation refers to the process of combining the functionally integrated operations of a multiple-entity affiliated corporate group that operates as a single economic enterprise into a single unit for purposes of determining the taxable unit. The group’s combined income is then calculated, with internal transactions excluded, and apportioned by formula, with the income and factors of all of the unitary businesses combined into a single return. The use of the term ‘formula apportionment’ may refer to its application to a single entity or to a multiple entity, whereas the term ‘unitary taxation’ refers to the process of combining the operations of a group of corporations that are engaged in a unitary business into a single unit for tax purposes.

Under this method of unitary taxation, adopting a formulary apportionment process, profits are allocated to respective jurisdictions based on a pre-determined formula. The implementation of this methodology involves a two-step approach. The first step is to determine the tax base which is to be apportioned. The second step is to determine the formula to be used for distributing the tax base. These steps are investigated later in the chapter.

8.2.3 Current Use of Formulary Apportionment

There is ongoing debate on the acceptance of formulary apportionment at a range of levels: within counties; within economic groups; and globally. There is the limited use of formulary apportionment within the State tax regime of the United States, the Provincial tax system in Canada and in the allocation to the Cantons of Switzerland.

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Most recently, the European Union has moved towards the adoption of formulary apportionment within its boundaries. There are also proposals by various authors suggesting formulary apportionment for other economic groups. For example, it has been suggested that a treaty-based formulary apportionment system within NAFTA should be adopted with any issues arising being resolvable.\textsuperscript{22}

There are currently, however, no examples of formulary apportionment being used in its pure form at an international level.\textsuperscript{23} Nor has there been any comprehensive effort to do so.\textsuperscript{24} Furthermore, traditionally formulary apportionment has not been applied at industry level. A unitary tax model based on global formulary apportionment is usually proposed, based on geographical boundaries (such as country, economic groups or globally), rather than industry boundaries (such as multinational banking). Yet, there is no reason why a unitary tax model could not be implemented to apply specifically to an industry that warranted it where there is the failure of the current jurisdiction and allocation principles to accurately reflect the economic reality of that particular industry.

Despite the lack of international implementation and the lack of industry implementation, the United States state regime provides an example of the application of a formulary apportionment model, along with problems that may arise. In particular, this model provides an example of the opposition facing such a regime. The United States of America history of formulary apportionment dates as far back as 1920.\textsuperscript{25} Opposition to formulary apportionment has been fierce enough to reach the Supreme Court where its validity was upheld.\textsuperscript{26} Government then placed

\begin{itemize}
\item[23] There are advance pricing agreements which contain elements of formulary apportionment currently in operation.
\item[26] Container Corp. v. Franchise Tax Board 463 U.S. 159, 77 L.Ed. 2d 545, 103 S. Ct 2933 (1983).
\end{itemize}
limitations on its use where foreign source income was involved. Consequently, the adoption and application of a unitary approach in the United States has been significantly reduced in spite of the continued support of the United States Supreme Court. An important reason for this reduction was the international pressure placed on the U.S. states that adopted unitary taxation, particularly from the United Kingdom. As such, the state model is experiencing a hiatus, yet the unitary tax regime of the United States is the only example of a comprehensive adoption of a unitary regime. The use of formulary apportionment at United States level would appear to be discouraging, notwithstanding the fact that the regime reflects economic reality. Much of the international opposition, however, may no longer be present. This is due to the increased recognition of the failings of the traditional model.

There are now proposals to introduce formulary apportionment between countries within the European Union. In 1992, the use of global formulary apportionment was rejected in the European Union. A decade later the pendulum has swung and there is now a strong push for formulary apportionment. The European Union Commission recently endorsed the strategy of a common company tax system within the European Union Member States. A central element to this policy is

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27 These limitations were introduced during the Regan era.


29 For example, the United Kingdom enacted legislation denying tax credits to companies connected to some of the unitary states.


apportionment between these States. The European Union Commission, at an April 2002 conference, committed to a consolidated tax base for companies operating in the European Union, with formulary apportionment to be used to allocate the common tax base to the member states. This move towards formulary apportionment recognises that the internal market, along with the effects of globalization, has changed the corporate tax agenda within the European Union.

The Commission of European Communities report supporting the use of formulary apportionment within the European Union provides '[a] consolidated corporate tax base for the EU-wide activities of companies would contribute to greater efficiency, effectiveness, simplicity and transparency in company tax systems and remove the hiatuses between national systems which provide fertile ground for avoidance and abuse.' The Commission goes on to say:

Only providing multinational companies with a consolidated corporate tax base for their EU-wide activities will really, through a single framework of company taxation, systematically tackle the majority of the tax obstacles to cross-border economic activity in the Single Market. Companies with cross-border and international activities within the EU should in future be allowed to 1) compute the income of the entire group according to one set of rules and 2) establish consolidated accounts for tax purposes (thus eliminating the potential tax effects of purely internal transactions within the group).

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Formulary apportionment does not solve all of the issues associated with the current international tax rules governing jurisdiction and allocation of income. It does remain, however, a potential solution to many of the problems associated with the separate entity approach, and recognises the consequences of globalisation by multinational entities. Principally, it removes the requirement to identify and price internal transactions. Furthermore, it provides a complete solution to the issue of allocation of profits between relevant jurisdictions where there is international acceptance of this model. As such, many of the issues, which arise in the context of multinational banking, may be resolved through a unitary tax model. The model, however, will only be truly successful where global formulary apportionment is applied on the basis of the whole enterprise, which is not an easy task. Before considering the implementation difficulties, it is necessary to examine why unitary taxation based on global formulary apportionment is a more theoretically sound model for determining the jurisdiction to tax and allocation of profits of multinational banks.

8.3 The Theoretical Benefits of the Unitary Tax Model for Multinational Banking

When the unitary tax model based on global formulary apportionment is applied to multinational banks, it has several interrelated theoretical advantages over the exiting arm's length model. The most significant advantage to global formulary

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apportionment is that because multinational banks are highly integrated, unitary
taxation has greater consistency with economic reality. Unitary taxation also
conforms to the aim of efficient operations within the multinational bank providing
the advantage of consistency between bank policy and tax policy. Further, formulary
apportionment has the theoretical advantage of aspiring to the aim of finding an
equitable split of profits between the jurisdictions, which should ultimately be the
overall aim of any taxation regime.\textsuperscript{46} There are also consequential practical
advantages arising out of the implementation of unitary taxation based on formulary
apportionment. Each is examined in turn.

8.3.1 Unitary Taxation Reflecting the Economic Reality of Multinational
Banking

Underlying formulary apportionment is the assumption that each part of the
multinational entity contributes to the overall profits of the entity.\textsuperscript{47} Rather than
focusing on the individual transactions entered into, formulary apportionment
focuses on the contribution made by the separate parts of the entity.\textsuperscript{48} This model
concentrates on the practical question of how much each jurisdiction gets, rather than
dealing with issues like theoretical prices.\textsuperscript{49} In this sense, formulary apportionment
looks to the economic activity rather than the enterprise.\textsuperscript{50} The OECD, while not
supporting global formulary apportionment, recognises the 'economic reality'
argument put forth by proponents of this model. It states:

\textsuperscript{46} Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational

\textsuperscript{47} Robert H Cuttler, 'Formulary Apportionment – Is this Alternative to the Arm's Length
Standard Possible and Practical under the United States' Current Tax Treaties?' (Working

\textsuperscript{48} Robert H Cuttler, 'Formulary Apportionment – Is this Alternative to the Arm’s Length
Standard Possible and Practical under the United States’ Current Tax Treaties?' (Working

\textsuperscript{49} Richard M Bird and J Scott Wilkie, 'Source- vs. Residence-Based Taxation in the European
Union: The Wrong Question?' in Sijbren Croessen (ed), Taxing Income in the European

\textsuperscript{50} Peggy Musgrave, 'Interjurisdictional Equity in Company Taxation: Principles and
Applications to the European Union' in Sijbren Croessen (ed), Taxing Income in the
These advocates also take the position that global formulary apportionment methods are more in keeping with economic reality. They argue that an MNE group must be considered on a group-wide or consolidated basis to reflect the business realities of the relationships among the associated enterprises in the group. They assert that the separate accounting method is inappropriate for highly integrated groups because it is difficult to determine what contribution each associated enterprise makes to the overall profit of the MNE group.\textsuperscript{51}

Economic interdependence by multinational banks has two effects on the economic reality of the entity as a whole. The first effect is that multinational banks are so highly integrated that the entity cannot be divided into any smaller component parts with any degree of accuracy. This is particularly relevant where the multinational bank is undertaking global trading, as the integrated parts of the entity 'are not susceptible to further functional division.'\textsuperscript{52}

The second effect of economic interdependence is that there are advantages to the multinational entity because of their very existence in a foreign direct investment form, explained by internalisation theory. The consequence of this is that the modern multinational entity as a whole is greater than the sum of its parts, because of economies of scope and scale.\textsuperscript{53} Even more than this, the multinational entity is 'an indivisible whole rather than a mere sum of its separate parts'.\textsuperscript{54}

\textbf{8.3.1.1 Reflecting Integration}

It has previously been demonstrated that multinational banks are so highly integrated that it is effectively impossible to divide the entity into smaller parts with any degree of accuracy. The advantage of formulary apportionment is that it recognises the economic reality of this, and does not attempt to do divide the entity into separate

\begin{itemize}
\item \textsuperscript{52} Charles T Plambeck, 'The Taxation Implications of Global Trading' (1990) 44 \textit{Bulletin for International Bureau of Fiscal Documentation} 527, 537.
\item \textsuperscript{54} Miller, Benjamin F, 'A Reply to 'From the Frying Pan to the Fire' (1993) 61 \textit{Tax Notes} 241, 256.
\end{itemize}
parts. The arm’s length standard does attempt such a division and consequently, this is one of its fundamental flaws.\textsuperscript{55} While the arm’s length standard, may have, in the past, reflected economic reality,\textsuperscript{56} when it is applied to highly integrated multinational banks it is conceptually wrong.\textsuperscript{57} The arm’s length approach requires a dissection of the entity, whereas the unitary taxation model reflects economic reality by treating multinational entity groups on a consolidated basis, thereby recognising the essence of the modern multinational entity.\textsuperscript{58} This economic reality is reflected in the integrated nature of the group as a whole, and the underlying rationale that the modern ‘multinational entity is, as a rule, unitary in character’.\textsuperscript{59}

This economic reality is supported by an examination of a multinational entity, which will most often reveal a structure very similar to that of a single entity. As Joann Weiner explains

\begin{quote}
\textit{[t]he rationale for using formula apportionment is that despite separate corporate entities, related companies may have collectively many of the characteristics found in a single corporate entity. For example, affiliates may be under common ownership and have shared management and expenses, economies of scale, and functional integration. These characteristics make it difficult to draw a line between integrated parts of the corporation for purposes of computing income earned by the various pieces of the company.}\textsuperscript{60}
\end{quote}


\textsuperscript{57} Richard M Bird, ‘The Interjurisdictional Allocation of Income’ (1986) 3(3) \textit{Australian Tax Forum} 333, 348.


By ignoring the separate parts of the multinational entity, the formulary apportionment model also ignores the legal structure of the multinational entity, making the structure adopted meaningless for tax purposes, just as it is meaningless for the purposes of management decisions. Instead, the formulary apportionment model looks to economic substance of the multinational entity, and in this sense, adopts a substance over form approach.\textsuperscript{61} The fundamental nature of this model is not to distinguish between a head office with affiliated branches and a parent company with multiple subsidiaries as the traditional model does, but rather it examines the location of the economic activity undertaken by the entity as a whole and allocates based on that activity.\textsuperscript{62} It recognises, therefore, that branches and subsidiaries are integrated and part of the one unitary business.\textsuperscript{63} The model then considers what factors contribute to the income of the entity as a whole and incorporates this into the allocation formula, thereby recognising that the income is generated by those factors utilized by the multinational entity.\textsuperscript{64}

Formulary apportionment also recognises the impossibility of using arm's length pricing for economically interdependent multinational entities.\textsuperscript{65} The need for comparables is also a fundamental flaw in the application of the arm's length standard. It has previously been established that economic interdependence of vertically integrated multinational entities, such as multinational banks, also often


means there are no comparable transactions. Further, even where comparable transactions do exist, the level of vertical integration may mean that the comparable prices do not reflect the contributions made by the component parts of the entity. The continued globalisation and integration of multinational entities means that the problem of determining comparables will only worsen. Formulary apportionment recognises that related party transactions are not undertaken on arm's length terms, and removes the need for any such comparables.

The current source and transfer price regime attempts to allocate a geographical source to income by looking at the location of the income producing activities. Because of the legal principles that have developed, however, the geographical source that is allocated to the income may not be the location of the income producing activities. For example, parts of the multinational bank will often be allocated along functional lines. Furthermore, the traditional regime fails to recognise the economic reality that the component parts are ‘dependent upon or contributory to’ each other part. The formulary apportionment model does not attempt to apply this legal perspective of economic activity, but rather is based on the economic perspective that all of the activities of the multinational entity contribute to

the profits. Where the income of a multinational has its source in the integrated operations of the entity as a whole, it is economically inaccurate to characterise the income as being from one specific geographic source.

8.3.1.2 Reflecting Internalisation

Internalisation theory also supports the use of global formulary apportionment for multinational banks as a theoretically superior model. Internalisation theory means that the arm's length standard does not accurately represent the reason why an entity becomes multinational. This same theory may be used to demonstrate that the unitary tax model is consistent with economic reality. One proponent of this argument is Stanley Langbein, who relies on internalisation theory to posit an alternative to the arm's length price. His suggested model does not discard the arm's length price altogether, rather it is a more liberal approach to the current regime, combined with a formula apportionment methodology, which may accord with current economic thinking.

His model, proposed nearly a decade ago, attempts to dispel the myth that the arm's length method and unitary taxation cannot work together. Instead, he postulates a pricing regime that involves a two-step process. The first step is an allocation of adequate return to components, consisting of a recoupment of cost and a profit margin, the profit margin being determined by reference to an appropriate rate of return. The second step involves the residual profit being allocated according to a formula based method using assets and sales and the factors to be taken into

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75 See chapter five.


Stanley Langbein suggests that this approach is a modified fractional apportionment approach, because the first step, by allowing a market rate of return on assets, utilizes an accepted feature of the current arm's length approach to the allocation of profits.

This model proposed by Stanley Langbein founded on the notion that 'multinational integration occurs to obviate certain hazards'. The hazards obviated are those external to the firm such as quality control, security of information, reputation debasement, and holdups. Stanley Langbein, commenting on his hazard analysis, states:

This exegesis of the origin of multinational firms, and of the 'integration economies' they effect, suggests the futility of constructing a transfer pricing regime based on the identification of 'inputs' to the productive process and the association of profit with particular inputs. It suggests, rather, that allocations seek to provide profits among the components of a multinational group according to the relative contributions of the components to the group profit. And the development of the 'harzard' analysis of the MNE suggest a crude, but logical method for asking what the relative contribution of a component is.

Internalisation means that there are factors which contribute to the overall profitability of the multinational entity that are not taken into account when allocating income under the arm's length model. For example, 'functional integration, centralization of management and economies of scale are simply not reflected in any "transactions" between entities in a corporate group, but arguably do

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impact on the profitability of the various aspects of a multinational’s business.\textsuperscript{84} Savings in transaction costs and economies of scale, both of which are experienced by multinational banks and are part of the motivation for becoming multinational,\textsuperscript{85} are also important features of a vertical integrated multinational entity,\textsuperscript{86} which contribute to the efficiency of the entity as a whole.

The economic reality of multinational banks does not reconcile with the underlying assumptions of the arm’s length pricing model that an entity can be divided into component parts with an accurate allocation of profits attributable to those parts.\textsuperscript{87} On the other hand, formulary apportionment does accurately reflect these factors inherent in global trading,\textsuperscript{88} and avoid the problems of economic interdependence not being recognised by the current model.\textsuperscript{89}

The overall approach of global formulary apportionment means that it recognises the ‘economic reality of the integrated, interdependent, yet expansive, business enterprise.’\textsuperscript{90} Most importantly, formulary apportionment recognises not only the highly integrated nature of multinational banks, but also the advantages gained by operating via foreign direct investment. Consequently, by recognising the economic reality of the highly integrated multinational entity and the internalisation advantages, there is consistency between the taxation model and corporate


management philosophy. This is the second theoretical advantage to the formulary apportionment model.

8.3.2 Consistency between Unitary Taxation and the Aim of Efficient Operations within the Multinational Bank

Unitary taxation conforms to the aim of efficient operations within multinational banks by providing the advantage of consistency between bank management policy and tax policy. The aim of any multinational bank is profit maximisation, and it is the responsibility of management to ensure that this occurs.\(^91\) As such, resources will be allocated according to the location that ensures this profit maximisation. Consequently, a tax model, which allocates income consistent with management policy, is an economically sound and theoretically superior model. Formulary apportionment allocates income to the place of the economic activity by recognising the factors that contribute to the overall profits of the entity, consistent with management policy.

Not only are the business decisions within the multinational bank reflected in the formulary apportionment model, but also reflected is the decision to become multinational. It has previously been discussed that internalisation theory suggests that multinational banks come into existence due to their ability to reduce costs and transact more efficiently than they would have with an independent third party. The current arm's length model requires a recharacterisation of transactions, which does not accord with the efficient nature of the multinational bank, and those factors which initially brought it into existence. This need for examination and recharacterisation of international transactions is no longer necessary for formulary apportionment.\(^92\)

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The OECD holds the contrary view that there is inconsistency between unitary taxation and the aim of the multinational entity. It expresses the concern 'that predetermined formulae are arbitrary and disregard market conditions, the particular circumstances of the individual enterprises, and management’s own allocation of resources, thus producing an allocation of profits that may bear no sound relationship to the specific facts surrounding the transaction'. 93 There are, however, several key problems with this statement. Foremost is the fact that it is the use of a formula through a profit split approach (a transactional method), which is arbitrary, not the use of one under a unitary tax regime. Quite the contrary, formulary apportionment provides a model that has the rationale of consistency between similar multinational entities, such as multinational banks, with the formula designed with market conditions factored in.

This statement by the OECD is further flawed when management’s own allocation of resources is taken into account, as this is the very essence of formulary apportionment. The resources are the factors in the formula, weighted according to relative importance and reflecting management’s decisions to allocate those resources to a particular jurisdiction. The formula used for unitary taxation purposes is one that represents the allocation of resources by the multinational entity to a particular jurisdiction, thereby again reflecting the economic decision of the firm.

There is justification to the statement made by the OECD that the allocation may bear no sound relationship to the specific facts surrounding the transaction, as formulary apportionment is not, and does not purport to be, a transactional method. It recognises that to attempt this is a fiction and, unlike the arm’s length transactional model, does not purport to achieve such a goal. Arm’s length pricing, which does purport to bear relationship to the specific facts surrounding transactions, often fails in this goal, especially for multinational banking transactions where it becomes an impossibility. The claim of formulary apportionment is that it allocates income based on an economically justifiable formula. The process will still be somewhat

contrived, but because the model is founded in an economic solution the result is not the fiction achieved by the present regime.\textsuperscript{94}

When corporate tax differentials are disregarded, internal transactions are meaningless to management, as it is the overall aim of the entity to minimise the expense and maximise the profits of the entity as a whole, not minimise the expense and maximise the profits of the separate parts of the entity, at the expense of another part of the entity. Yet, inconsistent with this rationale, arm's length pricing takes into account these transactions and assumes that each part of the entity is a separate profit centre. Generally, this is not overall management strategy. Consequently, formulary apportionment, which ignores all of the internal transactions, is consistent with the aim of the efficient operations of the multinational entity.\textsuperscript{95}

The OECD also expresses the concern that 'a formula based on a combination of cost, assets, payroll, and sales implicitly imputes a fixed rate of profit per currency unit (e.g. dollar, franc, mark) of each component to every member of the group and in every tax jurisdiction, regardless of differences in functions, assets, risks, and efficiencies and among members of the MNE group.'\textsuperscript{96} This statement necessarily assumes that the functions, assets, risks, and efficiencies are significant to the overall profits of the entity, but that they are not taken into account in determining the formula. A formula does not have to be based in costs, assets, payroll, and sales. Such a formula would be unsuitable for multinational banks where the significant factors are likely to be value, risk, and activity.\textsuperscript{97} Consequently, a formula for multinational banks would take into account the differences in functions, assets,

\begin{itemize}
\end{itemize}
risks, and efficiencies by adopting a formula which is representative of these factors. Where this is done, factors considered significant to management would also be reflected in the tax model.

The OECD believes that by abandoning the separate entity approach important geographical differences would be ignored, as would separate company efficiencies and other sub group specific factors. The OECD concern specifically relates to loss centers or profit centers which it believes will not be adequately recognised under a formulary apportionment regime. Yet again, this approach is contrary to the overall aim of management to maximise the profits of the entity as a whole. Every part of the entity is integral to this profit and as such, contributes. Unlike the arm's length model, the formulary apportionment model recognises this contribution.

The way that formulary apportionment allocates income to a particular jurisdiction is in direct contrast with the arm's length model. Inconsistent with management policy, the transactional approach attempts to allocate income based on the geographical source of income. On the other hand, formulary apportionment, which is consistent with management policy, apportions income according to economic or business activity undertaken in a particular jurisdiction. It may be argued, therefore, that formulary apportionment contains the characteristics of an optimal regime.

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8.3.3 Distributing Taxing Rights through an Equitable Model

A system that distributes taxing rights in an equitable manner between the relevant jurisdictions ensures that each country receives its fair share of tax revenue. A jurisdiction will receive its fair share of revenue where the tax model reflects the economic activity undertaken in a jurisdiction. The economic activity undertaken in a jurisdiction is reflected under a formulary apportionment model via the specific factors in the formula, along with the relative weighting.

The fact that formulary apportionment operates in a vacuum, by only considering firm specific information, is purported to be a reason why this method fails to distribute the taxing rights in an equitable manner. Yet, the economic reality of multinational banks is that they do operate in a vacuum. It is only the income or loss of the individual multinational bank that is relevant to determine the income or loss to be attributed to each jurisdiction in which that entity operates. It is not the industry in which the multinational bank operates that determines the profit or loss of that bank. The formulary apportionment model accepts that the market does not dictate the profits of individual multinational banks, and seeks a "fair" or "proper" division of the overall profits regardless of how the marketplace would operate.

The formulary apportionment model also recognises the reality that modern multinational entities, such as multinational banks, are highly integrated and does not

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attempt a fiction by trying to separate that entity into component parts. Where this is not recognised there is a failure to acknowledge the true nature of the situation. A model, which ignores this reality, may necessarily lack the attributes of efficiency, equity, and achievability.

Neutrality, in all forms, is also an essential feature of an equitable tax regime. A unitary model based on global formulary apportionment has the potential to achieve both jurisdictional neutrality and taxpayer neutrality. Jurisdictional neutrality is achieved through the provision of a single formula for calculating tax liability. While differing corporate tax rates between jurisdictions may mean that there are still differences between jurisdictions, this is not a product of the unitary tax model. Further, a successful formulary apportionment model makes the use havens pointless, as there is no longer the opportunity to have income sourced within that jurisdiction unless factors in formula are present. The use of tax havens by multinational banks is one of the reasons why there is such a distortion in the allocation of profits as compared to economic activity. This distortion would be limited under a formulary apportionment regime.

The unitary tax model, focusing on taxpayer activity rather than taxpayer location, also achieves taxpayer neutrality. As Benjamin Miller points out ‘[i]t levels the playing field for all business competitors by basing taxes on what they actually earn


on an overall basis, not on the basis of whether they are domiciled in the United
States or another country, or the skill of their tax compliance staff in manipulating
the rules. The model would focus on the substance of the multinational bank,
rather than the form of the multinational bank.

An equitable model is also one where each taxpayer pays their fair share of tax. A
global formulary apportionment model may assist in this goal by reducing tax
evasion and avoidance by multinational entity. This occurs due to the extent of
reorganisation a multinational entity would have to undertake to avoid tax. While
the incentive would still be there, it would be reduced by the physical movement
required, rather than the simple book transactions, which achieve tax avoidance
under the current regime. To avoid tax under a formulary apportionment model, the
taxpayer would have to shift formula factors to the low tax jurisdiction. It is
unrealistic to believe that such movement would not take place. This type of
avoidance, however, would be less than under the traditional regime because
multinational entities would have to undertake actual movement and alter their real
business operations to effect any tax changes.

The outcome of an analysis of the current regime and the economic realities of
modern multinational entities, such as the multinational bank, is that 'it would seem
that some form of fractional apportionment regime represents the optimum way to
reflect the economic realities of modern multinationals in an allocation scheme.'
As Daniel Sandler points out 'if the primary purpose of international co-operation
in taxation is to achieve an equitable division of the international corporate income

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113 Benjamin F Miller, 'None Are so Blind as Those Who Will Not See' (1995) 66 Tax Notes 1023, 1035.

114 Lorraine Eden, Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in

115 Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational

116 Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational

117 Stanley I Langbein, 'Transaction Cost, Production Cost, and Transfer Pricing' (1989) 44 Tax
Notes 1391, 1413.
tax base amongst the various competing nations, it is rationally more sound and more consistent with economic reality to tax highly integrated multinational as a single unit, rather than as a group of separate entities acting at arm’s length.\textsuperscript{118}

Consequently, it may be argued that the unitary tax model based on global formulary apportionment is a theoretically superior model to the current arm’s length pricing method for the taxation of multinational banks. The most significant advantage of unitary taxation based on global formulary apportionment is the fact that it reflects the location of the economic activity undertaken by the multinational bank. As such, intermediary services are reflected. This means that it reflects the decisions of management and produces an optimal result. Because of the theoretical superiority, there are several key practical advantages to the regime. These are considered in turn.

8.3.4 The Consequential Advantages to a Unitary Taxation Model

A formulary apportionment regime may provide such practical benefits as greater certainty, improvement of tax compliance due to increased simplicity, a reduction in avoidance, and a reduction in double taxation. These benefits also contribute to the unitary tax model being an optimal model for taxing multinational banks.

Currently, unless the taxpayer enters into an advance pricing agreement, it is left with the knowledge that the relevant taxing authority, may, at any time undertake a transfer-pricing audit and substitute an arm’s length price for one which the taxpayer has used. This is despite the taxpayer’s best intentions. In addition, the taxing authority will be privy to competitor information, which a taxpayer will not have access to, thereby allowing the taxing authority to more accurately determine an arm’s length price due to a greater data base of comparables. A unitary tax regime alleviates this uncertainty and the taxpayer is left with the knowledge that so long as


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the formula is complied with there is little chance of the taxing authority amending an assessment.\footnote{Eugene E Lester, 'International Transfer Pricing Rules: Unconventional Wisdom' (1995) 2 ILSA Journal of International and Comparative Law 283, 300.}

Certainty is also increased where formulary apportionment is applied in a uniform manner to corporate groups and on an international scale.\footnote{Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56(12) Bulletin for International Fiscal Documentation 586, 598.} Furthermore, the information required administer the formulary apportionment model has greater objectivity and is grounded in more reality than the information required to determine the hypothetical arm’s length price under the current transfer pricing regime.\footnote{Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1995) 79 Cornell Law Review 18, 69.}

It may also be argued that formulary apportionment encourages greater compliance, with this compliance achieved through a reduction in compliance costs and increased simplicity.\footnote{Eugene E Lester, 'International Transfer Pricing Rules: Unconventional Wisdom' (1995) 2 ILSA Journal of International and Comparative Law 283, 300; Charles E McLure Jr, 'Replacing Separate Entity Accounting and the Arm’s Length Principle with Formulary Apportionment' (2002) 56(12) Bulletin for International Fiscal Documentation 586, 598; T Scott Newlon, 'Transfer Pricing and Income Shifting in Integrated Economies' in Sijbren Chosen (ed), Taxing Income in the European Union - Issues and Options for Reform (2000) 214, 235; Benjamin F Miller, 'Worldwide Unitary Combination: The California Practice' in Charles E McLure Jr (ed), The State Corporation Income Tax (1984) 132, 160; Sijbren Chosen, 'Tax Policy in the European Union: A review of Issues and Options' (2001) Rotterdam: Erasmus University 78.} In its most extreme form, formulary apportionment is a very straightforward model to apply. It simply takes the income from the unitary business and divides it between the relevant jurisdictions based on a predetermined formula. This is unlike the current arm’s length approach, which is inherently complex in its application.\footnote{The OECD acknowledges this claim. It states: 'Apart from these arguments, advocates contend that a global formulary apportionment approach reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes.'; OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995) 3.62.} Formulary apportionment removes a large percentage of the
complexity associated with the arm's length model, as transfer prices, determined on a transactional basis, would no longer need to be ascertained.

This simplicity results in a reduction of compliance costs, and where compliance costs are reduced, tax compliance may be improved. This reduction in complexity and increased compliance will be at its greatest level where there is international implementation of a formulary apportionment model, and agreement on all relevant issues. The necessary requisite international agreement is generally the argument used to support the view that there are increased compliance costs and complexity introduced with a formulary apportionment regime. This view is based on the premise that it would be difficult to reach international agreement on the elements of the formulary appointment model, particularly the relevant tax base to be used. The OECD is one such body that opposes formulary apportionment based partially on this argument. It states:

Contrary to the assertions of its advocates, global formulary apportionment methods may in fact present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction on the basis of the currency and the book and tax accounting rules of that particular jurisdiction. Thus, the documentation and compliance requirements for an application of a global formulary apportionment approach would generally be more burdensome than under the separate

entity approach of the arm’s length principle. The costs of a global formulary apportionment approach would be further magnified if not all countries could agree on the components of the formula or on the way the components are measured.\textsuperscript{130}

There is belief that the multinational entities themselves also hold this view. It has been stated that ‘the view of business is that the documentation and compliance requirements under a unitary approach would be more burdensome than under the separate entity approach.’\textsuperscript{131} It is arguable that while this may still be true of traditional multinational entity businesses, it is not the case for multinational banks. The fact that multinational banks are entering into advance pricing agreements emulating a formulary apportionment model, suggests that this statement may not apply to the international banking sector, and that banks may be receptive to an allocation method that openly accepted a formulary basis for profit distribution.

While there is still an amount of complexity associated with formulary apportionment, it is a comparison between the current model and the proposed model that must be drawn. To this extent, ‘[a] comparison of the administrative and compliance burdens involved in preparing a combined report and computing the income derived from a particular jurisdiction by formula accounting with those involved in rigorous arm’s-length examination must inevitably lead to the conclusion that the former is superior.’\textsuperscript{132}

The theoretical advantage of formulary apportionment offering an equitable regime because taxpayers pay their fair share of tax is juxtaposed to the practical advantage of the reduction in the opportunity for income shifting.\textsuperscript{133} By reducing the need to determine transfer prices based on an arm’s length methodology, the opportunity for


\textsuperscript{131} Diane Hay, Frances Horner and Jeffrey Owens, ‘Past and Present Work in the OECD on Transfer Pricing and Selected Issues’ (1994) *9 Tax Notes International* 249, 255.


income shifting is also reduced. As stated earlier, while a formulary apportionment model introduces the incentive to move formula factors to lower tax jurisdictions, this is not as easy as transfer price manipulation, due to the need to relocate economic activity to those locations.\(^{134}\)

A final advantage to formulary apportionment, which is also a consequence of this model achieving greater equity, is the elimination of double taxation.\(^{135}\) The possibility of double taxation is removed where a formulary apportionment model is adopted globally and uniformly implemented.\(^{136}\) Double taxation then becomes impossible, as the tax base to be divided between the relevant jurisdictions is never more than one hundred percent of the taxable profits.

The advantages of a consolidated corporate tax base may be real and substantial. Potentially, compliance costs are reduced, many of the transfer pricing problems largely disappear rendering the tax regime simpler, and there is less opportunity for over or under taxation. Furthermore, businesses can undertake a comprehensive consolidation of profits and losses, and a restructuring is simplified.\(^{137}\) Multinational banks would no longer have to rely on advance price arrangements to gain any certainty in their pricing allocation of income.

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8.4 The Practical Implications of Accepting Formulary Apportionment as an ‘Optimal’ Regime for Taxing Multinational Banks

Acceptance and international agreement of unitary taxation based on global formulary apportionment as a theoretically superior model for taxing multinational banks is essential if it is to be embraced internationally.\(^{138}\) Lack of international acceptance has been described as the most debilitating disadvantage to formulary apportionment.\(^{139}\) This thesis, however, is not proposing that unitary taxation based on global formulary apportionment, replace the current tax regime for all multinational entities. Rather, it proposes that it be implemented for multinational banks. There is already evidence that the current jurisdiction and allocation rules, while adequate for traditional multinational entities, do not work for multinational banks. As such, international acceptance of this model as theoretically superior for the specific industry of banking may not be as onerous as its acceptance for multinational entities generally.

Acceptance of formulary apportionment as a superior regime, however, does not guarantee its implementation, and it is this implementation process that may in the end lead to its demise as an alternative regime.\(^{140}\) The initial hurdle of reaching international agreement to implement a formulary apportionment regime is exacerbated by complex methodological questions.\(^{141}\) The implementation process requires a high degree of co-operation among nation states to agree also to the various key economic components of the formulary apportionment regime. In particular, consensus as to the tax base, the composition of the formula and the

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definition of the factors and the scope of the unitary business are essential. Such agreement would not be reached without conflict. The practical implications related to the theoretic examination of the use of formulary apportionment are a consequence of its acceptance as a superior model. As such, while they do not add to the discussion of the theoretical merits, they may provide an aid to determine whether formulary apportionment is a fundamentally fair and practical model. This part of the chapter first considers the degree of international acceptance required before implementation stage. It then considers the three key components to the regime. The issues relating to these components are raised with a view to disclosing the pertinent questions that need to be dealt with at a practical level before implementation would be possible.

8.4.1 Requisite Degree of International Consensus

The most fervent argument against formulary apportionment is its lack of general acceptance internationally. The OECD relies on this argument to dismiss formulary apportionment, stating that reaching such an agreement would be time consuming and extremely difficult. It believes that ‘transition to a global formulary apportionment system … would present enormous political and

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administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation.\textsuperscript{147}

Many jurisdictions adopt a similar stance. For example, the Australian Taxation Office recognises that global formulary apportionment is a method that is an alternative to the arm's length principle as a means of determining the proper allocation of profits across competing national tax jurisdiction. As such, it recognises the theoretical merits of the model. It does not consider, however, global formulary apportionment to be an acceptable alternative to the arm's length principle in practice.\textsuperscript{148} One reason given for this stance is the high degree of international cooperation and coordination needed.\textsuperscript{149} Yet, international bodies and domestic jurisdictions have generally viewed unitary taxation as an all or nothing approach, rather than an industry specific solution. The OECD, as a potentially difficult area for taxation has already singled out the multinational banking industry, and consequently, there is no reason why it could not be singled out for possible use of formulary apportionment. Where, however, there is not international consensus problems arise.

The consequence of jurisdictions not agreeing to exclusive use of formulary apportionment would be the need to calculate profits attributable to the relevant jurisdictions using two different standards.\textsuperscript{150} Difficulty in reaching international consensus, however, is an inadequate reason for dismissing formulary apportionment outright, and should not be an obstacle to its inception.\textsuperscript{151} Formulary apportionment is addressing the same fundamental issue as the current tax regime in attempting to


\textsuperscript{148} \textit{Taxation Ruling} TR 97/20, paragraphs 3.100 - 3.101.

\textsuperscript{149} \textit{Taxation Ruling} TR 97/20, paragraph 3.104.


find an equitable distribution of income to the relevant jurisdictions.\textsuperscript{152} Reaching international agreement on this equitable distribution is ultimately difficult, whether it is achieved through the traditional regime or by agreement on a new model.\textsuperscript{153} It is also argued that the implementation of formulary apportionment is not feasible without international acceptance.\textsuperscript{154} Yet, the obstacle of reaching international agreement on an equitable distribution can be overcome; the current regime being an example of where this has occurred.\textsuperscript{155} To this extent, Reuven Avi-Yonah believes that the present 'international tax regime, based on voluntary consensus, can be regarded as one of the major achievements of twentieth-century international law.'\textsuperscript{156}

The current regime, with its arm's length pricing requirement, is an example of a model that requires a substantial amount of international cooperation to find an equitable distribution.\textsuperscript{157} This equitable distribution is attempted through the arm's length requirement despite the fact that, in the case of a highly integrated entity, it does not achieve a result that reflects economic reality.\textsuperscript{158} Furthermore, where the traditional arm's length standard does not result in an accurate allocation, jurisdictions, while explicitly adopting the official stance of opposing formulary apportionment, implicitly accept its use.\textsuperscript{159} Consequently, there is already a level of international cooperation as to how to achieve this equitable allocation of profits to

\begin{itemize}
  \item \textsuperscript{156} Reuven S Avi-Yonah, 'The Structure of International Taxation: A Proposal of Simplification' (1996) 74 Texas Law Review 1301, 1301.
  \item \textsuperscript{157} Richard M Bird, and D J S Brean, 'The Interjurisdictional Allocation of Income and the Unitary Taxation Debate' (1986) 34(6) Canadian Tax Journal 1337, 1409.
  \item \textsuperscript{158} Richard M Bird, and D J S Brean, 'The Interjurisdictional Allocation of Income and the Unitary Taxation Debate' (1986) 34(6) Canadian Tax Journal 1337, 1409.
\end{itemize}
the relevant jurisdictions. Multinational banking is an ideal example of where this has happened.

The current regime also provides an example of circumstances where many of the rules are not without disagreement. For instance, the current application of the arm's length principle itself causes difficulties in practice where different methodologies are used. This means that the arm's length rules are not applied uniformly, nor is there uniform consensus as to the assignment of income and expenses. Currently, disputes between nations are voluntarily resolved via treaty provisions. Where jurisdictions continue to disagree, there is no solution to the possibility of double taxation.

It has been stated that for unitary taxation, to be successful, it would need to be accepted internationally. At the very least, it would need to be implemented multilaterally to achieve any sort of equitable distribution. Implementation of a unitary model by only one jurisdiction would not be a satisfactory approach to the issue of allocation as there would be a dual requirement to satisfy by the arm's length model and formulary apportionment model. There may also be complications for

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161 Benjamin F Miller, 'A Reply to 'From the Frying Pan to the Fire' (1993) 61 Tax Notes 241, 248.

162 Benjamin F Miller, 'A Reply to 'From the Frying Pan to the Fire' (1993) 61 Tax Notes 241, 248.


a unitary taxation model where it is only adopted by a group of countries, as there may still be the dual requirement to satisfy both regimes.\textsuperscript{166}

As with the current international tax regime, international agreement would likely need to be in the form of a multilateral treaty to operate efficiently.\textsuperscript{167} The use of such treaties is possible as the role of the tax treaty is increasing.\textsuperscript{168} Further, many other regulatory issues are being dealt with at a global level.\textsuperscript{169} A multinational treaty enables not only the application to be consistent but also aids administration through cooperation of information gathering and consistent enforcement.\textsuperscript{170} At present, treaties allow formulary apportionment in a limited number of cases. By expanding on this limited acceptance and adopting a multilateral approach, such agreement would ensure that jurisdictions collaborate to develop a uniform application of the formulary apportionment model.\textsuperscript{171} Again, this would not be an easy task and the opposition from developing countries cannot be discounted as it may be argued that they have little to gain from a formulary apportionment regime.\textsuperscript{172} This would, however, be achieved more easily under an industry specific proposal than a broad adoption of the regime for all multinationals.


A multilateral approach may also require individual jurisdictions to relinquish a certain degree of control over the taxation of multinational banks, which is likely to be approached with a degree of reluctance by all jurisdictions concerned. A suggested, albeit recognised extreme approach to unitary taxation is the assessment of profits by a central administering body, which would allocate the income to the relevant jurisdictions according to the relevant formula. This would require a central body to administer all multinational banks, and the jurisdictions to agree on both the tax base and tax rate. Such an approach would obviously require jurisdictions to hand over many of the rights currently assessed domestically. Consequently, it may be argued that sovereignty over taxation would be compromised. It is unlikely, therefore, that in the near future agreement of this type would be reached. A more flexible version, however, would allow the individual jurisdictions to apply their own tax rate and make base adjustments. The current regime also deals with these issued without an international body overseeing implementation and administration. As such, this should not be a bar to unitary taxation based on global formulary apportionment.

Opposition to formulary apportionment based on the difficulty in reaching international consensus also encompasses a compliance aspect. Opponents argue that agreement will not be reached because of the underlying issue of the extra burden placed on entities to provide information on a global basis, as well as


translation requirements and the ongoing burden of complying with the accounting standards of individual jurisdictions. Previously, this chapter has argued that compliance may be less burdensome for multinational banks under the unitary tax regime than it is currently. At the very least, any additional compliance would not be excessive.

This thesis concludes that a move towards a unitary tax model based on global formulary apportionment for tax multinational banks would require vast changes in attitude by tax authorities internationally. There is no doubt that politically and administratively, the substitution of the arm's length pricing model with a unitary tax model for the taxation of multinational banks, would introduce a range of complex issues to be overcome. Furthermore, the most successful way of achieving harmonization is through full international acceptance, without which compliance would be required of two systems. This should not be dismissed, however, as being impossible to achieve, as the current regime is one which effectively requires a similar degree of international acceptance and compliance to operate effectively.

Consequently, this first step of achieving international acceptance, while difficult, is not insurmountable. This acceptance, however, that formulary apportionment is a more theoretically sound model for taxing multinational banks sets only the foundation for implementation of such a regime. Agreement to a formulary apportionment approach does not connote agreement on the operation and administration of the regime.

Before formulary apportionment could be implemented for multinational banks, agreement would need to be reached on jurisdiction to tax, the tax base to be divided, the formula, the unitary business, and enforcement principals.\(^{184}\) Difficulties are generally associated with what are known as the key components to the regime. As such, the next part of this chapter considers those key components to a formulary apportionment regime for taxing multinational banks.

### 8.4.2 Key Components of the Formula Apportionment System

As with the current transfer pricing regime, the implementation of a unitary tax model based on global formulary apportionment requires agreement on certain issues. The effective implementation of this model requires consensus on key components to the regime, namely: the unitary business, the tax base, and the composition of the formula.\(^{185}\) There is also potentially the scope for agreement on the corporate tax rate. This, however, is an issue neither exclusive, nor integral to unitary taxation and formulary apportionment. The current regime is one with differing corporate tax rates between taxing jurisdictions and this is unlikely to diminish in the future.\(^{186}\) Furthermore, just as it is not necessary to have a uniform corporate tax rate under the current regime, it is not necessary to have uniform corporate tax rate for an effective formulary apportionment regime.

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The current regime also provides guidance as to how to reach consensus on key issues. Consensus has generally already been reached on the key issues of the current regime, and many of these are similar to the ones arising under a unitary tax model. For example, determining what constitutes the unitary banking business can be equated to determining whether there are related parties for arm's length pricing purposes. Determining the formula can be equated to the arm's length standard itself, as it is simply a means of allocating profits according to a predetermined method.\textsuperscript{187} As such, many of these issues are not new, with the exception of the tax base, which may pose new questions.\textsuperscript{188}

As stated earlier, the OECD broadly opposes formulary apportionment based on the high degree of international consensus required. More specifically, the OECDs most significant concern lies with the requirement of 'substantial international coordination and consensus on the predetermined formulae to be used and on the composition of the group in question.'\textsuperscript{189} Without this agreement there may be double or less than single taxation.\textsuperscript{190} This agreement is, however, not impossible to achieve. The key components are examined in turn.

\section*{8.4.2.1 The Unitary Business}

The first key economic component of the unitary tax system is the \textit{unitary business}. That is, which parts of the banking business are considered part of the multinational bank for taxation purposes? Defining the unitary banking business is essentially a question of fact and needs to be considered on a case-by-case basis.\textsuperscript{191} It will usually

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be obvious that a branch is part of the unitary banking business, and therefore, main issue is whether separately incorporated affiliates should be included in the combined banking business.192

The United States State model is an example of where this issue has had to be decided in a broad spectrum of cases. While unitary taxation is used in the United States only in a limited sense, the courts have had to decide the definition of a unitary business. In this setting definition is, and continues to be a source of controversy.193 Two tests, however, have been formulated which may provide a foundation upon which to base international tests. These tests are not statutory based, but rather a product of the court system. Furthermore, the Supreme Court, rather than defining what is meant by the unitary business, has left it to be decided on a case-by-case basis. It states ‘... the application of the unitary-business principle requires in each case a careful examination both of the way in which the corporate enterprise is structured and operates, and of the relationship with the taxing State.’194

It is the Californian courts that have formulated two tests for determining the unitary business.195 The first is the three unities test in Butler Brothers v. McColgan.196 Under this test, there is a unitary business if there is (1) unity of ownership, (2) unity of operation, and (3) unity of use. The second test is the contribution test of Edison California Stores.197 Under this test 'if the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the


196 Butler Brothers v. McColgan 17 Cal 2d 664 (1941).

197 Edison California Stores 30 Cal. 2d 472 (1947).
business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered separate. 198

The debate as to which test applies has been ongoing. 199 The tests, however, do provide guidance as to the types of issues that can be considered to determine the unitary banking business at a global level. Further, as suggested earlier, this may be no more than the debate over associated enterprises and permanent establishments, as the question is one as to which of the branches and subsidiaries should be included in the unitary banking business. The question in a unitary taxation setting does, however, have the advantage of being a determination of fact based on the individual circumstances, rather than one that considers the legal structure of the business. 200 Consequently, the subsidiary/branch recognition and distinction would not play a part in the allocation process.

Determining the unitary business for the purposes of multinational banking would generally not be a difficult task. It will usually be obvious whether a branch or a subsidiary is contributing to the overall business and, therefore, should be included as part of the unitary business for tax purposes. There may be some difficulty in deciding whether an agency is part of the unitary business, but this assessment would be no more difficult than determining whether the agent is dependent or independent for the purposes of the permanent establishment threshold test.

198 Edison California Stores 30 Cal. 2d 472 (1947) 481.


8.4.2.2 The Tax Base

Once the unitary banking business is identified, the formulary apportionment system requires a definition of the tax base to determine the amount to be apportioned. This tax base has been referred to as the business taxable income, which is the amount to which the formula should be applied.  

Before the formula can be applied, however, there needs to be a commonly agreed method for determining the profits to be apportioned. To maintain equity and ensure that there is not under or over taxation, there must be a common definition of business income. To this extent there also needs to be consensus on the issue of timing for the purposes of income and deduction recognition.

Consensus on the multinational banking tax base may be more difficult than consensus on the unitary banking business as there is no counterpart in the current regime. The current regime, by operating on a transactional basis, ensures that the rules applicable in the country of allocation apply. There are, however, recognised methods for determining the tax base for multinational entities in general. The best example of these methods is found in the work already undertaken by the European Union Commission within their proposals to move towards formulary apportionment. The European Union Commission is currently focusing on two alternatives; home state taxation (HST); and common (consolidated) base taxation.

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205 For a discussion on the advantages and disadvantages of these approaches see Joann M Weiner and Jack Mintz, 'An Exploration of Formula Apportionment in the European Union' (2002) 42 European Taxation 346.
Under the home state taxation method, the home jurisdiction would determine the tax base according to their domestic rules. Alternatively, under the common base method, common rules would determine a standardized taxable income of all multinational entities.

Common (consolidated) base taxation is seen as the ultimate goal of a formulary apportionment regime. This method, however, would require an immense degree of cooperation between nation states. Currently, therefore, home state taxation would appear to be the more pragmatic approach to the problem of defining the tax base. If this method were adopted for the application to multinational banks there would be no change from the current system.

8.4.2.3 Composition of the Formula and the Definition of the Factors

Once the multinational banking tax base has been determined, it is necessary to allocate that base according to a predetermined formula. The composition of the formula is the main challenge facing the implementation of a formulary apportionment model. The challenge is to 'develop a list of objective and easily

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206 Commission of the European Communities, Commission Staff Working Paper: Company Taxation in the Internal Market (2001); Commission of the European Communities, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee – Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-Wide Activities (2001). There are two further methods which are not the subject of focus.


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measurable criteria that could be used to allocate, in an equitable manner, taxable income across tax jurisdictions. It is pertinent that this objective is met, as formulary apportionment will only represent an optimal regime for taxing multinational banks, superior to arm's length pricing, where the formulary factors reflect the location of the economic activity.

As with the previous key components, it is agreement that is essential, and it is the agreement upon a formula that is important, rather than choosing a particular formula. While the definition of the formula and factors are important to the apportionment system, the choice of the actual formula to be applied is less important than is often recognised. If agreement is not reached, there is the potential for over or under taxation. Whereas, once the agreement is reached only 100 per cent of the tax base may be allocated.

The choice of factors to agree on, however, is influenced by competing forces. The factors should reflect how the income is produced and identify contributions made by the relevant jurisdictions. Where the contributions are recognised the interest of accuracy is met. The interests of accuracy, however, must be weighed against the

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interests of simplicity. An increase in accuracy may lead to a decrease in simplicity. From an accuracy perspective, the formula should reflect the contributions that are present in the income producing process, whereas, from a simplicity perspective, the formula should be able to be easily administered. There is also the inherent incentive for individual jurisdictions to achieve a formula that places emphasis on factors which have a significant presence within the jurisdiction. There is also the problem that developing countries may be disadvantaged where emphasis is placed on such factors as labour and capital that have lower costs in developing counties. As such, they are unlikely to agree to a formula which weighs these factors heavily.

Because of the complex array of competing interests, both conceptually and at a practical level internationally, agreement to the factors is a difficult task. The OECD explains the competing jurisdictional interests:

Even if some countries were willing to accept global formulary apportionment there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country would have a strong incentive to devise formulae or formula weights that would maximise that country's own revenue. In addition, tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g. sales, capital) to low tax countries.


The choice of formula should reflect an optimal regime, or one, which allocates income to the relevant jurisdictions, based on economic activity, with the aim of achieving interjurisdictional equity. Economic theory does not provide a single formula for accurately allocating income. As such, international agreement is necessary on what is considered 'fair'. As to what is considered fair, there are various factors, which may be considered to contribute to the economic activity undertaken in a jurisdiction.

Examples of factors that may make up the formula include the share of physical assets or intangible assets, the share of employment, and the share of sales. Other examples, which have been used at some time in the United States state formula, include manufacturing costs, purchases, expenditures for labour, accounts receivable, net cost of sales, capital assets, and stock of other companies. While all of these factors have, at some time, been used for the purposes of the United States State tax regime, property, payroll and sales are now seen as the acceptable factors. It is believed that 'the property, payroll and sales formula strikes a

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228 The OECD believes that there are problems with the use of these factors. It states: ‘Difficulties also would arise in determining the sales of each member and in the valuation of assets (e.g. historic cost versus market value), especially in the valuation of intangible property. These difficulties would be compounded by the existence across taxing jurisdictions of different accounting standards and of multiple currencies. Accounting standards among all countries would have to be conformed in order to arrive at a meaningful measure of profit for the entire MNE group. Of course, some of these difficulties, for
balance between ... competing influences.\textsuperscript{230} The rationale for the use of the three factor formula is that these factors ‘provide a reasonable measurement of the income generated by the business activities located in the state. It does not place a disproportionate weight on any of the factors, and it apportions some income to the states where production occurs and some income to the states where sales occur.’\textsuperscript{231}

These factors, however, may not be suitable for multinational banking. It is generally understood that inequities may be created where the same formula is applied across differing industries.\textsuperscript{232} In the context of global trading Charles Plambeck suggests that ‘most in accordance with economic theory would be to select factors of production (inputs) as the basis for this formula, on the theory that if unrelated parties in each jurisdiction were to enter into a joint venture to conduct global trading, they might be expected to divide the profits in accordance with each one’s relative contribution of inputs.’\textsuperscript{233} Further, he states that the predominant factor would be one that measures trader (human resource) input.\textsuperscript{234}

The only example of formulary apportionment being used for global trading is found in the advance pricing arrangements entered into in the United States. These formulas are not true instances of global formulary apportionment as they have regard to the particular facts of the individual cases. They do, however, provide an example of suitable factors. The Internal Revenue Service, in arriving at an example the valuation of assets and intangibles, also exist under the arm’s length principle, although significant progress in respect of the latter has been made, whereas no credible solutions have been put forward under global formulary apportionment.’ OECD, \textit{Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations} (1995) 3.70.


appropriate formula, considered that the factors of value, risk, and activity were the most significant to determine the source of income. 235 The advance pricing arrangements were entered into where the Internal Revenue Service considered that the businesses were functionally integrated operating under a central management and risk model. 236 The agreements allocated income on a profit split basis using these three factors. 237 Consistent with an equitable interjurisdictional allocation, the use of these factors 'was designed to measure the economic activity in each trading location and its contribution to the overall profitability of the worldwide business.' 238

The value factor, which is used in the advance pricing arrangement, represents a measure of the contribution of a trading location to the worldwide profits of the entity; the best measure of this factor being the compensation of the traders at a trading location. 239 Both the taxpayers and taxing authorities considered that trader compensation, including bonuses, was the best measure of this factor. 240 As such, it contained the greatest weighting. 241

The risk factor used in the advance pricing agreements was a measure of the potential risk to which a trading location exposes the worldwide capital of the entity. 242 This factor is measured in a number of alternative ways, 'such as the


maturity weighted volume of swap transactions or open commodity positions at the end of the year entered into in that trading location.\textsuperscript{243}

The activity factor used in the advance pricing agreements was a measure of the contribution of a trading location to the worldwide profits of the entity, which takes into account key support staff.\textsuperscript{244} It can also be calculated by reference to the net present value of transactions executed at a trading location.\textsuperscript{245}

While the advance pricing arrangements were firm specific, this does not need to be the case as formula's can be based on industry or other broad economic data.\textsuperscript{246} Using these factors, a possible formula for multinational banking is exhibited in the table below.


\textsuperscript{246} Joann M Weiner, 'The European Union and Formula Apportionment: Caveat Emptor' (2001) 41 (10) \textit{European Taxation} 380, 381.
Possible Formula\textsuperscript{247}

\[ T_i = t_i \Pi \left[ \alpha_i^V \frac{V_i}{V} + \alpha_i^R \frac{R_i}{R} + \alpha_i^A \frac{A_i}{A} \right] \]

Where:

\( i \) = jurisdiction

\( T_i \) = tax liability in jurisdiction

\( t_i \) = statutory tax rate in jurisdiction

\( \Pi \) = tax base

\( V_i \) = Value in jurisdiction

\( R_i \) = Risk in jurisdiction

\( A_i \) = Activity in jurisdiction

\( \alpha_i^V \) = weight on value in jurisdiction

\( \alpha_i^R \) = weight on risk in jurisdiction

\( \alpha_i^A \) = weight on activity in jurisdiction

\( V = \) total value

\( R = \) total risk

\( A = \) total activity

\( \alpha_i^V + \alpha_i^R + \alpha_i^A = 1 \)

It is not possible to predict the international reaction to the issue of agreement on the key components to a formulary apportionment regime for multinational banks. As such, this chapter does not attempt to determine the 'best' way of defining these components, but rather it offers suggestions and a foundation for discussion, which may ultimately lead to consensus. What is evident, however, is that agreeing to the use, and the implementation of unitary taxation based on global formulary apportionment at an industry specific level, such as multinational banking, will be easier than the implementation of this model at a broad level applying to all multinational entities.

\textsuperscript{247} Adapted from Commission of the European Communities. Commission Staff Working Paper: Company Taxation in the Internal Market (2001) 413.
8.5 Conclusion

A move to unitary taxation based on global formulary apportionment is a ‘big bang’ approach to the problems associated with the application of the traditional international taxing model when applied to multinational banks. Consequently, there would need to be radical change in international tax procedures for such a model to be implemented. While, some commentators believe that formulary apportionment introduces its own set of problems, it has greater parity with the economic reality of multinational banking, thereby achieving a result which reflects an optimal way to tax multinational banks. Global trading is one such activity undertaken by multinational banks where economic functions cannot be divided according to geographical boundaries. Accordingly, the traditional arm’s length model does not achieve a result which accurately reflects the economic activity undertaken in a jurisdiction. Formulary apportionment would achieve this result, and at the same time ensure that the intermediary activities undertaken by multinational banks are captured for taxation purposes.

Global formulary apportionment is also a pragmatic answer to the problems associated with the current regime, as it accepts that it is not possible to determine an accurate allocation of income on a transactional basis. Rather, it focuses on an approximate answer, which most closely reflects the economic reality and business strategy of the multinational banks.

The obvious downfall, however, of the formulary apportionment model is not related to its theoretical soundness, but to the problem of international acceptance and

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agreement, not only to implement the model but also to the agreement on the key components to the regime. Without international compliance, global formulary apportionment may not exhibit many of the purported advantages and may not be a viable alternative to the current model.\textsuperscript{253} It is arguable, however, that international acceptance may be achievable in an industry specific setting, particularly where that industry is multinational banking. This is because multinational banking exhibits unique characteristics that make it difficult, if not impossible, to apply the traditional jurisdiction and allocation rules to the taxation of these banks. Whereas unitary taxation based on global formulary apportionment represents an optimal way to tax multinational banks because it recognises the unique characteristics and the economic reality of the industry.

Chapter 9

Summary, Findings and Conclusion

9.1 Summary

This thesis has argued that the traditional international tax rules that govern jurisdiction to tax and allocation of income that apply to multinational entities to distribute the taxing rights to the relevant jurisdictions do not provide an optimal regime when applied to multinational banks. The regime is not optimal because it fails to take into account the unique features of multinational banks that allow the banks to manipulate their tax position. This manipulation occurs through both the use of the traditional jurisdictional allocation principles and the use of the traditional transactional allocation principles.

This research is significant due to the increased internationalisation and globalisation of multinational entities in general, and multinational banks in particular. The increase in the number of multinational banks, which are undertaking more globalised and complex trading operations, has outpaced the ability of the traditional tax regime to allocate the income from these entities in a manner reflecting the economic activity undertaken. Compounding this inadequacy is the fact that the traditional regime does not have the requisite degree of flexibility required to adapt easily to the modern multinational bank.

This thesis has analysed the purported inadequacies of the traditional tax rules governing jurisdiction to tax and allocation of income when applied to multinational banks. In order to undertake this analysis, it was necessary to consider what an optimal regime would be for taxing multinational banks. This thesis considered that an optimal tax regime is one that allocates according the location of the significant economic activity undertaken. An optimal regime provides a system that distributes taxing rights in an equitable manner between the relevant jurisdictions and ensures that each country receives its fair share of tax revenue. This thesis argued that countries are currently not receiving their fair share of tax revenue because of the
application of the strict legal principles contained in the traditional international tax regime. Consequently, the current regime should be replaced with a theoretically superior model that does accurately allocate income to the relevant jurisdictions based on significant economic activity. Unitary taxation based on global formulary apportionment was the proposed alternative.

9.2 Findings

Four propositions were examined in this thesis to demonstrate the inadequacies of the current regime, and to argue that global formulary apportionment is a theoretically superior model. The first proposition was that multinational banks are a unique subset of multinational entities. Chapter two demonstrated that multinational banks are unique in both the services and consequent products provided, and the organisational structure adopted. The services and consequent products are unique because the multinational bank is offering intermediary services. The organisational structure is unique because the multinational bank is a highly integrated, vertically aligned multinational entity with internal transactions going in both directions. Chapter three demonstrated that, despite these unique features, and despite the increase in multinational banking, there has not been an adequate consideration of the tax consequences arising. The conclusion drawn from chapters two and three was that the unique nature of multinational banks is significant enough to warrant an investigation into the tax consequences, especially in light of the rapid growth of the multinational banking industry.

The second proposition was that the traditional rules of source fail to allocate the right to tax to the relevant jurisdictions in an optimal manner, accurately reflecting economic activity. Chapter four argued that the source rules are inadequate when applied to multinational banks because of their unique intermediary role. The role undertaken by the multinational bank allows the manipulation of the source rules through the classification of the income into legal categories. As such, the location of the source of income is often the place where the ancillary product is supplied rather than the location of the provision of the services. Chapter four concluded that a robust source regime is required for the taxation of multinational banks but that the
current source regime does not allocate income to the relevant jurisdictions in an optimal manner.

This thesis concluded that resolving jurisdictional allocation issues does not mean that income is being allocated according to economic reality. The third proposition was that profits attributed to a jurisdiction may be distorted by a multinational entity by the separate but related parts of that entity manipulating the prices at which goods and services are transferred internally. Chapters five, six and seven examined transfer price manipulation. Chapter five initially considered the OECD response of arm’s length pricing to transfer price manipulation, along with the suppositions underpinning its application to multinational banks. It then investigated the theoretical justifications for the arms length approach and concluded that, while this approach may be theoretically justifiable for traditional multinational entities, it was not theoretically justifiable for multinational banks. This conclusion was based on the fact that the unique features of the multinational bank means that the arm’s length model fails to account for the internalisation of market efficiencies or the synergistic benefits. Further, because of their unique intermediary role, there may simply be no recognition of internal transactions taking place. Consequently, there is not an accurate allocation of income when that income is earned by multinational banks. Chapter five concluded that the arm’s length regime was not a theoretically superior model for allocating the income of multinational banks.

Chapter six then considered the fundamental failing of the arm’s length model when actually applied to multinational banks. Chapter six examined the requirement to determine the hypothetical distinct and separate banking enterprise, coined conceptual comparability, and concluded that this step is a fiction. Chapter six concluded that the step of conceptual comparability is a fiction because it is not possible to unbundle the multinational entity as it operates as an integrated whole. Chapter six also examined the requirement to determine the profits of the hypothesised distinct and separate entity through a transactional comparison. The traditional arm’s length methodologies were examined and it was concluded that this step is also a fiction. Transactional comparability results in a fiction because of the unique organisational structure of the multinational bank, the absence of comparables
for multinational banking transactions, and the intangible nature of the internal transactions within the multinational bank.

Chapter seven considered the consequences of the conclusions drawn from chapters five and six. It examined the use of non-traditional methodologies, particularly the profit split method, and the implementation of that method through the advance price arrangement regime. The conclusion from chapter seven was that there is currently a furtive move towards formulary apportionment. As such, tax authorities should consider an overt move towards formulary apportionment and embrace it if it is a theoretically superior model.

The fourth proposition was that unitary taxation based on global formulary apportionment should be considered as an alternative to the current model as it is a theoretically superior model to arm’s length pricing. Chapter eight argued that global formulary apportionment is a theoretically superior model because it reflects the economic reality of the multinational bank. This reality is reflected because unitary taxation recognises the fact that the multinational bank operates as a single unit that cannot be divided into component parts. Further, the aim of the entity as a whole, to maximise profits, is reflected in the model. Consequently, chapter eight concluded that the global formulary apportionment model meets the criteria of an optimal regime to distribute the taxing rights to the profits of multinational banks.

9.3 Conclusion

The purpose of this thesis was to argue that there are significant faults with the traditional international tax rules of jurisdiction and allocation of income when applied to multinational banks to distribute the taxing rights to the income earned. The conclusion drawn from this investigation is that the current model for taxing multinational entities is not an optimal model for taxing multinational banks. An optimal model for taxing multinational banks is unitary taxation based on global formulary apportionment. It was argued that global formulary apportionment is a theoretically superior model, which yields a fair interjurisdictional allocation of income.
This conclusion was arrived at by examining the recent work of international commentators to develop underlying international tax law theory. This work, along with the work of the OECD, and domestic taxing authorities, such as the Australian Taxation Office, was then used to critique the current regime. The thesis identified the ways in which multinational banks, through their unique features, are able to distort the true economic location of the income earned, such that the tax position does not reflect this true economic location. The recurring themes of source and transfer pricing were examined as possible measures used in this distortion. It was concluded that this failure of the tax regime to reflect the location of the true economic activity cannot be rectified by the continued allegiance to the traditional outdated model.

Consequently, a model of unitary taxation, based on formulary apportionment, provides the best means of achieving a result that aligns with the economic theory of the multinational bank. This conclusion is based on the argument that global formulary apportionment is a theoretically superior model for taxing multinational banks. It is recognised, however, that a model based on global formulary apportionment encounters significant implementation barriers, along with various technical details to be determined. This thesis has identified the key components to a formulary apportionment regime and highlighted the pertinent issues. It has also suggested a possible formula. It does not claim to solve the implementation issues but rather highlights the fact that they can be overcome.
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